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July 9, 1999

To:            Members of the Executive Board

From:         The Secretary

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

This paper provides further background information to the staff report on the 1999 Article IV consultation discussions with the People's Republic of China, which was circulated as SM/99/156 on July 2, 1999.

Mr. D.J. Robinson (ext. 37489) or Mr. Husain (ext. 34941) is available to answer technical or factual questions relating to this paper prior to the Board discussion.

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INTERNATIONAL MONETARY FUND

PEOPLE'S REPUBLIC OF CHINA

**Selected Issues<sup>1</sup>**

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Approved by the Asia and Pacific Department

July 9, 1999

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<sup>1</sup>The term "country" as used in this paper does not in all cases refer to a territorial entity that is a state as understood by international and law practice. The term also covers some territorial entities that are not states for which substantial data are maintained and provided internationally on a separate and independent basis.

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## I. PRICE FORMATION IN CHINA: EXAMINING THE CAUSES OF DEFLATION<sup>2</sup>

### A. Introduction

1. China's performance on the economic growth and reform fronts over the past two decades has been impressive. These achievements notwithstanding, economic performance has, until recently, been punctuated by recurrent episodes of macroeconomic instability, characterized by periods of cyclical overheating alternating with sharp but short-lived periods of retrenchment. The occurrence of such macroeconomic cycles can be traced in large part to the monetary accommodation of surges in aggregate demand, followed by an abrupt tightening of financial policies. More recently, however, China achieved a "soft landing"—a sharp reduction in inflation with only a modest slowing of growth—which many observers have interpreted as a sign that the structure of the economy, and macroeconomic management, is improving.

2. Since late 1997, however, the earlier problem of overheating has turned to one of slowing growth and falling prices.<sup>3</sup> The Chinese authorities have on a number of occasions underlined the seriousness of the deflation problem, which they view, in part, as reflecting weak domestic demand. It is this concern that prompted them to announce, in mid-1998, a 2½ percent of GDP fiscal stimulus package. GDP growth has risen since the middle of last year in response to the stimulus, but prices have continued to fall.

3. Deflation has a number of potential costs. First, real interest rates will rise in a deflationary environment, absent concomitant cuts in nominal interest rates. If deflation expectations become entrenched, this will lead to lower private consumption spending as consumers postpone purchases in anticipation of further price falls. Moreover, private investment spending will be negatively affected. In addition, since there is a zero bound on nominal interest rates, sustained deflation could eventually result in a situation where monetary policy becomes incapable of stimulating demand (a "liquidity trap"). Second, deflation redistributes income and wealth in ways which are not the outcome of a deliberate and openly debated public policy. For example, unexpected deflation raises the real value of debts, thereby transferring resources from debtors to creditors.

4. While it is in principle difficult to describe accurately the price formation process in a transition economy, deflation in China could plausibly reflect a number of factors. First, it could be interpreted as sign of weak underlying domestic economic activity, with output growing below potential. Second, deflation in China could reflect structural adjustment to

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<sup>2</sup>This chapter was prepared by Christoph Duenwald (ext. 37184).

<sup>3</sup>Note that inflation has fallen for several years (since late 1994) but the decline in the general price level of goods and services is a more recent phenomenon. The former is referred to as "disinflation" while the latter refers to "deflation."

excess capacity, as budget constraints in state enterprises harden, state monopolies are broken up, and commercial principles are increasingly applied to banks' lending decisions. Third, deflation could reflect, under a fixed nominal exchange rate, an adjustment to external developments, for example lower external demand or an appreciation of the effective exchange rate.

5. The implications for policy makers vary greatly according to which factor is deemed responsible for deflation. If deflation reflected weak domestic demand, a response in a fixed exchange rate environment would be to ease fiscal policy, which the authorities have done. They have, in addition, lowered interest rates several times. If, on the other hand, deflation reflected structural adjustment to excess capacity, the need for a policy response would be less obvious. The aim of this paper is to examine the price formation process in China in an attempt to shed light on these issues.

6. The estimation results of a model of inflation—which must be interpreted with caution given the small sample size and low data quality—suggest that external (exchange rate), real activity (output gap), structural (price liberalization), and monetary (income velocity of money) variables are all important determinants of price formation in China. The results suggest that weak domestic demand contributed to deflation in 1998, although this was not the only, or even the most important, factor. Indeed, the results indicate that the exchange rate gap (lagged one year)—defined in terms of the deviation of the real effective exchange rate from its trend—is the key variable explaining deflation in 1998. Nevertheless, boosting demand will help alleviate the deflation problem by narrowing the negative output gap. While deflation is likely to remain a problem in the short term, some of the factors now causing deflation (especially exchange rate appreciation) are already unwinding and foster a diminution of deflationary pressures.

7. The next section provides an overview of China's inflation indicators and a description of price developments in China over the period 1978–94. Section C reviews the disinflation/deflation episode in the post-1994 period, followed by a discussion of possible causes of deflation in China. Section D presents a simple model of inflation in China. The subsequent section discusses the results of estimating the model, while the final section offers concluding remarks.

## **B. China's Inflation Experience, 1978–94**

### **China's inflation indicators**

8. Any empirical analysis of the Chinese economy is hampered by the poor quality of the country's statistics. While progress has been made to strengthen the coverage, quality, and timeliness of Chinese economic data, serious problems remain, and the area of price statistics is no exception. Box I.1 presents an overview of China's main price statistics, including a summary of the main statistical problems associated with these statistics.

9. China publishes a number of different measures of inflation, including the retail price index (RPI), the consumer price index (CPI), and the producer price index (PPI). While collection methods, frequency, and timeliness of the data are all broadly consistent with international practice, these price indices all suffer from a major drawback: year-to-year comparisons are made relative to shifting bases, such that a consistent time series is not available. In addition, the Chinese authorities have not disclosed the weights of the components of these price indices, revisions are not announced, and no seasonally adjusted data are published.

10. While the CPI is in principle a more appropriate indicator to study because its coverage is broader than that of the RPI, the CPI data only go back to 1985 while the RPI data extend back to 1978. Therefore, the RPI is used for most of the analysis.

### **Episodes of inflation**

11. China has experienced recurrent episodes of cyclical overheating alternating with sharp but short-lived periods of retrenchment (Chart I.1).<sup>4</sup> Upswings have typically been characterized by sharp increases in inflation and a deteriorating external position, as domestic demand tended to increase rapidly. Reflecting subsequent moves toward restraint, downturns in economic activity have tended to be relatively sharp but accompanied by large reductions in inflation.<sup>5</sup> As a result, inflation in China has registered wide swings over the past two decades (standard deviation: 6 $\frac{2}{3}$  percentage points), although mean annual inflation over this period, at 6 $\frac{2}{3}$  percent, was low by developing country standards.

12. In describing the inflation-output growth nexus in China, three distinct periods can be identified:

**1978–84:** This period was marked by high growth accompanied by low inflation, reflecting strong noninflationary agricultural expansion in response to far-reaching agricultural reforms as well as the continuation of many price controls.<sup>6 7</sup>

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<sup>4</sup>Macroeconomic instability is typical in transition countries as central planning controls over the economy are often dismantled before market-based aggregate demand management tools are developed fully.

<sup>5</sup>For example, between 1988 and 1989, GDP growth dropped by 7 percentage points. For a detailed analysis of the causes of China's macroeconomic cycles, see Oppers (1997).

<sup>6</sup>Prior to the onset of reform in 1978, when prices were largely government controlled, inflation was virtually nonexistent.

<sup>7</sup>Note that this type of analysis may obscure important lagged relationships between output  
(continued...)

**1985–90:** The trade-off between growth and price stability worsened in the latter half of the 1980s, with any given growth rate being associated with higher inflation than in the earlier period. Financial policies vacillated between tightening and relaxation, resulting in a high degree of macroeconomic instability. High money and credit growth, fueled by lending to state-owned enterprises (which faced soft budget constraints), the lifting of some price controls<sup>8</sup>, and sharp increases in retail sales and fixed investment led to higher inflation in this period (Chart I.2).

**1990–94:** The 1990s initially saw an improvement in the trade-off between growth and price stability, moderate growth associated with relatively low inflation. Subsequently, however, inflation accelerated sharply, peaking at over 25 percent in October 1994. This reflected the combination of an investment boom—rooted in Deng Xiaoping’s famous tour of southern China in early 1992 during which he called for an acceleration in growth—and renewed price reform, which, *inter alia*, resulted in a sharp increase in food prices. Money growth also experienced high rates of growth, concomitant with high credit growth (Chart I.2).

13. It is clear from the foregoing that the growth/inflation trade off varied substantially over this period. The nature of the relationship was influenced by macroeconomic policy (including investment policy), problems in the state-owned enterprises which complicated macroeconomic control, and structural reform, including price reform and adjustment (particularly in the agricultural sector).

### **C. From Disinflation to Deflation, 1994-99**

#### **The “soft landing”**

14. Since 1994, inflation and output growth have been on a secular downward trend. While inflation came down quickly, this was not, as in the past, accompanied by a sharp reduction in GDP growth. In addition to favorable developments in agriculture (a record grain harvest in 1996), possible factors accounting for the soft landing, and the apparent improvement in the growth/price stability trade-off, include: (1) the improving structure of the Chinese economy, with the relatively more dynamic non-state sector accounting for a larger share of GDP; (2) a more gradual tightening of economic policies—notably investment approvals and monetary policy; (3) greater attention to the composition and efficiency of investment; (4) the implementation of structural reforms to increase the market orientation and openness of the economy; and (5) rapid growth of fixed investment in the upswing of the cycle, which led to overcapacity in a number of sectors, facilitating the decline in inflation.

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<sup>7</sup>(...continued)  
growth and inflation. See Garnaut and Ma (1993).

<sup>8</sup>Box I.2 presents an overview of price reform in China.

15. While disinflation has characterized price developments in China since late 1994, this gave way to deflation starting in October 1997, in the case of the RPI, and starting in February 1998, in the case of the CPI (Chart I.3).<sup>9</sup> Deflation has been recorded on a 12-month percentage change basis every month since then.<sup>10</sup> On an annual average basis, the RPI declined by 2½ percent in 1998, while the CPI declined by ¾ percent. On a seasonally adjusted basis, CPI inflation had moved back into positive territory in late 1998, but has turned negative again in 1999.

### **The possible causes of deflation**

16. While deflation in the context of relatively robust economic activity is somewhat puzzling, there are a number of possible explanations for this phenomenon in China, which are broadly characterized as supply side, demand side, and policy factors.

#### ***Supply side factors***

- While data are incomplete, most observers would agree that the Chinese economy suffers from considerable excess capacity in many sectors, particularly in industry and agriculture.<sup>11</sup> In addition, inventory accumulation, which had averaged slightly over 5 percent of GDP in the five years prior to 1998, exceeds typical rates for developing countries (Chart I.2).<sup>12</sup> While inventory accumulation was also high in the 1980s (without deflation), the hardening of state-owned enterprises' budget constraints in the 1990s compelled them to dispose of inventories at lower prices.

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<sup>9</sup>Unlike the RPI, the CPI includes services. Prices for services have risen substantially on a sustained basis, which accounts for the difference (about 2 percentage points on average) between RPI and CPI inflation.

<sup>10</sup>Most components of the CPI registered declines in 1998, with the exception of medical and health care goods, housing, and services (prices of the latter rose by 10 percent). Food prices declined by more than nonfood prices. Sectorally, the primary and secondary sectors have experienced deflation, but not the tertiary (services) sector.

<sup>11</sup>For example, a recent research report by Morgan Stanley (Xie and Yam (1999)) noted that capacity utilization could be as low as 60 percent in China's nonagricultural economy. This number is consistent with the finding last year by China's National Bureau of Statistics that more than 40 percent of the production capacity for about half of the 900 industrial products surveyed was idle. Another survey, conducted in the second half of 1998 by China's Domestic Trading Bureau, found that out of 601 goods, only one was in short supply.

<sup>12</sup>Inventory accumulation/decumulation normally fluctuates between +2 and -2 percent of GDP over the business cycle in developing countries. See Borensztein et al. (1998).

- China's excess capacity and high inventories have much to do with the former planned economy in which production targets were set without regard to market demand. In a market economy, equilibrating forces would bring this process to an end: firms' mounting losses would lead to mergers or bankruptcies, eventually reducing output. In China, however, loss-making state-owned enterprises were kept afloat by the government through directed credit from the banking system.
- The problem of excess supply in China is not confined to its industrial sector. High output in the agricultural sector, reflecting successive good harvests in 1996-1998, has depressed agricultural prices in recent years. Low agricultural prices, in turn, have depressed rural incomes and consumption.
- Deflation pressures have also been intensified by the recent sharp drop in world commodity prices. In 1998, the IMF's index of non-fuel primary commodity prices fell 15 percent—after having declined in 1996 and 1997—while the price of petroleum declined by 32 percent. Lower import prices would have put pressure on domestic import-competing industries to lower their prices, while lower world prices would have exerted downward pressure on China's export prices.<sup>13</sup>

#### *Demand side factors*

- Deflation in China could also reflect weak domestic demand. Private consumption and investment were relatively sluggish through 1998, thus compounding the deflationary pressures coming from excess supply. However, if one were to judge demand as "inadequate", however defined, it is not entirely clear that increasing demand will arrest deflation immediately because any increase in private demand could be met, at least partially, from inventories.<sup>14</sup>
- External demand has also been weak, reflecting the Asian crisis. This, in turn, has diverted some exports to the domestic market, putting downward pressure on prices.

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<sup>13</sup>Note that China's import and export deflators—the import-weighted and export-weighted average of goods deflators from China's trading partners (as calculated in the World Economic Outlook)—have declined for three consecutive years.

<sup>14</sup>This is true to the extent that the inventory does not consist entirely of unsaleable products, in which case new demand would have to be met by new production and therefore increased resource utilization.

### ***Policy factors***

Macroeconomic policies may also have contributed to the deflationary pressures:

- The tightening in financial policies beginning in mid-1993 set in train a slowdown in economic growth and inflation.
- The steady appreciation of the nominal and real effective exchange rate from the mid-1990s through mid-1998 likely exerted some downward pressure on inflation (Chart I.4). This partly reflected the policy choice of keeping the renminbi/U.S. dollar exchange rate stable in nominal terms. While interest rates have been reduced on several occasions since 1996, falling inflation, and, latterly, deflation have kept rates high in real terms. The combined impact of monetary/exchange rate policy on aggregate demand was therefore contractionary.

### **D. A Simple Model of Inflation in China**

17. To help explain price formation in China, the following equation, based on the expectations-augmented Philipps curve, can be specified:

$$\pi_t = \alpha + \pi_t^e + \sum_{i=0}^{\infty} (\beta_i YGAP_{t-i} + \theta_i VELGAP_{t-i} + \lambda_i ERGAP_{t-i} + \gamma_i PLIBDUM_{t-i}) + \epsilon_t \quad (1)$$

where

$$YGAP_t = y_t - y_t^*, VELGAP_t = v_t - v_t^*, ERGAP_t = e_t - e_t^*,$$

and  $\pi$  is actual inflation,  $\pi^e$  is expected inflation,  $y$  is actual output,  $v$  is money velocity<sup>15</sup>,  $e$  the real effective exchange rate, the asterisk denotes the trend value of the variable<sup>16</sup>,  $\alpha$ ,  $\beta$ ,  $\theta$ ,  $\lambda$ , and  $\gamma$  are parameters, and  $\epsilon$  is a stochastic error term.<sup>17</sup> *PLIBDUM* is a dummy variable

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<sup>15</sup>Defined as (in logarithms)  $Y/M2$ , where  $Y$  is nominal GDP and  $M2$  is broad money.

<sup>16</sup>In all cases, the trend value is calculated using the Hodrick-Prescott filter.

<sup>17</sup>All variables, with the exception of inflation, are specified in log form.

capturing the impact of price liberalization.<sup>18</sup> Assuming for simplicity adaptive expectations, i.e.  $\pi_t^e = \pi_{t-1}$ , equation (1) becomes:

$$\Delta\pi_t = \alpha + \sum_{i=0}^{\gamma} (\beta_i YGAP_{t-i} + \theta_i VELGAP_{t-i} + \lambda_i ERGAP_{t-i} + \gamma_i PLIBDUM_{t-i}) + \epsilon_t \quad (2)$$

where  $\Delta$  is the first difference operator.

18. *YGAP*, the output gap, is designed to capture the impact the real economy exerts on (changes in) inflation. It measures the difference between actual and potential output.<sup>19</sup> Inflation will tend to rise if the gap is positive, fall if it is negative, and remain stable if it is zero. As a result, the model predicts that  $\beta$  is positive so that inflation will tend to rise if *YGAP* exceeds zero. Estimates of the output gap suggest that it was negative in 1998 (Chart I.5), which is consistent with the observed decline in prices.<sup>20</sup> However, the chart also shows that inflation was declining in 1995–97, a period in which, by our estimation, the economy was characterized by excess demand (actual output above potential), implying, *ceteris paribus*, upward pressure on inflation. One possible explanation is that output was boosted by strong agricultural production over this period, which would exert downward pressure on inflation. Indeed, as Chart I.3 shows, food prices declined substantially over this period, reflecting strong harvests.<sup>21</sup>

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<sup>18</sup>The dummy was defined as 1 for those years in which significant price liberalization occurred and 0 in all other years. Liberalization of agricultural prices had to be used as a proxy for retail prices, since a liberalization series for the latter was available only with significant gaps (Chart I.6).

<sup>19</sup>Potential output is commonly defined as the level of output consistent with a stable rate of inflation. It is the output the economy could produce at full employment given the existing resources.

<sup>20</sup>The estimates were derived using a statistical smoothing technique (the Hodrick-Prescott filter) to approximate potential output as the trend in actual output. Such estimates of output gaps are sensitive to the smoothing criteria and observations at the beginning and the end of the sample period, and are therefore subject to a significant margin of error. The alternative approach involves the estimation of an aggregate production function. See De Masi (1997), which summarizes IMF research on potential output.

<sup>21</sup>Thus, separating China's economy into agricultural and nonagricultural sectors, and using the gap in the nonagricultural sector in the regression, is one possible way of explaining the poor performance of the gap model in explaining inflation developments in the mid-1990s. However, no perceptible difference with the results original estimations (Section E) was

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19. *VELGAP*, the money velocity gap, captures the impact on (changes in) inflation of the monetary sector of the economy.<sup>22</sup> The velocity gap, defined as actual less trend velocity, is a measure of monetary overhang, i.e., the extent to which the quantity of money in the economy deviates from that typically needed to support the current level of transactions. A negative velocity gap (trend velocity exceeding actual velocity), for example, might indicate either a monetary overhang (and thus inflation pressures) or, perhaps, that interest rates are lower than those typically associated with the state of demand in the economy. As a result, the model predicts that  $\theta$  is negative so that inflation will tend to fall if *VELGAP* is positive. Actual and trend velocities are shown in Chart I.5.

20. *ERGAP*, the exchange rate gap, captures the effect of deviations of the real effective exchange rate (REER) from its trend value on changes in inflation. A movement of the REER above its trend would tend to be associated with downward pressures on inflation: not only would the price of imports fall, but a higher REER would also tend to reduce aggregate demand and thus reduce inflation. As a result, the model predicts that  $\lambda$  is negative so that inflation will tend to fall if *ERGAP* is positive. Actual and trend REERs are shown in Chart I.5.

21. One of the key weaknesses of the inflation model outlined above is that it does not fully capture the significant structural reforms that have taken place in China since 1978. Thus, the sectoral shift of production away from the agricultural to the manufacturing and services sectors would have implications, at least for relative prices. More recent structural reforms, especially since 1994, are also not fully captured by the model. For example, the pace of state-owned enterprise reform has accelerated in recent years, through ownership diversification, downsizing, and increased use of bankruptcy procedures, resulting in a hardening of firms' budget constraints. This in turn would have contributed to lower inflation. In addition, much progress has also been achieved in price reform, which would put upward pressure on inflation. Price liberalization in a transition economy would tend to release existing monetary overhang and turn repressed inflation into open inflation. The impact of price liberalization is captured, albeit imperfectly, by the dummy variable in equation (2), *PLIBDUM*.<sup>23</sup> The model predicts that the parameter on *PLIBDUM*,  $\gamma$ , is positive so that price liberalization results in higher inflation.

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<sup>21</sup>(...continued)  
detected. See Callen and Chang (1999) for an application of these ideas.

<sup>22</sup>This concept was applied to Korean data by Corker and Haas (1991). The authors use the  $P^*$  approach, where  $P^*$  is defined as the product of the velocity gap and the output gap, the two sources of price pressures in the model.

<sup>23</sup>Another way of incorporating the impact of price liberalization involved scaling each of the explanatory variables by the proportion of market prices. However, this reduced the explanatory power of the regression.

### E. Estimation Results

22. The results of OLS estimation of equation (2) using Chinese data from 1978 to 1998, are shown in Table I.1.<sup>24</sup> All of the variables, three with one period lags, were found to be statistically significant at the 5 percent confidence level, both individually and jointly, and of the expected sign. The results confirm that when output exceeds potential, there are upward pressures on (the change in) inflation. Thus, a one percentage point increase in the output gap raises the change in inflation by about 0.6 percentage points. The sign on the velocity gap lagged one period is negative as predicted by theory: when velocity is above its trend level during the previous period, pressures on inflation are in the downward direction in the current period. The sign on the exchange rate gap lagged one period is also negative, as expected: when the exchange rate is above trend, pressures on inflation will be in the downward direction because, as domestic goods become more expensive relative to foreign goods, there will be pressure on domestic producers to lower their prices. Finally, the sign on the price liberalization dummy suggests that, as expected, periods of price liberalization are followed by upward pressure on inflation.

Table I.1. Inflation Equation Estimates (by OLS) Yearly Data, 1978-98 (Dependent variable: Change in RPI inflation, in percentage points)				
Regressor	Lag	Coefficient	F-test	Adjusted R-squared
Constant		-2.10		
YGAP	0	55.67 (2.18)		
VELGAP	1	-84.97 (-4.88)		
ERGAP	1	-21.61 (-2.48)		
PLIBDUM	1	4.98 (2.41)	10.66*	0.68

NOTE: Regressors (excluding the constant) were specified in logs. Data in parentheses are t-statistics. \* denotes F-test rejects null of the sum of coefficients being zero simultaneously at 5 percent confidence. The Durbin-Watson statistic for this regression was 1.79.

A number of additional points can be made with respect to the estimation results:

- Judging by the residuals, the model tracks actual changes in inflation relatively closely for the period 1984–94 (see Chart I.7). After 1994, the model underpredicts the reduction in inflation, suggesting that the contribution of factors outside the model—particularly structural reform—in explaining the price formation process in China has increased. In particular, the hardening of budget constraints facing state-

<sup>24</sup>The results should be interpreted with caution due to the small sample and due to the large margins of error associated with the calculation of the “equilibrium”, or trend, variables.

owned enterprises exerted downward pressure on inflation by forcing downsizing in production, investment outlays and labor, and by inducing enterprises to dispose of inventories at lower prices.

- The estimation results also provide statistical evidence for some of the observations commonly made about the causes of China's inflation in the past. In previous inflationary periods, for example in 1988 and 1993, the price liberalization variable explains a large proportion of the observed rise in inflation, implying that major price reforms led to higher inflation. In addition, in 1988, the output gap was a very significant contributor to the rise in inflation, while the velocity gap played an important role in explaining the jump in inflation in 1993, consistent with the common belief that high money and credit growth fueled inflationary pressures at that time.
- With regard to developments in 1998, the output gap and the exchange rate gap (in 1997) were the dominant variables explaining deflation. The exchange rate gap (lagged one period), in particular, explained the bulk of the deflation (or, more precisely, the negative change in inflation) observed in 1998, which is perhaps somewhat surprising. The output gap explained the remainder. Money velocity (lagged one year) did not have any bearing on price developments in 1998.
- For 1999, the equation would predict a further substantial decline in prices, based on the estimate of the exchange rate gap in 1998 and the likely continued slowdown in aggregate demand growth in 1999. However, the deflationary impact of the external variable in the model should recede towards the end of the year as the renminbi has depreciated in real effective terms since mid-1998 (Chart I.4). Moreover, tradeables prices are likely to stage a modest recovery in 1999 in line with strengthening external demand. Sustained excess capacity, on the other hand, will probably exert further downward pressure on inflation. Money velocity in 1998 was actually slightly below its trend, providing a modest offset in 1999 to the deflationary impetus from the other two variables.
- These results are broadly consistent with earlier work on modeling inflation in China. Oppers (1997) estimates the gap model using the output gap and its first lag, as well as the "capital gap" (the excess of the capital stock over its long-term trend) and finds that the Chinese data conform to the model quite well. The World Economic Outlook (1996) reported that the cumulative effects of output gaps on inflation are significantly positive for a host of emerging market countries, including China. In contrast, Coe and McDermott (1997) find that the level of the output gap is not a significant determinant of the change in inflation in China (in contrast to most other Asian economies in their sample). They point out, by way of explanation, that this may reflect the relatively few observations available since the implementation of economic reforms.

## F. Concluding Remarks

23. The inflation model estimated in this paper fits the data quite well, although the results must be interpreted with caution given the small sample size, the technique used to arrive at the “equilibrium” or trend variables, and the exclusion of potentially important factors. The model suggests that external (the exchange rate), real activity (output gap), structural (price liberalization), and monetary (income velocity of money) variables are important determinants of price formation in China. It also suggests that weak domestic demand was a factor—albeit not the dominant one—in explaining deflation in 1998, and that therefore boosting demand will assist in alleviating deflationary pressures. The results indicate that the exchange rate gap (lagged one year) is the key variable explaining deflation in 1998. The structural factors not captured by the model but likely to be important determinants, particularly state-owned enterprise reform and financial sector reform, as well as economic agents’ continued adjustment to excess capacity are likely to be enduring factors keeping inflation in China low or negative in the near term. Moreover, the impact of excess supply on prices will be compounded by relatively weak aggregate demand in the near term, in part reflecting the short-term effects of structural reform. Other factors, such as the recent exchange rate depreciation in real effective terms and higher tradeables prices, should provide an offsetting influence, such that deflationary pressures will eventually disappear.

### Box I.1. China's Price Statistics

China publishes three main indicators of inflation: the consumer price index (CPI), the retail price index (RPI), and the producer price index (PPI). The broadest indicator is the CPI, which is available back to 1985. The CPI is available for both rural and urban areas, and the primary sources of information for the market basket and index weights are the rural and urban household income and expenditure surveys. The consumer basket consists of 325 representative items (supplemented to some extent at the local level) collected in 550 areas throughout the month. This list of items is reviewed annually. Two indices are calculated: the first (and official) index is a 12-month change index which uses prices for the current month and the same month in the previous year and weights from the previous year; and the second is a one-month change index which uses the current and previous months' prices and a mixture of weights. The CPI, as well as the other indices published by the Chinese authorities, do not in general conform to international practice and are not very user friendly. Several IMF Technical Assistance missions have highlighted a number of problems with the CPI as currently produced, including:

- the CPI is not produced in a time series format, hampering analysis of price developments;
- price changes measured by the 12-month and the one-month indices are not consistent;
- indices in which prices are linked monthly tend to be upward biased and thus will overstate price change;
- the National Bureau of Statistics does not publish seasonally adjusted indices (the shifting Chinese Year holiday is a particular problem in this respect); and
- the authorities do not publish the weights of index components.

Many of these problems apply equally to the RPI and the PPI. The main differences between the RPI and the CPI are as follows: (1) length of series: the RPI is available back to 1978, the CPI only back to 1985; (2) the RPI includes a number of business items that are not in the CPI and excludes services which are covered in the CPI; and (3) the CPI item weights are derived from the household expenditure survey while the RPI weights come from the business survey. The PPI covers industrial activities in mining, manufacturing, water supply, and electricity production. However, the coverage excludes intermediate and capital goods used by enterprises.

### Box I.2. China: Price Reform

In 1979, China began to reform its pricing system, which to that point had been controlled by the state. Thus, the prices of almost all goods had been administratively set by the central or provincial authorities for their own objectives, including supporting the development of heavy industry and preserving the purchasing power of the population in terms of basic consumer goods. The resulting prices reflected neither relative scarcities nor international price levels, and resulted in relative price distortions, which were compounded by the infrequency of administered price adjustments. In 1978, 3 percent of total retail sales were conducted at free market prices, while 97 percent of retail sales were conducted at state-determined fixed prices.

Initial price reform focused on the agricultural sector. The prices of the main agricultural products were adjusted six times between 1979 and 1984. The prices of the compulsory delivery quotas were increased by 20 percent, and those of voluntary deliveries by 50 percent. Raw materials prices (coal, iron, and steel) were also significantly increased.

The 1984-88 period was marked by major liberalization and saw the introduction of a dual pricing system for a number of sectors whereby products within the planning system were sold at fixed prices and additional output could be sold on the market. Under the new procurement system for agricultural products, the government purchased part of agricultural output at a fixed price and allowed the above-quota output to be sold at market-related prices. The system was soon extended to a number of industrial commodities and means of production: while plan prices prevailed for key industries and for production within the state-determined quotas, production in excess of quota could be sold in the free market. For a significant portion of total sales, however, guided pricing persisted, so that, in effect, the dual system had three sets of prices: (1) prices fixed by the state; (2) guided prices, for which state authorities determined a range; and (3) free-market prices. Introduction of the dual-track pricing system led to a rapid increase in the proportion of goods sold at market prices. In 1985, 34 percent of retail sales took place at free-market prices, while 19 percent was subject to price guidance (Chart I.6). By the end of 1985, the dual pricing system had been extended to all sectors of the economy.

The sharp rise in inflation in 1988 led to a temporary setback in the process of price reform. The authorities adopted a "Rectification" program, which included a part-reversal of earlier price reform, as the prices of a number of commodities were brought back under the control of the central government. With a slowdown in economic activity and a decline in inflation beginning in 1989 and through the early 1990s, price reform was once again stepped up, so that by 1993, the proportion of agricultural output sold at market-related prices had increased to almost 90 percent. In industry, a major price liberalization reduced the proportion of producer goods sold at state-determined prices from nearly half in 1990 to 20 percent at the end of 1992.

Despite these reforms, the apparatus for directly controlling prices remained intact, and surging inflation in 1993 and 1994 led to an intensification of price surveillance, the establishment of benchmark prices for key commodities, increased price subsidies, and some postponement of planned administered price increases. Since then, progress on price liberalization has continued to be a function of macroeconomic developments. Thus, with inflation declining in 1997, the authorities eased some of the temporary price control measures that had been implemented during the earlier period of inflation. This resulted in several localities raising rents for state-owned housing and fees for certain government-provided services. The state also increased centrally administered prices for electricity, oil, natural gas, and rail freight. In 1998, with the RPI and CPI falling, a system of "self-regulatory" pricing was introduced, resulting in the announcement by several industry associations of price floors for a number of products (including autos, steel, sugar, farm vehicles, and chemical fibers). In addition, oil and cotton prices were liberalized and a uniform electricity price was adopted for urban and rural areas.

*Note: This box is adapted from Oppers (1997). Laffont (1997) was also used as a source.*

Chart I.1  
CHINA - OUTPUT AND INFLATION, 1978-98  
Annual percent change

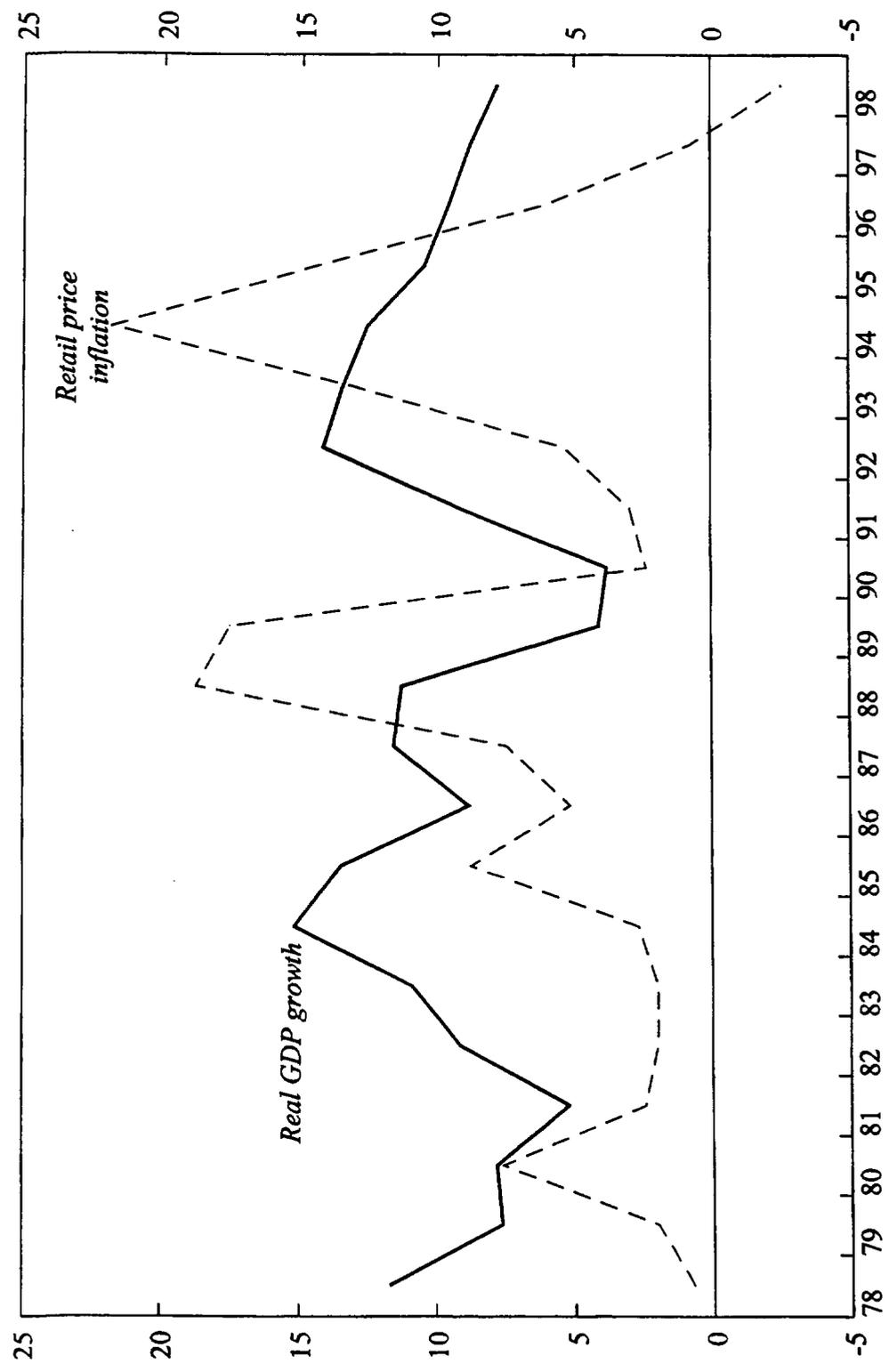
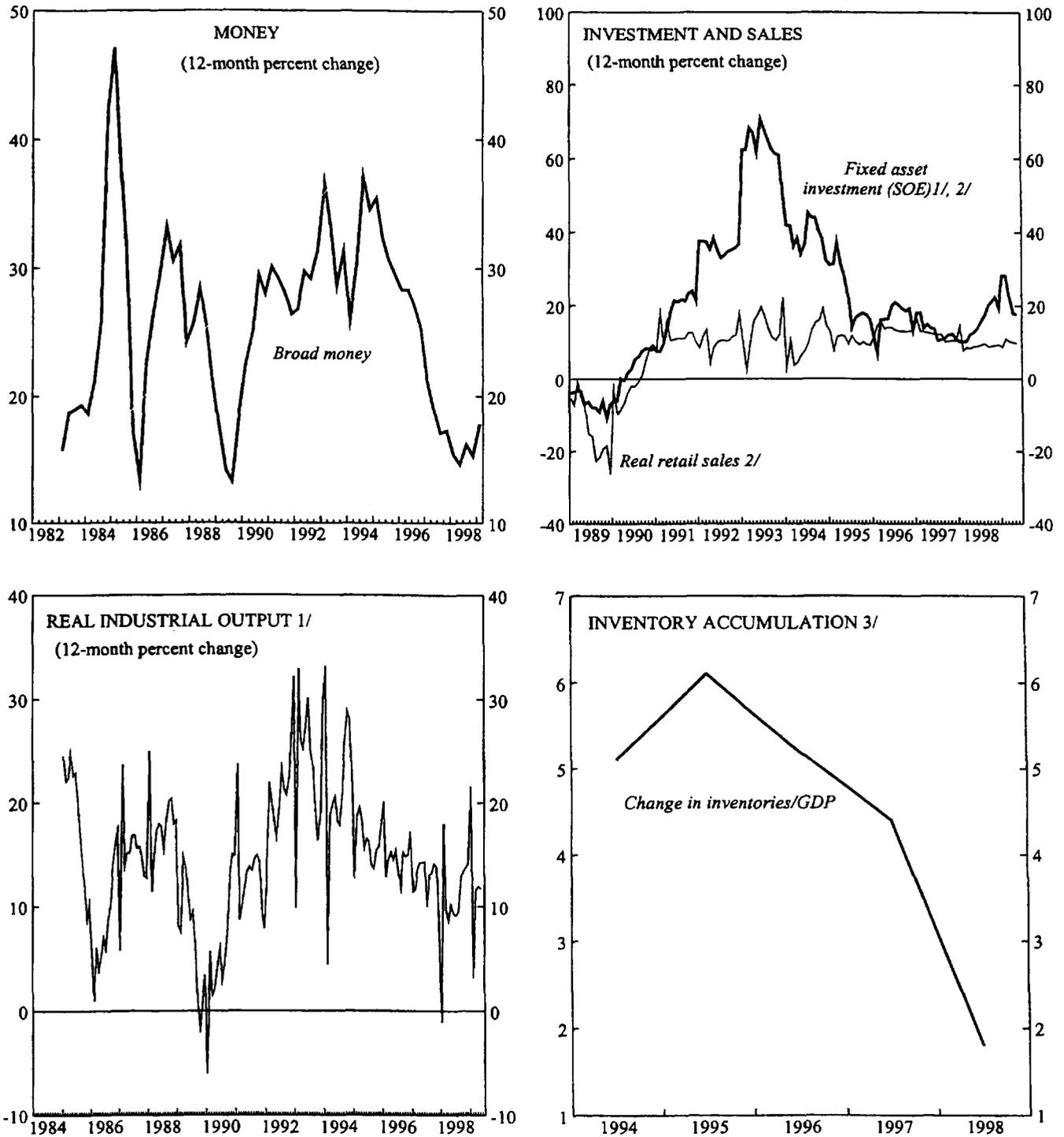


Chart I.2  
CHINA: SELECTED ECONOMIC INDICATORS, 1982-99



1/ Data for 1996 are not directly comparable to previous year due to changes in methodology and coverage.

2/ Cumulative from beginning of year.

3/ Data provided by the Chinese authorities.

Chart I.3  
CHINA: INFLATION, 1979-99

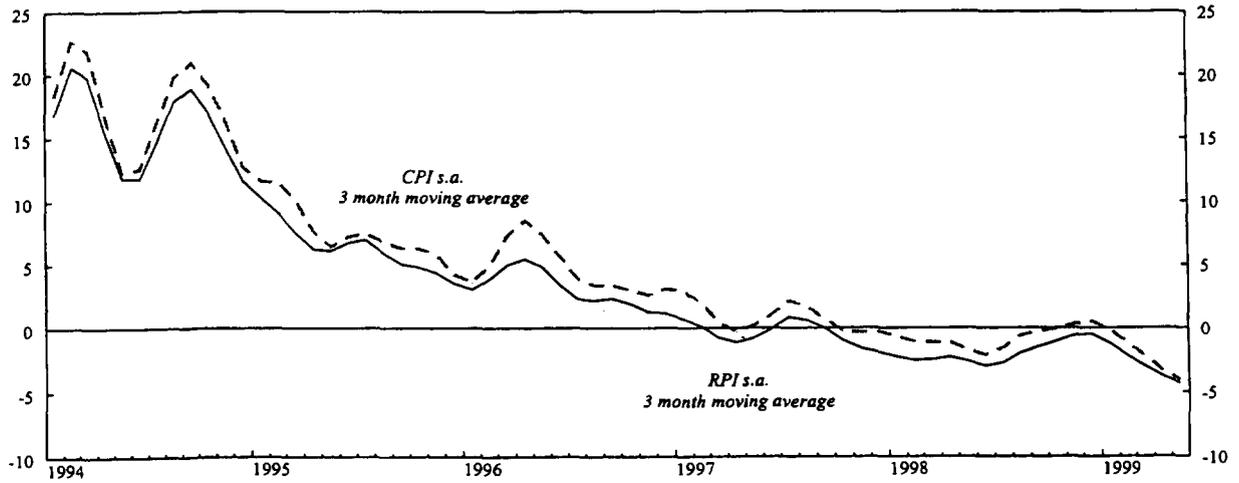
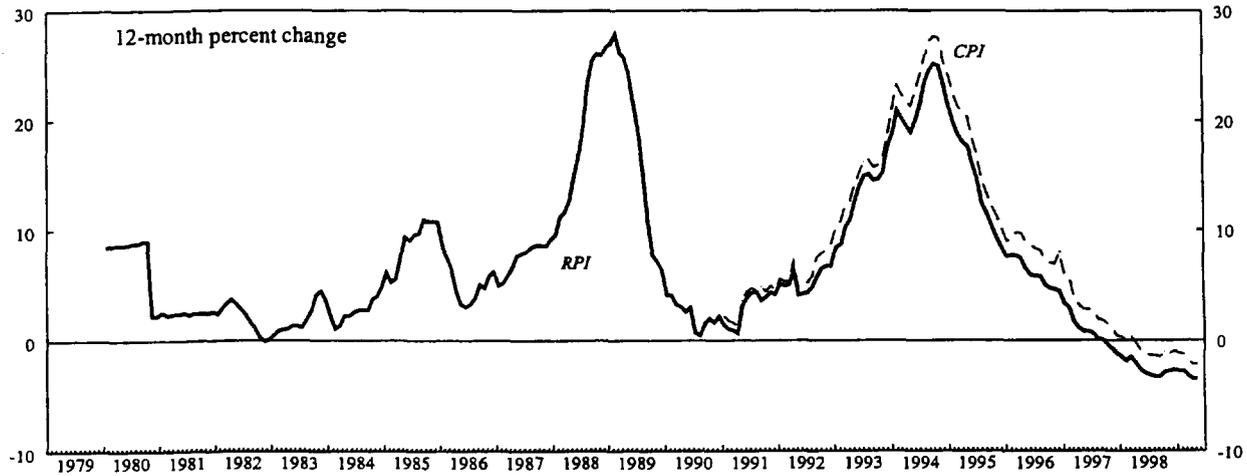
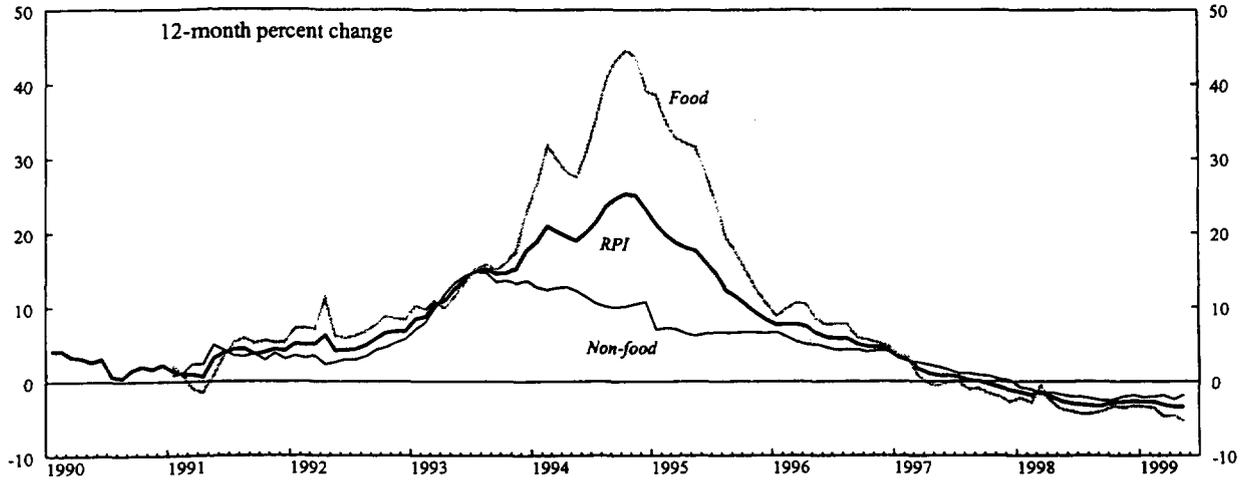


Chart I.4  
CHINA: EXTERNAL INDICATORS, 1994-99

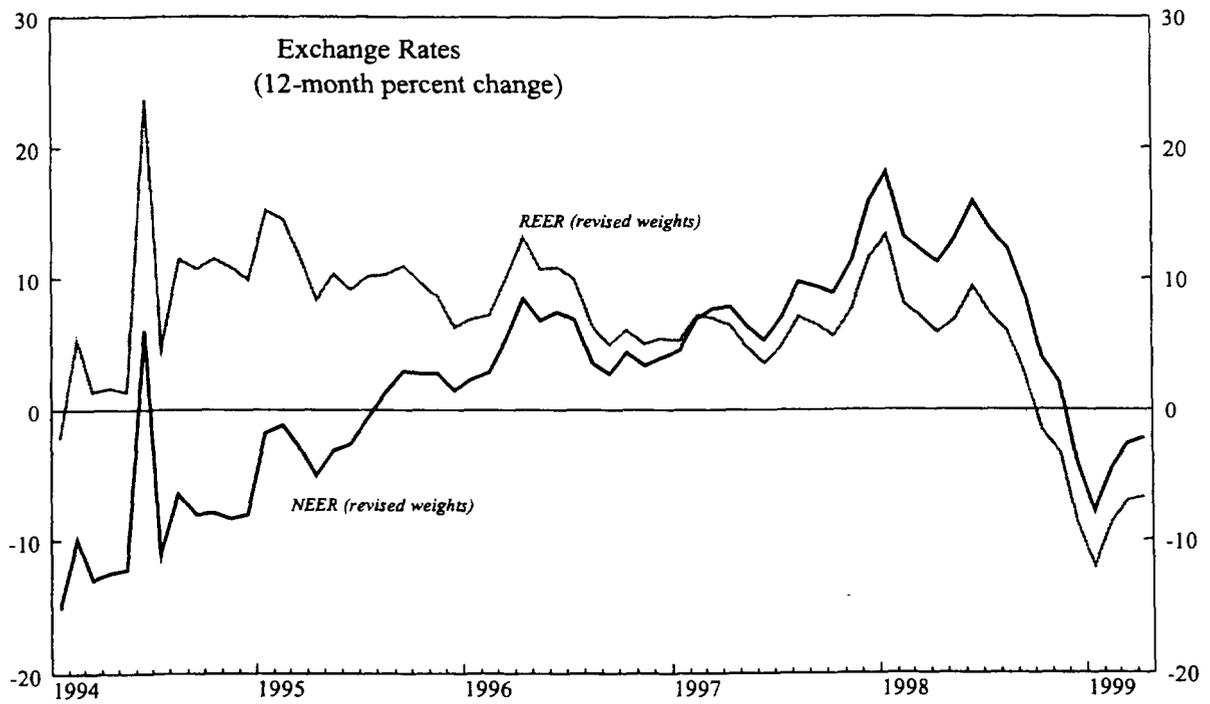
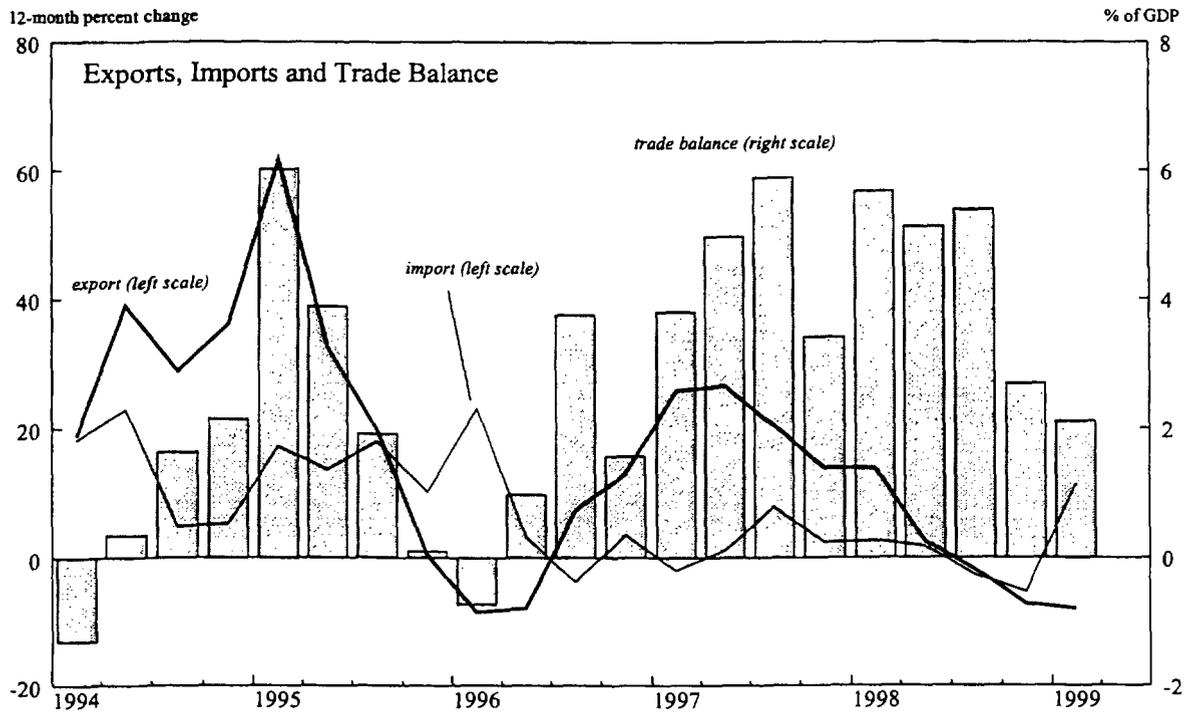
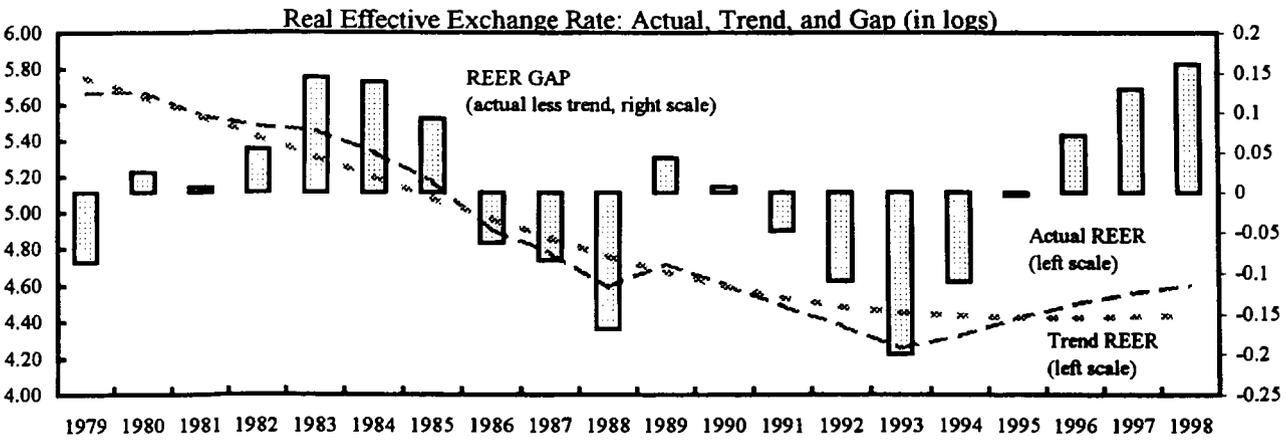
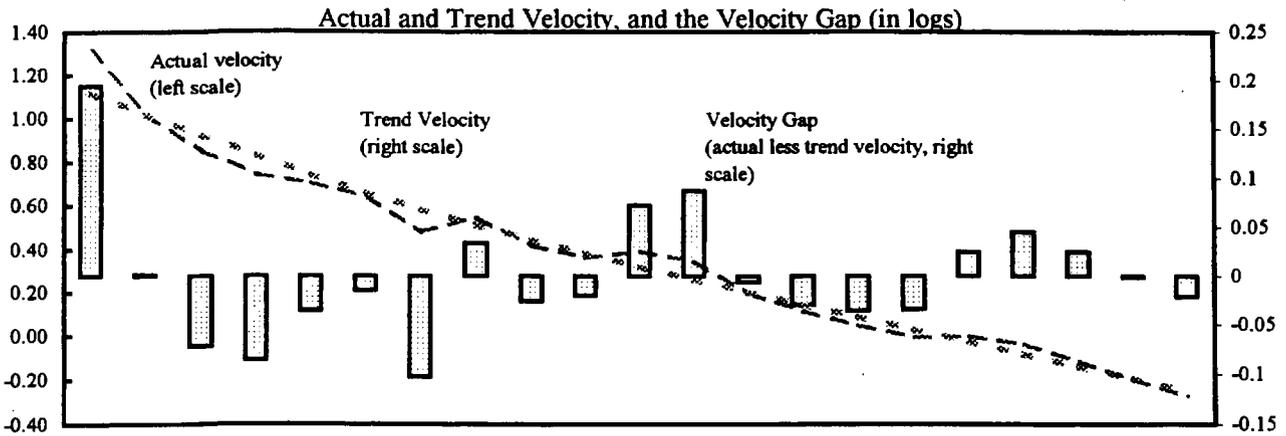
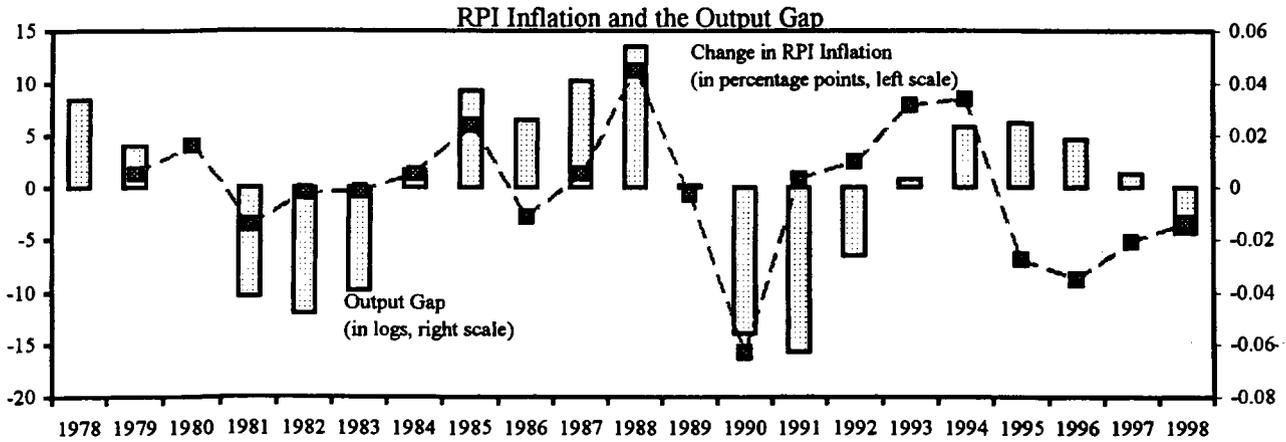
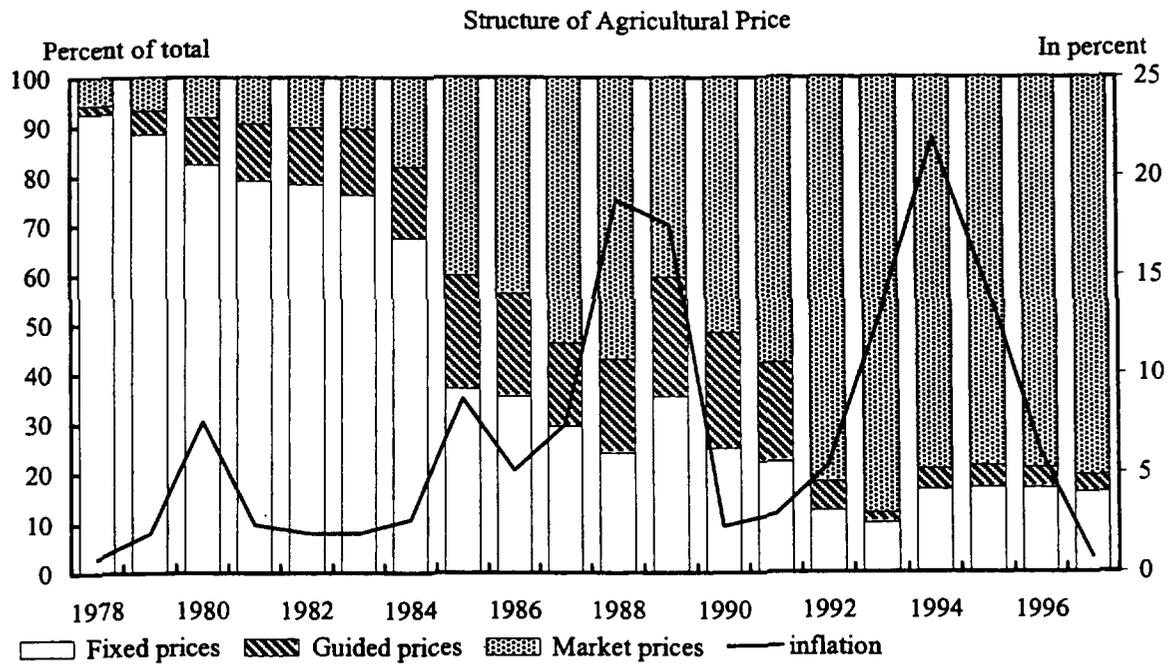
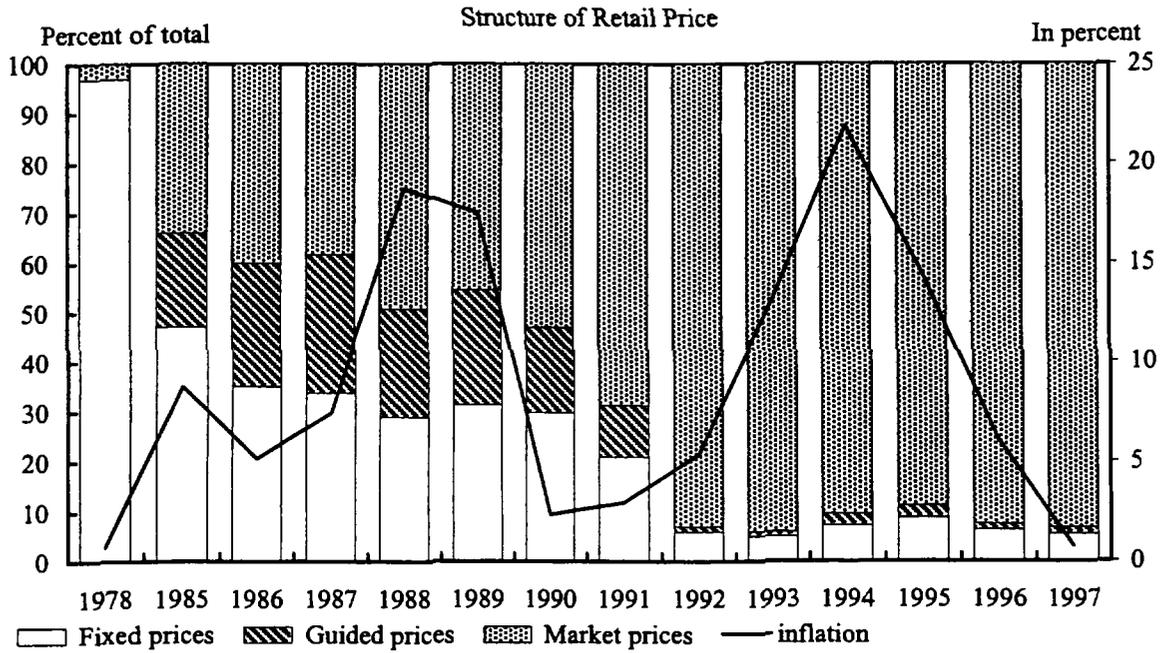


Chart I.5. China: Inflation, Output Gap, Velocity, and Exchange Rate, 1978-98



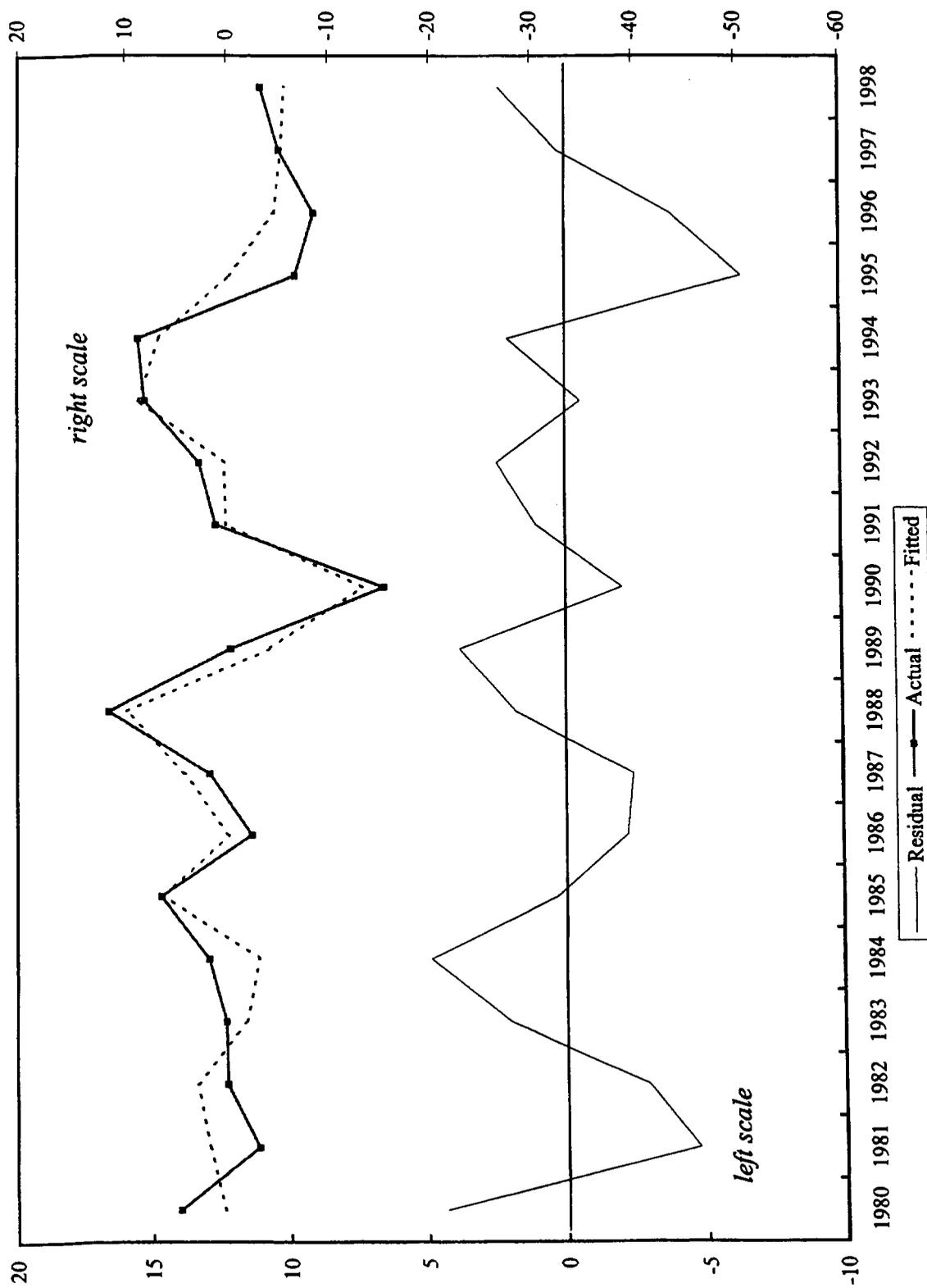
Source: National Bureau of Statistics, People's Bank of China Quarterly Bulletin, and staff estimates.

Chart I.6 China  
STRUCTURE OF RETAIL AND AGRICULTURAL PRICE, 1978-97



Source: National Bureau of Statistics.

Chart I.7. China: Regression Residuals, 1980-98



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## **II. AN ASSESSMENT OF CHINA'S EXCHANGE AND CAPITAL CONTROLS<sup>1</sup>**

### **A. Introduction**

1. China's exchange and capital controls have been credited with helping to maintain the stability of the renminbi exchange rate at a time when other East Asian countries were forced into an exchange rate crisis (Krugman, 1999). On this basis, it has been argued that capital account liberalization in China and elsewhere should be slowed or even reversed in the interest of maintaining stability.

2. This paper addresses two questions: What are China's exchange and capital controls and what has been the impact of controls, particularly on the level and composition of China's external liabilities, and its vulnerability to contagion from external developments. The paper concludes that China's exchange and capital controls has had some success in limiting foreign borrowing in an environment of weak financial discipline in banks and state-owned enterprises and serious moral hazard problems, and in insulating the economy from external contagion to some extent. However, the controls have also entailed administrative and efficiency costs, and were only partially successful in limiting unwanted flows.

### **B. China's Exchange and Capital Controls**

3. China's exchange and capital control system has been progressively liberalized in recent years, but substantial controls remain. Liberalization began in the late 1970s, first with direct investment inflows, followed by portfolio and credit markets. Significant mileposts in recent years in China's path toward liberalization are the unification of the exchange rate at the beginning of 1994 and the acceptance of the obligations of Article VIII in late 1996, both of which were accompanied by other supporting reforms. However, China retains an extensive system of controls, involving discretionary control of capital flows and approval and verification of both current and capital account transactions. Current account transactions are now regulated primarily to verify that foreign exchange is being used for an underlying transaction that is both for a valid current account purpose and in full compliance with relevant laws and regulations. Controls on capital transactions are undertaken for policy purposes as well as for compliance with other economic regulations.

4. China's foreign exchange controls take the form of direct regulation of essentially all foreign exchange and cross-border transactions. These include cross-border transactions in goods, services, and capital; conversion of foreign exchange into renminbi and vice versa; and the establishment, deposit of funds into, and withdrawal of foreign exchange from, bank accounts. The foreign exchange controls are interwoven with regulations on other economic activities, including foreign trade, establishment of enterprises, and banking operations.

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<sup>1</sup>This chapter was prepared by Thomas Dorsey (ext. 34047).

However, these other areas of economic regulations are covered below only to the extent that they interact with the exchange and capital controls.

5. Foreign direct investment in China is strongly encouraged, but tightly regulated.<sup>2</sup> The encouragement is evident in the openness of most sectors to foreign investment and the high level of inward direct investment. Nevertheless, even in sectors where foreign investment is encouraged, each investment involves conditions which seek to maximize equity injections, exports, local content, technology transfer, investments outside the coastal provinces, employment, and (where applicable) control by the local partner in the joint venture while minimizing outflow of royalty payments and foreign exchange. To encourage potential investors, local and national authorities can offer an array of tax holidays and incentives, preferred access to infrastructure services, and regulatory treatment that gives (de facto) preferred market access over its competitors in local markets.<sup>3</sup>

6. Each inward foreign investment has a binding schedule of equity injections into the foreign funded-enterprise, typically over three years, and limitations on the capital structure of enterprises that imply binding ceilings on foreign and domestic borrowing. The schedule of equity injections is strictly enforced and it is generally difficult to remove equity subsequently except in the context of liquidation. Monitoring compliance with these terms takes a variety of forms, including annual audits of foreign exchange use, and limitations on access to foreign exchange borrowing by the State Administration of Foreign Exchange (SAFE) and the commercial banks (acting as agents of SAFE in the implementation of SAFE regulations).

7. Portfolio investment in China is strictly segregated between residents and nonresidents. Two classes of markets exist for instruments in which foreign holdings are permitted: one purchased with foreign exchange (typically U.S. or Hong Kong dollars) for nonresidents, another denominated and purchased in renminbi for domestic residents. For equity shares, foreign investors are permitted to hold B-shares (traded onshore but purchased with foreign exchange) and H- and N-shares (purchased with foreign exchange and traded offshore in Hong Kong SAR and New York, respectively). Domestic residents are limited to A shares (denominated and purchased in renminbi). Similarly for bonds, foreigners are permitted to hold foreign exchange denominated bonds issued abroad, while the domestic bond market is denominated in renminbi closed to foreigners (including domestic foreign-

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<sup>2</sup>China's definition of foreign-funded enterprise (FFE) generally provides that any foreign ownership, even ownership falling well short of majority ownership or controlling interest, is sufficient to establish an enterprise as an FFE for the purposes of capital controls and most other regulations.

<sup>3</sup>The role of these other factors in the process of negotiating establishment of a new foreign-funded enterprise in China is described in Rosen (1999).

funded financial institutions). Therefore, in principle, international portfolio flows are determined at the time securities are first issued.

8. The restrictions on portfolio holdings appear to be effective in limiting arbitrage, although there is evidence of considerable evasion in anecdotal reports. Nevertheless, the persistence of divergent trends in pricing between foreign and domestic shares, including for shares in the same enterprise, suggests that the controls are partially effective.<sup>4</sup>

9. Restrictions on other investments (e.g., loans) also distinguish between domestically-funded and foreign-funded enterprises (FFE). Aggregate limits are applied to domestically-funded enterprises in the context of annual and multi-year borrowing plans which require approval, and by the allocation of the credit quotas by the administrators of the various "windows" for external borrowing (e.g., state-owned banks). There are no aggregate limits on external borrowing by FFEs, but FFEs are subject to entity-by-entity controls negotiated at the time of their establishment. These take the form of limits on the overall capital of an FFE and the portion of capital that must consist of equity; the difference between the two is the maximum permitted borrowing from both domestic and foreign sources.

10. Not all forms of foreign borrowing are subject to the restrictions above. Trade credit of less than one year had been exempted prior to mid-1998 and trade credit of less than 90 days continues to fall outside debt approval, registration, and monitoring. Borrowing by foreign bank branches in China is treated as offshore borrowing outside the scope of debt regulations (although lending by these banks to domestic or FFEs is regulated as external debt, notwithstanding the banks' resident status).

11. A full description of China's exchange control regulations is beyond the scope of this paper.<sup>5</sup> A summary of the regulations on the payment for imports by a letter of credit (Box II.1) and the regulations for loan approval to a FFE (Box II.2) illustrates the controls affecting current and capital account transactions respectively. Other transactions have their own regulations, documentary requirements, and administering agents.

12. The regulations on specific transactions are supplemented by an array of limitations on financial market transactions. Foreign exchange may only be purchased from designated banks, and transactions among nonbanks are not permitted. Foreign-funded banks operating in China are subject to geographic limitations, and regulations discourage (although they do not prohibit) domestically-funded enterprises from doing business with foreign banks. Foreign banks are also prohibited from domestic currency business (except in Pudong, Shanghai and Shenzhen, Guangdong), and even in these cities, domestic currency business is

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<sup>4</sup>See Chapter VII for discussion of China's stock markets.

<sup>5</sup>A more complete description of some of the key regulations listed in the appendix is in Zee (1999).

subject to strict limitations on customers and amounts. For both foreign and domestic banks, it is generally not possible to use banks in one city for transactions taking place elsewhere in China (e.g., a bank account in Beijing cannot generally be used to pay for imports in Shanghai). Finally, payments and receipts for current and capital account transactions are made to separate bank accounts to prevent mingling of funds for current and capital transactions.

13. The exchange and capital controls are clearly leaky. Disguised outflows have been growing, particularly in late 1997 and 1998 when errors and omissions in the balance of payments rose, the gap between trade and FDI inflows and the overall balance increased, and the accumulation of international reserves slowed sharply (Table II.1). Also confirming the leakiness of controls are substantial levels of unregistered debt that can be observed in Bank for International Settlements and other creditor source data. An investigation of foreign exchange documentation requirements revealed high levels of missing, incomplete, or forged documents. In response, the authorities tightened the administration of foreign exchange, including closer scrutiny of capital account transactions and increasing documentation and verification requirements on current transactions. Anti-smuggling efforts were also stepped up, conducted in substantial part through exchange controls.

### **C. Benefits and Costs of China's Exchange and Capital Controls**

#### **Benefits of Controls**

14. The theoretical arguments for capital controls falls into two groups (Dooley, 1996). One group is based on "second best" arguments in which capital controls are proposed as welfare improving in the face of market failures or distortions. Another group bases its arguments on the potential of capital controls to insulate an economy from the effects of overshooting in financial markets or herd behavior on the part of investors.

15. The "second best" argument for controls of greatest relevance to China relate to evident market failures and distortions in the bank and enterprise sectors. Due to poorly defined property rights, soft budget constraints, and management incentives that are inconsistent with profit and welfare maximization, there is a substantial likelihood that excessive inflows of foreign capital would have been used for purposes that would not generate an economic return sufficient to cover the cost of debt service. In such circumstances, it can be argued that capital controls are efficiency enhancing.

16. The high levels of nonperforming loans for state commercial banks in China clearly indicate that there have been serious distortions due to imprudent lending practices. In these circumstances, excessive capital inflows channeled through banks would likely have generated a return that was insufficient to cover the costs of debt service. Given the inefficiencies in financial intermediation and weaknesses in the banking regulations and

supervision, it can be argued that exchange and capital controls have helped ensure that China's external debt remains manageable.

17. Thus, the benefit to China from exchange and capital controls appears largely in the extent to which controls prevented the accumulation of debt that would not generate economic return sufficient to cover the costs of debt service. It is difficult to quantify the stock of such debt that was not accumulated due to exchange and capital controls because assumptions about the counterfactual capital control regime are needed to reach any firm conclusions. Theoretically, the incremental effects of the controls might be discerned from examination of the influence of marginal changes in the stringency of controls on debt stocks and flows. However, as noted above, the discretionary, case-by-case nature of China's exchange and capital controls and the lack of any recent history without controls does not permit the direct estimation of such effects. Nevertheless, enough is known about the implementation of Chinese regulations to get a sense of where marginal debt would otherwise have been incurred.

18. The potential benefits to China of its exchange and capital controls may be seen by examining the structure of China's external debt (Table II.2). Presumably, official borrowing (light shading in the table) has not been affected by the controls since SAFE permits the government to borrow whatever it would like. Similarly, Sino-foreign joint ventures and purely foreign firms are likely to have been less constrained in their foreign borrowing (dark shaded areas) as these borrowers are partly exempt from approval and registration requirements. Indeed, borrowing by these joint venture enterprises may be inflated by the controls as Chinese entities have reportedly been able to disguise their identities to take advantage of the tax incentives and liberal capital control regime for joint ventures (e.g., by setting up a joint venture through a Chinese-controlled Hong Kong SAR 'front' company). The debt that is left in the unshaded areas for which the control regime is relevant is composed of debt owed by state commercial banks (about half), by nonbank financial institutions such as the international trust and investment companies (ITICs), and by Chinese airlines to leasing companies.

19. A case for the potential benefits of controls emerges if it is accepted that the marginal debt prevented by the controls would have been largely additional borrowing by state commercial banks and ITICs. These institutions are treated in credit markets and by rating agencies as benefitting in substantial measure from an implicit sovereign guarantee. This remains true as an explicit consideration by rating agencies even after the recent downgrades following the bankruptcy of the Guandong International Investment and Trust Company (GITIC). Accordingly, foreign lenders are likely to have paid less attention to the underlying quality of the projects they were financing or the financial viability of the borrowers. Also, to the extent that the perception of an implicit guarantee is correct, there is a considerable problem of moral hazard in that these borrowers are able to gamble with the public's money in the event of losses while retaining the fruits of successful ventures to themselves. As noted

above, the high levels of nonperforming loans believed to be in China's domestic financial institutions suggests that these moral hazard problems are serious.

20. Alternatively, the major effect of the controls might have been to limit borrowing by domestic private enterprises and township and village enterprises. It could be argued that such borrowing would have been beneficial for China given the significant contribution of these sectors to economic growth. While this cannot be excluded given the discretionary nature of the controls, it seems unlikely that small- and medium-size, unambiguously nonguaranteed borrowers operating in an environment of poor accounting and ineffective legal procedures for seizing collateral would have attracted much additional interest from international capital markets. Most managers at foreign banks in China interviewed in the preparation of this paper generally agreed that such enterprises would have seen little new credit from abroad and that any additional credit would likely have gone mostly to domestic banks and state-owned enterprises.

21. The limitations on the ability of investors to move funds into or out of China quickly or take short positions is likely to have been helpful as well. More liberal capital controls in some of the other Asian countries allowed investors greater flexibility to hedge currency risk in response to concerns about depreciation or speculate against the domestic currency by borrowing in domestic currency and converting the proceeds to foreign exchange. Such transactions are made much more difficult with respect to renminbi by China's exchange and capital controls. Experience in other Asian countries indicates that contagion was a problem. Movements in parallel markets such as the nondeliverable forward market for the renminbi suggest that the desire to take positions was present for China as well during the Asian crisis.

### **Costs of Controls**

22. China's exchange controls have clearly had significant administrative and efficiency costs. However, assessing the costs of China's capital and exchange controls is complicated by several factors. The system is a cumbersome patchwork of regulations and controls that have evolved over many years. Also, the nature of the regulations and controls is likely to result in very different costs for different entities, making the overall efficiency and resource costs to China very difficult to quantify. Finally, even within an entity, the costs appears to vary substantially over time and location as different SAFE officials apply differing interpretations of regulations.

23. An indirect measure of the efficiency and resource costs is however provided by surveys of multinationals on the impact of the new and reinforced exchange controls implemented in 1998. The survey results paint a worrying picture as to the costs of the controls, at least so far as FFEs are concerned.<sup>6</sup> Among the major findings: over 80 percent of

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<sup>6</sup>The survey was prepared by the USCBC (an organization of mostly U.S.-based multinational  
(continued...)

U.S.-China Business Council (USCBC) respondents report significant adverse effects of the new exchange control measures; 40 percent of those affected characterized the adverse effects as extremely significant (equivalent data for European respondents are more than 90 percent and almost 40 percent respectively). All USCBC respondents and 66 percent of European respondents reported problems with importing raw materials for exports due to restrictions on payments in foreign currency. Three quarters of USCBC respondents and over 80 percent of European respondents reported increases in accounts receivable, typically on the order of 10–30 percent, but with a significant minority among both groups experiencing much larger increases in accounts receivable. Finally, and perhaps of greatest concern for China's medium-term balance of payments, nearly 50 percent of USCBC respondents and over 40 percent of European respondents with investment plans have decided to reconsider, delay, or cancel such intended investment financing.

#### D. Conclusions

24. China's exchange and capital controls have clearly entailed costs, and there have been leakages, but they have also had some success in limiting foreign exposure in an environment characterized by weak financial discipline in banks and state-owned enterprises, and serious moral hazard problems. This—together with the limited possibilities for nonresidents to take positions against the renminbi—have helped, to some degree, in limiting the contagion effect of the Asian crisis, but of course it was not the only factor.

25. Nevertheless, the gradual liberalization of exchange and capital controls remain a medium-term goal of the Chinese authorities as they continue the opening up and reforms of the Chinese economy. This will require substantial reforms of banks, enterprises, the legal framework, and banking regulation and supervision, and the authorities have accelerated their work in these areas.

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<sup>6</sup>(...continued)

firms operating in China) and conducted in November 1998 for the USCBC membership. The Delegation of the European Commission in China sent the survey to European-based multinationals in January and February 1999. Together, these surveys cover more than 200 mostly large foreign investors from the United States and Europe. The FFE managers for U.S. and European-based enterprises in China, broadly agreed that they were generally *less* affected by the new measures than investors from other countries or domestically-funded enterprises. Also, in some cases, the same FFE managers reported that their firms have benefitted from the anti-smuggling campaign. The USCBC survey results may be found on the USCBC web site (United States-China Business Council, 1998) as is SAFE's response to the results (SAFE, 1999). The results for the Delegation of the European Commission are unpublished, but available upon request.

### **Box II.1. Payments for Imports Through a Letter of Credit**

Importers seeking to pay for goods with a letter of credit must submit the following documents to the designated foreign exchange bank processing the payment (SAFE's agent for enforcing these controls): the import contract, the Import Verification Statement, the Recordal Form (where applicable), the *original* customs declaration, the letter of credit application, and any other documents deemed relevant by the bank. Some of these documents are generic; others are specific to SAFE's regulatory regime. The Import Verification Statement is a document issued by SAFE for each transaction with copies to SAFE, the importer, and the bank. The Recordal Form is a document also issued by SAFE for transactions for foreign trade companies with unknown or poor records of compliance with regulations, imports with payment terms exceeding 90 days, some cases in which advance payments or deposits are made, and in cases where the bank making payment and the import take place in different regions or municipalities. The bank is directed to scrutinize the documents, and issue the letter of credit only if it is fully satisfied that all documents are in order and the transactions is bona fide. If the bank is not satisfied, it may refuse to issue the letter of credit or direct the importer to take the documents to SAFE for verification. After the goods have arrived but within 30 days of arrival the importer will submit to SAFE the importer's copy of the Import Verification Statement, the importer's copy of the recordal form, and the originals of the customs declaration documents. SAFE will match its own, the bank's, and the importer's copies of the various documents and satisfy itself that the transaction is genuine, the payment is proper, and the goods have arrived.

A number of problems can arise in this process, any one of which can result in the inability to make payment in foreign exchange. At the simplest level, the originals of one of the documents may be accidentally lost or destroyed; as copies or faxes are not acceptable, it then becomes impossible to make payment legally. More seriously, the foreign trade company (FTC) importing the goods may have smuggled the goods to avoid paying customs duties and VAT or forged some documents. Because all FIEs and many domestic-capital enterprises are not permitted to import goods themselves (even in transactions among related parties), it is necessary for these importers to retain an FTC to clear goods through customs; where FTC paperwork is not in order, payment in foreign exchange cannot be made even if the exporter and buyer of the imports are blameless in any malfeasance by the FTC. In each of the cases above, there is reportedly no administrative means of appealing or rectifying problems. Aside from the possibility that permission to purchase foreign exchange or make payment may ultimately be refused, there are costs attributable to the delays and uncertainties in timing that can arise as the various documents are matched, scrutinized, and processed. One FIE manager interviewed for this paper summarized the situation by stating that foreign exchange was available for current transactions in China, but only if the documentation is "perfect."

### **Box II.2. Registration and Repayment of Debt by Foreign-Funded Enterprises**

Documents for registration of foreign debt by FFEs and repayment of that debt involve an array of documents similar to those required for payment for imports. For registration of debt, FFEs need to provide SAFE (not the bank) with a copy of the approved joint venture contract of articles of association; the loan contract together with a summary of major provisions; the FFE's Foreign Exchange Registration Certificate (FERC—a document issued by SAFE with separate procedures for issuance), an investment verification report issued by an accounting firm registered in China showing that the FFE's capital contribution has been made in accordance with the approved joint venture contract or articles of association; a legal opinion from a Chinese law firm verifying the loan contract; and any other documents or information required by SAFE. After SAFE verifies that the capital contribution has been made, that the aggregate amount of debt after the new loan does not exceed the difference between total investment and registered capital, and that the interest rate charged is not excessive in SAFE's view, it issues a Foreign Debt Registration Certificate (FDRC) for the loan. Documents required by SAFE for loan repayment include the FDRC, the loan contract, the lenders notice of principal repayment, and the account entry notice issued by its bank documenting the deposit of the proceeds from the loan in a particular account. If the FFE wishes to purchase foreign exchange for payment, it must also supply specific documentation from its bank showing that it does not have sufficient foreign exchange on its own account to make the payment.

The documentation and document processing requirements for loan transactions raise many of the same issues of delays and denials as with import transactions; however, in the case of loan approval, SAFE has discretion to prevent an otherwise valid transaction from taking place. Where payment for trade transactions is in principle automatic when the various documentation and verification steps are completed to the satisfaction of the bank or SAFE, SAFE has considerable discretion to refuse registration of debt. In particular, SAFE can reject registration if it deems the interest rate to be too high, other terms to be too onerous, or if it believes that the loan could be detrimental to third parties (e.g., other creditors).

Table II.1. China: Quarterly Balance of Payments, 1994-99

(In billions of U.S. dollars)

	1994				1995				1996				1997				1998				1999		
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	
<b>Merchandise Trade</b>																							
Exports	19.1	29.3	31.0	41.6	31.0	38.9	37.2	41.8	28.2	35.8	40.0	47.2	35.6	45.4	48.2	53.8	40.1	46.5	47.2	49.8	37.3	37.3	37.3
Imports, customs value	20.4	28.8	28.9	37.6	23.9	32.7	34.0	41.5	29.4	33.8	32.7	43.0	28.8	34.0	35.4	44.0	29.5	34.8	34.4	41.6	33.0	33.0	33.0
Trade balance, customs basis	-1.3	0.5	2.2	4.0	7.1	6.1	3.2	0.3	-1.2	2.0	7.2	4.2	6.8	11.4	12.8	9.7	10.6	11.7	12.8	8.2	4.3	4.3	4.3
<b>Foreign direct investment</b>																							
Inward investment credits	7.7	7.7	7.6	10.7	6.8	9.5	8.7	13.1	7.9	11.8	9.5	13.2	7.8	12.9	10.8	13.8	8.6	11.9	10.9	14.2	7.6	7.6	7.6
<b>Identified private capital inflows</b>																							
BIS Bank Claims on China	-2.2	5.8	3.1	1.2	2.0	2.0	1.5	5.1	3.1	4.9	2.4	2.3	1.7	4.3	5.2	-0.3	0.3	-3.3	-6.3	1.0	...	...	...
BIS Equity Issues	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.6	0.2	1.4	2.9	1.9	3.0	0.6	0.2	0.0	0.2	0.0	0.0	0.0
BIS Securities	1.8	0.7	1.3	0.6	0.6	0.2	-0.4	-0.4	-0.4	-0.3	1.4	0.0	0.3	1.9	-0.1	-0.1	-0.1	-0.7	-0.9	0.6	-0.4	-0.4	-0.4
Identified Private (Non-FDI) Inflows	-0.4	6.5	4.4	1.8	2.6	2.2	1.1	4.7	2.7	4.6	4.4	2.5	3.4	9.1	7.0	2.6	0.8	-3.8	-7.2	1.8	...	...	...
Change in stock of foreign exchange	7.4	3.3	8.1	11.6	6.4	4.0	7.8	3.8	7.2	5.8	8.8	9.6	7.1	8.8	13.2	5.8	0.7	-0.1	0.6	3.9	1.6	1.6	1.6
Change in other foreign exchange assets of the monetary authorities	-6.16	4.35	0.99	-3.71	0.1	0.0	1.0	3.9	0.4	7.2	-4.7	0.4	9.9	0.5	0.3	0.8	-2.3	-0.3	0.3	-0.4	-0.2	-0.2	-0.2
Change in total foreign assets of the monetary authorities	1.3	7.6	9.1	7.9	6.5	4.0	8.8	7.7	7.6	13.0	4.1	10.0	17.0	9.4	13.4	6.6	-1.6	-0.4	0.9	3.5	1.4	1.4	1.4
<b>Residuals:</b>																							
1. Trade + FDI - reserve change	1.0	-5.0	-1.7	-3.1	-7.5	-11.6	-4.1	-9.6	0.5	-8.0	-7.9	-7.8	-7.5	-15.4	-10.4	-17.7	-18.5	-23.7	-23.1	-18.5	-10.3	-10.3	-10.3
2. Trade + FDI + identified private capital - reserve change	1.4	-11.5	-6.1	-4.8	-10.0	-13.8	-5.2	-14.3	-2.3	-12.5	-12.3	-10.3	-10.9	-24.5	-17.4	-20.3	-19.3	-19.8	-15.9	-20.3	...	...	...
3. Trade + FDI + identified private capital - foreign assets change	-4.8	-7.1	-5.1	-8.5	-9.9	-13.8	-4.2	-10.4	-1.8	-5.3	-17.0	-9.9	-1.0	-24.0	-17.2	-19.6	-21.6	-20.1	-15.6	-20.7	...	...	...

Table II.2: China - Reported Debt at end-1998

(In millions of U.S. dollars)

Debtors	Creditors	Bilateral official	Multilateral Foreign loans and Financial Institutions	Buyer's credit (bank and non-bank)	Loans from exporters & their non-banks	Loans from foreign banks in China	Debt issued abroad (e.g., bonds)	International financial leasing	Other	Total
Government		13,458.8	22,363.2	449.5	0.0	0.0	5,318.1	0.0	51.8	41,641.4
State commercial banks (excl BoC)		1,055.5	0.0	3,986.1	242.9	160.3	1,545.2	0.0	136.5	10,506.0
Investment finance companies		0.0	0.0	3,679.7	48.9	889.9	3,356.6	17.8	7.5	8,007.9
Bank of China		7,882.4	0.0	5,072.7	8,232.4	0.0	1,460.6	1.2	796.0	23,471.2
Leasing companies		0.0	0.0	944.0	24.6	507.2	0.0	144.0	30.7	1,674.8
Sino-foreign joint ventures		2.9	385.2	7,361.3	553.2	8,498.3	748.7	50.8	282.2	27,064.0
Sino-foreign cooperative enterprises		0.0	0.0	1,542.4	478.8	974.7	0.0	6.9	60.3	6,924.0
Wholly foreign-funded enterprises		0.0	175.4	1,648.1	3,449.9	3,638.6	0.0	66.5	90.2	9,247.7
Domestic enterprises		6.5	30.0	1,334.6	232.1	412.1	0.0	12,736.4	654.5	15,501.3
Other debtors				1.3						1.5
<b>Total</b>		<b>22,406.2</b>	<b>22,953.8</b>	<b>26,539.7</b>	<b>17,352.9</b>	<b>16,281.0</b>	<b>12,430.3</b>	<b>13,053.5</b>	<b>2,055.8</b>	<b>146,043.2</b>
<b>Summary</b>										
<b>Official and officially guaranteed</b>				<b>41,641.4</b>						
<b>Foreign funded and Sino-foreign joint ventures</b>				<b>45,239.1</b>						
<b>Debt subject to control regime</b>				<b>59,162.7</b>						
Debt of state-owned banks				33,977.2						
Debt of state-owned non-bank financial institutions				8,007.9						
Debt for aircraft and other leasing				12,899.4						
Other debt				4,278.2						
<b>Total recorded debt</b>				<b>146,043.2</b>						

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### III. RECENT DEVELOPMENTS IN STATE-OWNED ENTERPRISE REFORM<sup>1</sup>

#### A. Overview and Summary

1. A little over a year has passed since Premier Zhu Rongji set out an ambitious three-year reform program to return China's larger state-owned enterprises (SOEs) to profitability at the conclusion of the National People's Congress (NPC) in March 1998. While the pace of SOE reform over this period may have fallen short of some observers' expectations, important progress was in fact made, despite concerns about slowing growth and social unrest. In particular, implementation of the reform program during 1998 was broadly in step with the pace and objectives set out in then-Premier Li Peng's annual work report opening last year's NPC, and accelerated in many key areas in comparison with previous years. The purpose of this chapter is to provide an update of developments in SOE reform and performance during the past year; discussions of SOE reform in previous years, as well as more detailed information on the broad strategic approach adopted by the authorities, are provided in SM/97/153 and SM/98/184.

2. The main findings of this chapter are as follows:

- The financial performance of SOEs continued to deteriorate in 1998. As in the past, poor performance was caused by a variety of macroeconomic and industry-specific factors, which were exacerbated by the Asian crisis, slowing growth and the worst summer flooding in a century. Most manufactured and industrial product sectors continued to be plagued by excess capacity, which prompted intense price competition among enterprises to maintain market share and reduce inventories. Other problems in the state enterprise sector included weak management, high debt, over staffing, outdated products and technologies, an excessive social welfare burden, and high relative tax rates.
- The speed and content of reform was broadly in step with the pace envisaged in then-Premier Li Peng's speech opening the NPC in March 1998. In particular, the way enterprises operate was dramatically changed when ties with government agencies and the military were severed; efforts to upgrade and improve management were intensified; sectoral restructuring was accelerated to reduce losses and excess capacity, particularly in the "breakthrough" textile industry; and supportive reforms focussing on the establishment of a social safety net and reemployment programs were also strengthened. On the other hand, poor sentiment on domestic and overseas stock markets slowed shareholding and ownership reform efforts for larger enterprises.

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<sup>1</sup>This chapter was prepared by Paul Heytens, Deputy Resident Representative. Questions regarding this chapter may be addressed to David J. Robinson (ext. 37489).

- The pace of reform in many key areas also accelerated in 1998 in comparison with previous years. The volume of debt writeoff rose to Y 40 billion, a 30 percent increase over 1997, and virtually all of the activity was focussed on large enterprises. Over six million workers were laid off from state enterprises, a significant increase over previous years, prompting the authorities to accelerate efforts to establish a social safety net. Activity to move small enterprises out of the state sector also accelerated significantly; by the end of last year, most southern and coastal provinces had “released” most of their smaller SOEs.
- Despite the progress made, directed lending to loss-making SOEs persisted, and the state enterprise sector continued to receive a disproportionate share of bank credit and the equity capital raised on China’s stock market. The increased number of layoffs indicates that enterprise budget constraints were nevertheless hardened in response to market pressures. SOE reform also continued to be constrained by a lack of funding, as evidenced by the relatively small number of bankruptcies and the difficulties faced by some localities in financing a social safety net. In addition, steps were taken to slow the sale of smaller enterprises owing to fears of social unrest and widespread reports of fraud and abuse, but even so the pace of disposal remained rapid.
- The authorities’ SOE reform strategy continues to be guided by the principle of “seize the large and release the small.” Premier Zhu in his annual work report opening the 1999 NPC pledged to redouble reform efforts and the pursuit of profitability in the state enterprise sector. It was also announced that the remaining two years of the three-year reform program would be focussed on improving the performance of a select group of 7,680 large and medium-sized SOEs. Reforms in other complementary areas, in particular in the financial sector and in creating an enabling environment for private sector activity, are also set to intensify and should help to facilitate a deepening of SOE reform in the period ahead.
- Amid growing signs of financial distress in the SOE sector, the most pressing issue in the near term is to remove the constraints on and accelerate the implementation of enterprise restructuring. While the authorities’ ability to bear the financial costs of restructuring has been and will continue to be a constraint on the reform process, the scope for restructuring has also been slowed by the weak institutional and legal framework. The recent decision to establish asset management corporations (AMCs) could be instrumental in accelerating the restructuring process, not only by helping to alleviate the financial constraints, but also by expediting development of the requisite legal and institutional infrastructure.
- Facilitating the movement of larger SOEs out of state hands continues to be the key issue over the medium term. The current approach remains unduly focussed on improving management within the existing ownership structure, rather than developing means to broaden ownership outside the state sector. With the reform of

China's stock market moving ahead, the authorities have indicated that the conversion of large SOEs into shareholding companies could be accelerated later this year.

- Finally, while mergers are a legitimate tool to promote the exit of resources given the fiscal constraints on the use of formal bankruptcy procedures, and to consolidate the excessive number of small regional producers in many sectors, this practice has frequently been used to avoid restructuring of smaller enterprises and to create large enterprise groupings to maintain the state's dominant economic role in key sectors. There nevertheless seems to have been a move away from the "chaebol" model following the onset of the Asian financial crisis. The recent announcement of the breakup of China Telecom and restructuring activities in the telecommunications and petroleum sectors are encouraging in this regard. In addition, the rapid growth of small and medium-sized enterprises (SMEs) has prompted officials to look at smaller companies, many of which are private in China, as the main engine of future income and employment growth.

### **B. Recent Developments in State Enterprise Performance**

3. The financial performance of the SOE sector continued to deteriorate during 1998, falling well below that of enterprises under other forms of ownership.<sup>2</sup> However, performance of medium and large enterprises began to improve late in the year, due in part to the anti-smuggling campaign and fiscal stimulus package, a trend that has continued during the early months of 1999.

#### **Production**

4. Available data indicate that the growth rates of industrial value added and gross value of industrial output of SOEs declined in comparison with recent years, and was again well below that of industrial enterprises falling under other forms of ownership. For example, while value added of industrial enterprises grew 8.9 percent in 1998, that of state-owned and state-controlled enterprises was only 4.9 percent. In comparison, industrial value added of collective enterprises grew by 8.7 percent, joint stock enterprises by 11.9 percent, foreign-invested enterprises by 12.7 percent, and enterprises under other (i.e., private) forms of ownership by 19.6 percent during the year. Similarly, growth in the value of gross industrial output of SOEs, at 4.6 percent, was less than half the 10.7 percent rate for the industrial sector as a whole.

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<sup>2</sup>As in previous years, detailed data on SOE performance in 1998 are generally only available for the industrial sector; the discussion below tends to focus on industrial SOEs at the township level and above with independent accounting status.

## **Profitability**

5. The profitability of industrial SOEs deteriorated significantly in 1998, despite implementation of the infrastructure investment program and the anti-smuggling campaign. While these factors helped to improve performance late in the year<sup>3</sup>—many large SOEs that had been recording losses earlier in the year returned to profitability by end year<sup>4</sup>—net profitability of industrial SOEs at township level and above with independent accounting systems declined to an estimated Y 25.8 billion (less than 1 percent of sales), a 40 percent drop from 1997. This is in comparison with total profits of Y 147.3 billion (2.2 percent of sales) for all industrial enterprises with independent accounting systems in 1998.

6. While larger SOEs continued to outperform smaller state enterprises—larger industrial SOEs were profitable as a whole, while smaller SOEs were unprofitable as a whole in 1998—the financial condition of the former deteriorated substantially in comparison with 1997, and roughly half of both large and small enterprises were loss making in 1998. Moreover, nearly one-third of the 512 “key” large SOEs and the same proportion of the targeted 7,680 large- and medium-sized enterprises suffered losses in 1998. Among the former group, less than 10 percent had recorded losses in 1997.

7. As in the past, poor state-enterprise performance was caused by a variety of macroeconomic and industry-specific factors, which were exacerbated by the Asian financial crisis and disastrous summer flooding, as well as a number of SOE-specific factors that have been adversely affecting the state sector for years. The former include weak domestic demand stemming from a sharp rise in precautionary saving, a sharp slowing of exports to the Asian region, and sectoral overcapacity and oversupply resulting from redundant productive capacity. These factors prompted intense price competition and price cutting among enterprises, particularly in consumer goods industries, to maintain market share and sales revenues. The SOE-specific factors include weak management, over staffing, high debt, outdated products and technologies, an excessive social welfare burden, and high relative tax rates.

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<sup>3</sup>The turnaround in performance of the larger enterprises that began late last year has continued in the early months of 1999. Net profits of the 512 key enterprises rose nearly 27 percent in the first two months of this year from the same period a year ago. The State Economic and Trade Commission (SETC) attributed the improved performance of the larger enterprises to the impact of the fiscal stimulus program, the crackdown on smuggling, and intensified SOE reforms.

<sup>4</sup>Cumulative net profitability of industrial SOEs was negative through the first 8 months of last year.

## **Debt**

8. The industrial SOE liability-to-asset ratio is estimated to have remained stable at about 65 percent in 1998. This result is unsurprising given that enterprises' main financing source continued to be the banking system and write downs of unrecoverable loans remained modest during the year (see para. 20 for more details).

## **Inventories**

9. Industrial inventory accumulation slowed steadily during the year, from year-on-year growth of 10 percent at the end of the first quarter, and 5.9 percent at the end of the third quarter, to a decline of 0.7 percent by year-end. This reflected increased sales of building materials and construction supplies following implementation of the fiscal stimulus package, the impact of accelerated sectoral restructuring, as well as the impact of tighter controls on investment in new capacity. However, inventories of many consumption goods are reported to have risen during the year, reflecting weak consumer demand and the legacy of earlier over investment in productive capacity.

## **C. Reform Implementation in 1998**

### **Background**

10. Since 1994, the broad strategy of state enterprise reform has been guided by the principle of "seize the large and release the small". Reform of large enterprises has been undertaken through a variety of pilot programs, centered on industrial consolidation through mergers and acquisitions and the creation of large enterprise groups; introducing greater autonomy and improved corporate governance through the separation of enterprises from government ministries and the introduction of modern management structures; and diversifying ownership primarily through issuance of stock on domestic and overseas exchanges. Small enterprise reform has been left to the provincial and local governments, who are removing them from state ownership through sales to management, workers or outside investors, among other methods.

11. State enterprise reform has occupied a central place in the authorities' policy agenda since the 15th Party Congress in September 1997, when President Jiang called for expansion and acceleration of the reform experiments already underway (see SM/98/184). In particular, he called for diverse forms of ownership (especially joint stock companies); downsizing of staff to encourage efficiency; promotion of industrial consolidation through mergers; standardization of bankruptcy procedures; and supporting reforms in the social security system and the housing market. The President noted that this would result—at least temporarily—in increased unemployment, and called on workers to "change their ideas about employment and improve their own quality".

12. An ambitious three-year SOE reform program set out in March 1994 by Premier Zhu Rongji aimed at achieving the “two majorities”, that is, to (i) transform the majority of loss-making state enterprises into profitable enterprises and (ii) have the majority of medium and large “core” state enterprises adopt modern enterprise systems. The main details of this program were laid out in the government’s annual Work Report to the NPC. These goals were to be achieved by combining the reform initiatives of earlier years with efforts to reorganize, upgrade and improve enterprise management, change the way enterprises operate, and carry out a strategic reorganization of SOEs. This was to be supported by complementary efforts to establish and secure adequate financing for a broad social safety net, and implement re-employment programs. In parallel, sector-specific restructuring programs aimed at eliminating excess capacity and redundant labor, the main underlying causes of chronic losses, were to be launched to surmount financial problems and return key industries to profitability—beginning with the textile sector—within the same three-year time span.

13. With this brief overview, the reform process can be broadly broken down into economic restructuring, reform of management and corporate governance, and ownership reform. Each of these areas will be discussed in turn below.

### **Economic restructuring**

14. **Claims on resources.** While the SOEs’ share of industrial output and employment is estimated to have declined further in 1998, the state sector continued to place a disproportionately large claim on domestic resources. In particular, SOEs’ share of bank lending, though down slightly from the previous year, remained near 60 percent at end-1998. Further, all but one of the 109 new initial public offerings on the domestic stock market were SOEs. In addition, the fiscal stimulus package was aimed almost exclusively at the state sector, and substantially increased the share of investment flowing to state-owned units, including to SOEs.<sup>5</sup>

15. Faced with short-term difficulties associated with slowing growth in part due to the Asian financial crisis, the authorities in mid-1998 reverted back to directed lending, thus contradicting newly initiated reforms in the banking sector. While the banks have been reluctant to lend to nonstate companies in part because of their own risk aversion, the state commercial banks continued to be used as vehicles for policy lending to keep state enterprises afloat, preserve jobs, and sustain relatively rapid economic activity. In reflection of this, numerous directives were issued in the middle part of 1998 instructing the state banks to continue lending to SOEs, including those making losses, as well as other targeted

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<sup>5</sup>Fixed asset investment undertaken by state-owned units in 1998 is estimated at Y 2,150 billion or 75 percent of total fixed asset investment. In 1997, the comparable numbers were Y 1,762 billion and a 71 percent share.

borrowers (Box III.1).<sup>6</sup> Nevertheless, the four large state commercial banks report that pressures for directed lending have declined in comparison with previous years, and the rising number of layoffs suggests that SOE budget constraints were in fact hardened somewhat.

16. **Bankruptcy and enterprise restructuring.** While the deteriorating performance of SOEs, and in particular the high proportion of loss-making enterprises, suggests there are a large number of potential candidates for bankruptcy or other fundamental restructuring, the actual number of bankruptcies has remained relatively modest. Indeed, the number of bankruptcies in the 111 pilot cities dropped from 551 in 1997 to 425 in 1998, while the number of mergers and acquisitions (M&As) rose from 1,022 to 1,433. In part, the lower number of bankruptcies reflects the focus on larger enterprises, but the slower pace of activity on the bankruptcy front and the rise in the number of M&As was also in response to concerns about social stability in some localities. Reflecting the greater focus on larger enterprises, the assets involved in these restructuring activities rose from about Y 100 billion in 1997 to Y 207 billion in 1998.

17. The main constraint on the bankruptcy and restructuring process in the pilot cities has been and continues to be a lack of financial resources—whether on the part of enterprises themselves, or of the central and local governments—to make the substantial separation payments to workers or to compensate banks for the write down of irrecoverable debts. There is a central government fund to recompense banks for debt writeoffs in bankruptcy proceedings and the write-down of overdue interest in merger activities in the 111 pilot cities, but the size of the fund—while increasing to Y 40 billion (½ percent of GDP) in 1998 from Y 30 billion in 1997—remains very small, particularly in comparison with the estimated stock of nonperforming loans in the banking system.

18. Nationwide, the number of bankruptcies during 1998 is estimated by local law firms involved in such proceedings at about 6,000, roughly the same as in 1997. A large proportion of these, perhaps half or more, are believed to have been in the nonstate sector. It is important to note that bankruptcy in China, particularly in cases involving SOEs, looks nothing like the Chapter 11 process in the United States. Rather, bankruptcy proceedings are used to spin the productive assets of an enterprise off into a viable entity, dispose of nonproductive assets (e.g., schools and hospitals) to local governments, and negotiate a reduction in the labor force. Thus, bankruptcy in China rarely results in the closure of enterprises common in western countries, though the entity that emerges from such proceedings typically looks nothing like the one that went into it.

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<sup>6</sup>Such practices reportedly continue in 1999. For example, the Bank of China reports that it loaned Y 3.1 billion to loss-making large enterprises engaged in foreign trade in January and February.

19. **Laying off surplus labor.** There is also a large pool of surplus labor in SOEs—estimated by some observers to be as high as 30 million workers (50 percent of SOE employment)—and a substantial portion have already been laid off. The Ministry of Labor and Social Security (MLSS) reports that SOEs shed an additional 6 million workers in 1998 (nearly 10 percent of SOE employment), a significant increase over previous years, prompting the authorities to accelerate efforts to establish a social safety net. Despite official concerns about the rising number of layoffs and the potential for social unrest, the declining financial performance of many SOEs and increasing reluctance of the banks to lend to them left local governments with no choice but to allow workers to be laid off. The MLSS has said that an additional 7 million workers could be laid off from SOEs in 1999.

20. **Reducing indebtedness.** While the entire amount of the “debt write-off” quota of Y 40 billion was reportedly utilized and enterprise debt service burdens fell with the steady reduction in interest rates, as noted above no progress was made during 1998 in reducing SOEs’ indebtedness. In particular, unprofitable SOEs continued to borrow from the state banks to cover losses and meet their payrolls, and direct financing raised on domestic and foreign securities markets dropped from Y 130 billion in 1997 to about Y 94 billion in 1998 as a result of poor market sentiment both at home and abroad. The effectiveness of listing on the stock market as a vehicle for reducing indebtedness has been limited by the standard practice of requiring all listed companies to spend part of the capital raised on the market to help smaller, financially distressed companies. A program, first announced in a circular issued in May 1998, to convert outstanding principal and interest of government-directed loans for infrastructure into equity shares in enterprises and eliminate about Y 50 billion in debt, also has yet to get off the ground.

21. **Reducing social burdens.** As outlined in SM/97/153, the transfer of nonproductive social assets (e.g., housing, hospitals and clinics, and schools) from SOEs’ balance sheets and the disposal of pension and unemployment liabilities are primary features in all of the pilot enterprise reform programs, as well as in the enterprise restructuring process more generally.<sup>7</sup> Widespread sales of enterprise housing to employees were reported early in 1998 after the announcement of the June 1 starting date for housing reform, but such sales quickly decelerated once it became clear that the reform program would only be introduced gradually. More generally, the SETC reports that progress in the transfer of social welfare units has been very uneven: many southern coastal provinces have transferred virtually all of their non-housing social welfare units, while in other areas—particularly in company towns

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<sup>7</sup>Unfortunately, there are no reliable time series data available on the social assets of SOEs, so it is difficult to gauge overall progress in this regard. However, according to the National Bureau of Statistics, overhead levels of SOEs—at an estimated 8 percent of output in 1998, down slightly from about 9 percent in the mid-1990s—remain about twice those of collectives and foreign-funded enterprises, suggesting that the social welfare burden is still high for state enterprises.

in the SOE-laden central and northeastern provinces—little progress has been made. The main constraint on the divestiture process has been a lack of sufficient funding for local governments to take on the additional obligations.

22. With layoffs mounting, efforts to set up a social safety net were accelerated in 1998, which has begun to reduce the financial burden on enterprises as they restructure and shed excess labor. To this end, enterprises with laid-off workers (*xiagang*) were required beginning in May 1998 to set up re-employment centers to facilitate the transition to new jobs. Laid-off workers registering with the centers became eligible for income support based on prevailing wages in the local area, which is financed in equal parts by local governments, local social insurance funds (financed in part by the workers' contributions), and the enterprises themselves. In addition, the central government has stepped forward with additional transfers to localities hardest hit by layoffs to help them meet their contributions to the re-employment centers. Steps have also been taken to limit enterprises pension contributions, and the MLSS has estimated that the state pension network will have been expanded to cover 110 million people by mid-1999, an increase of 26 million over 1998.

23. While the establishment of the re-employment centers is an important step forward in establishing a social safety net and removing financial constraints on enterprises to restructure, it continues to be the case that it is generally much easier for loss-making enterprises to simply idle production, send workers home on minimal monthly living stipends or no wages at all, reduce or stop payments to pensioners, and to stop servicing debts. Indeed, in early April of this year, a trade union leader at Capital Iron and Steel in Beijing, one of China's largest industrial enterprises, said tens of thousands of workers had not been paid for more than two months. In other parts of China and in other sectors, there are similar reports of state companies making only partial or no salary payments, and running up arrears in their pension obligations.

24. **Reducing excess capacity.** Excess capacity and production for inventory, and excessive fragmentation and large numbers of suboptimal-scale producers (see Box III.2), have long been identified as a major contributing factor to SOE losses. Massive investment in excess productive capacity—so-called “duplicated construction” (see Box III.3)—in earlier years resulted in extremely low levels of capacity utilization by the mid-1990s. While reliable time series data are not available for capacity utilization—the last full set of capacity figures were published in 1995, and are shown in Table IV.6 of SM/98/184—the available evidence suggests that additional capacity continued to come on line at least until late 1997, further intensifying an already very difficult situation in regard to market oversupply and competition. A recent survey by the State Statistics Bureau revealed that excess capacity was 40 percent or more for 450 major industrial and manufactured products in early 1997, while an investigation early this year by the State Internal Trade Bureau of 605 major consumer goods revealed 2/3 of these were in oversupply, up from about 1/3 in early 1998.

25. The intensification of the oversupply situation and the growing recognition of overcapacity as a major contributor to SOE losses pushed sectoral restructuring of industries with overcapacity to the top of the authorities' SOE reform agenda in 1998. In this connection, the State Council initiated three-year restructuring programs for the textile and coal industries during the year. Through eliminating at least 10 million obsolete cotton spindles (over 20 percent of total) and laying off 1.2 million workers (over 30 percent of total), the program for textiles aims to return the industry to profitability within the three-year time frame. The restructuring program for the coal industry focusses on delegation of management authority for 94 "key" coal-producing SOEs to local governments, widespread closure of and a ban on "illegal" small mines, and the deployment of State Council appointed inspectors to monitor progress. The progress in these and other major sectoral restructuring programs is described in Appendix I.

26. **Other industry-level restructuring.** Perhaps the most noticeable trend in enterprise reform since the mid-1990s has been the rapid increase in industry-level restructuring, including the formation of large enterprise groups, mergers and acquisitions, industrial downsizing, etc., depending on conditions and problems in particular industries. Such activity continued apace during 1998. Restructuring aimed at breaking up monopolies and fostering more competition was apparent in three key sectors during the year:

- In the petroleum sector, the operations of the China National Petroleum Corporation and the China Petrochemical Corporation are being restructured to foster direct competition in all aspects—exploration, refining, distribution (including direct export rights), production of petrochemical byproducts, etc.—of the industry where previously there had been none (the various activities had been divided up among the two). Since this restructuring has begun, the domestic crude oil price has fallen to near world market levels.
- In the telecommunications sector, China Unicom and others will be allowed to challenge the monopoly of China Telecom in the mobile phone market, and prices have already dropped significantly. Further, plans have recently been announced to break up China Telecom into four companies later this year based on its four main business areas, and to allow other firms to enter and compete in these areas.
- In the power sector, the State Power Corporation began separating the operation of the electricity grid from the power generation plants, with the aim of requiring them to bid for limited quotas to supply power to the grid.

27. In addition, the Baoshan steel company in Shanghai was merged with and given managerial responsibility for two other large steel companies in the city, with a view to rationalizing their operations, reducing excess productive capacity, and minimizing the influence of the municipal government on enterprise management.

## **Reform of management and corporate governance**

28. **Financial transparency.** New standards were implemented for accounting firms, and disclosure requirements for listed companies were strengthened and expanded with the passage of the new Securities Law in late December. In particular, the new Securities Law sets out tough new disclosure standards that has prompted an unprecedented increase in transparency among domestically listed companies; in the early months of this year, 80–90 listed companies issued profit warnings, in comparison with less than 10 last year. The State Audit Office also stepped up its scrutiny of SOEs' financial reports, and in late 1998 revealed evidence of widespread fraud in financial reporting among some of China's largest and best known SOEs. Audits of 23 medium and large companies revealed fraud on a large scale—assets were considerably overstated, while Y 3.7 billion of the Y 3.9 billion in current year profits were found to be false. Future inspection efforts, at least in the 512 key enterprises, will largely be channeled through a special supervisory corps set up late last year (see para. 31 below).

29. **Streamlining government supervision.** Another component of enterprise reform is the streamlining of government supervision. A major step in this regard, which was announced at the March 1998 session of the NPC, was the reduction in the number of government ministries from 40 to 29 carried out last August. While the bulk of the restructuring—in particular the retrenchment of central government civil servants, which are to be cut by half—is still ongoing, the reform plan has already transformed the structure of China's central government. The primary rationale of the restructuring was to eliminate the last of the remaining industrial branch ministries—which formerly directly managed SOEs under their control, but are now only to guide enterprises indirectly by issuing sector development plans and regulations—and lift government responsibility for micro-management of enterprises. This restructuring left two new economic super ministries, which took over the management and supervision functions of old ministries: the Ministry of Information Industry (MII) and the SETC.

30. Despite the significant reduction in the number of ministries and personnel that has taken place, the government still retains considerable influence on the management of enterprises. In particular, the central government's desire to control investment and economic planning to avoid duplicated construction at the local level remains very strong, as evidenced by the prohibition on new investment in steel and chemicals early this year.<sup>8</sup> The further streamlining of responsibilities for information technologies in the newly formed MII highlights the ways in which the restructuring has strengthened central-level control over certain sectors. In fact, the central government maintains overriding control of key industries

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<sup>8</sup>The SETC subsequently announced, on April 20, that it will no longer approve bank loans to SOEs to fund the construction of new plants, except for "selected high tech or promising product renovations projects".

such as automobiles, energy, steel, and textiles. The creation of the SETC also reflects a concurrent attempt to recentralize macroeconomic decision making.

31. In the wake of the government restructuring, the majority of the former industrial branch ministries were reduced to bureau status and placed under the jurisdiction of the SETC, effectively removing their direct enterprise management functions. To fill the vacuum, a Working Committee for Large Enterprises was created under the Central Party Committee to monitor performance of the large SOEs and, in cooperation with the Ministry of Personnel, to look after managerial and staffing issues. This has been complemented by the Supervisory Commissioner System, a group of former senior government officials who—after receiving specialized training in auditing, accounting, and finance—are now closely supervising the operations of the 512 key large enterprises, and assessing their financial performance, compliance with relevant legislation and sectoral development policies, and managerial performance. The supervisors, who report directly to Premier Zhu, have unlimited access to enterprises' financial records and staff, but otherwise cannot interfere with the enterprises' business operations. Initial reports on 21 enterprises were completed earlier this year (see Box III.4).

32. Other bold steps were taken in the second half of 1998 to further facilitate the functional removal of government from enterprise management. Following a series of corruption and smuggling scandals, President Jiang in October ordered the military, police, and other security agencies to completely divest themselves of their considerable commercial and financial holdings (with estimated assets of Y 51 billion, equivalent to 1¼ percent of total assets of industrial SOEs) by the end of the year. Also late in 1998 the government ordered all Party and government administrative organs to break links with the enterprises they controlled. The SETC set up a special Office for Military, Police, Government and Judicial Enterprises, with provincial branches, to oversee the transfer. Although the transfer began only in October, by the end of 1998, 80 percent of the estimated 6,300 enterprises established by the military, police, and judiciary had been transferred. In addition, about 70 percent of the 530 enterprises established by the Party and other administrative organs (with assets of Y 1.1 trillion, equivalent to 27 percent of industrial SOEs' total assets) had also been separated by the end of last year. However, questions of compensation and the ultimate ownership of many of these companies has yet to be resolved, and the enterprises nevertheless continue to be managed by government entities. For example, the People's Bank of China assumed responsibility for financial institutions, while the large number of smaller enterprises were transferred to local governments.

33. **Enterprise management and organization.** The establishment of modern enterprise systems, which began in 1994, continues to be one of the authorities' main measures to help SOEs to regain profitability and competitiveness. The main element of this program is the

adoption of modern corporate forms of governance in larger state enterprises.<sup>9</sup> By the end of 1997, 76 percent of the 2,560 large and medium-sized enterprises initially targeted had been corporatized, while the bulk of the remainder will be merged into large enterprise groups, bankrupted, or restructured. Even though these companies represent only a small fraction of the total number of state-owned enterprises, the largest 1,691 enterprises in this group account for 25 percent of total industrial assets, 15 percent of gross industrial output, and 12 percent of industrial employment. During 1998, the push toward the adoption of modern enterprise practices appears to have broadened considerably. According to a recent survey of 60,000 industrial SOEs by the National Bureau of Statistics' enterprise investigation team, nearly ¼ had adopted modern enterprise practices, while slightly more than half were preparing to do so, as of June 1998. The investigation team also found that the management structure of these firms had become more transparent, and that they were more independent in their decision making.

34. Considerably more attention was paid in 1998 to improving the performance of SOE managers. To this end, early last year the SETC began a "management training project" aimed at improving the quality of top SOE managers. SOE managers are required to participate in a three-month training program focussed on developing competent, technocratic managers capable of leading enterprises in a competitive market economy during the past year. In addition, the mandatory Executive Development Program (a kind of mini-MBA) has also been broadened in the past year, and now encompasses 56 universities nationwide, up from 26 a year ago. The authorities are also experimenting with headhunters and "auctions" for management professionals in an attempt to lure the best managerial talent into SOE management positions, and hiring preference is now being given to managers educated after the Cultural Revolution.

35. At the direct instruction of Premier Zhu, managers are now also being made more accountable for their performance, and systems are being developed to more closely link compensation and promotion with performance.<sup>10</sup> The SETC has reported that management teams at more than 71,000 SOEs were reshuffled last year, and many managers were either

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<sup>9</sup>In practice, this has meant incorporation under the Company Law, the creation of a Board of Directors and a Board of Supervisors. A key aim of the program has also been to clarify the ownership of state shares as well as to introduce outside supervision through incorporation with other investors, such as limited liability partnerships.

<sup>10</sup>It appears there are still limits to what SOEs can do to attract and retain competent managers. For example, in an attempt to reward good performance, 20 leading SOEs in Shanghai began offering stock options to their managers in 1997. However, this initiative was suspended earlier this year by the Party, which found it inappropriate for the heads of state enterprises to have such high incomes, noting that they should be content to work for modest salaries "for the whole people".

sacked or demoted for poor performance. Poorly performing large enterprises are also being threatened with loss of their special status. For example, with about 1/3 of the 512 "key" large SOEs posting losses in 1998, the SETC recently threatened that those still making losses this year would be removed from the list, losing preferential access to financing (see Box III.5) and other privileges. Finally, the Personnel Ministry is in the process of drafting new regulations for the supervision of SOE managers with a view to establishing more flexible personnel management practices in line with the transition to more modern enterprise systems.

### **Ownership reform**

36. **"Releasing" small SOEs.** Efforts to diversify ownership of small enterprises, which has long been the sole responsibility of local governments, accelerated in the wake of President Jiang Zemin's speech at the 15th Party Congress in September 1997. Viewed as being given the central government's blessing to transfer their small SOEs, city and provincial officials responded with enthusiasm. Hitherto slowly reforming provinces dramatically picked up the pace of ownership transfer, while provinces that were already quite far down the road of enterprise divestiture extended the process from industrial to nonindustrial, and from smaller to larger, enterprises. Indeed, in early 1998 there was a flood of announcements of small enterprise sales or auctions in various localities; some local governments even traveled abroad to offer their enterprises for sale.

37. However, less than a year later, the central government ordered local governments to slow the process down. In their haste to dispose of small enterprises, some localities had sold assets to enterprise managers at extremely low prices, written off debts (estimated at more than Y 100 billion) without consulting the banks, and forced workers to buy shares or lend to management for buyouts. This process also resulted in a surge of layoffs of state workers, raising central government fears of social unrest in some localities. In response, the SETC in July 1998 set out rules to protect the interests of workers, the state, and the banks. Anecdotal evidence suggests that the process of releasing small enterprises nevertheless continued apace in the wake of this announcement, though with considerably less publicity, prompting the SETC to release a reinforced set of rules in February 1999.

38. Quantitative data on the extent of ownership changes are not available; in fact, following the July 1998 Notice to slow the sale of small enterprises, local governments are reported to have begun under-reporting ownership transfers to disguise the true magnitude of their activities. The SETC has reported that there was no slowing of the process in the second half of 1998, and informally estimates that perhaps as many as 20,000 enterprises (about half of which were sales) were transferred during 1998, about twice the estimated number in 1997. By the end of last year, the coastal and southern provinces were believed to have divested almost all of their smaller SOEs, while many northeastern provinces had also made significant progress in disposing of small enterprises.

39. Finally, contrary to the popular perception, outright sales are not the only means of ownership transfer, and might not even be the most common. A SETC investigation of 20 provinces found that direct sales were used in only about 1/4 of all transfers of small and medium-sized enterprises in 1998. A variety of options have been employed to “let go” of small SOEs in addition to outright sales, including asset restructuring, mergers and acquisition, strategic alliances, leasing, and formation of stockshare or shareholding cooperatives. For example, Shanghai has now introduced the shareholding system to small enterprises in the past few years, and the pace of conversion has been accelerating.

40. **Equity issuance by large enterprises.** The pace of new listings, which had begun to decelerate in the second half of 1997, slowed significantly in 1998, partly due to weak stock market conditions. Only 109 new companies were listed on China’s stock markets, raising Y 43.2 billion, compared with 222 new listings raising Y 60 billion in 1997.<sup>11</sup> The pace of new listings has fallen further in recent months, and is now running at only about 8 per month on China’s A-share market; only one new company has listed on China’s B-share market in the past nine months. Sentiment also soured significantly on the Hong Kong SAR market as well in the wake of the GITIC closure and bankruptcy; three initial public offerings (IPOs) scheduled for early 1999 have been postponed, and work on other potential IPOs in the Hong Kong SAR market has also slowed.<sup>12</sup>

#### **D. The Direction of SOE Reform in 1999**

41. In the early months of 1999, senior officials renewed their commitment to SOE reform despite concerns over unemployment. Premier Zhu in his annual Work Report opening the NPC this past March pledged to redouble reform efforts and the pursuit of profitability in the state enterprise sector (Box III.6). Despite the continued deterioration in SOE performance in 1998, the authorities remain committed to their initial three-year time frame, and will focus the final two years of the program on improving the performance of a select group of 7,680 medium and large-sized SOEs. In particular, the objective will be to reduce the proportion of loss-making enterprises within this group from one-third in 1998 to

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<sup>11</sup>As of end-1997, 59 of the 120 pilot enterprise groups, 186 of the 512 key enterprises, and 40 of the 100 large enterprises targeted for conversion to modern enterprise systems had been listed on the stock market. The authorities were unable to provide end-1998 data.

<sup>12</sup>Sentiment has improved in the past two months, in part as a result of government stimulus measures, and domestic share prices as well as those of mainland-related companies listed in Hong Kong SAR have risen significantly. Therefore, it appears likely that the pace of new listings both at home and abroad will pick up significantly in the coming months.

no more than 15 percent by end-2000, a level comparable with developed market economies.<sup>13</sup>

42. To this end, the authorities have indicated that there would be greater emphasis on bankruptcy and sectoral restructuring, which would be aimed almost exclusively at reducing the number of large loss-making SOEs in line with the above target. Priority will be given to sectors with the largest numbers of loss makers, such as textiles, coal, metals, and defense-related industries, and the annual limit on debt write offs has been eliminated. In addition, the debt write-off scheme will no longer be limited to the 111 pilot cities, and the selection of enterprises for debt write off will be made at the central rather than at the local level by the SETC. Further, the commercial banks themselves will be able to directly approve the enterprises eligible for debt write off; previously, this had to be cleared by the People's Bank of China.

43. The SOE reform strategy will be continued in 1999. As noted by Minister Sheng Huaren of the SETC during this year's NPC, the "causes of the disease" are now well known—i.e., oversupplied products due to duplicated industrial activity, employee redundancy, and poor enterprise management—and "effective therapies" have already been identified—i.e., the basic approaches set out during the September 1997 15th Party Congress. A further major package of SOE reform measures along these lines is expected to be announced later this year, following the fourth plenary session of the Communist Party Central Committee this coming September, which is to be dedicated primarily to enterprise reform. Among the initiatives reported to be under consideration is an acceleration of the conversion of large SOEs into shareholding companies, a major plank of the SOE reform agenda tabled at the 15th Party Congress.

44. Reforms in other complementary areas, in particular in the financial sector and in expanding the scope for private sector activity, are also set to intensify and should help to facilitate a deepening of the SOE reform process in the period ahead. In particular, the AMCs, once up and running, could also play an important catalytic role in accelerating enterprise restructuring and relieving financing constraints. The prospect of WTO accession, still better at present than it has been during most of China's 13-year membership quest, should also prompt bolder steps on the enterprise reform front to make the state sector more competitive.

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<sup>13</sup>A special office devoted to achieving this objective has been set up within the SETC. The office is currently in the process of categorizing the 2,346 loss makers in this group by restructuring option—e.g., bankruptcy, debt/equity swap, corporate downsizing, etc.

### Box III.1. Directed Bank Lending

At the beginning of 1998, credit quotas were abandoned in favor of a credit guidance plan, and commercial banks were authorized to become more selective in their lending activities. In particular, government intervention in the banks' lending decisions was to be minimized to allow them to operate more fully on commercial principles. While the large state banks did in fact report that they were under less government pressure than in the past, the following indicates that directed lending nevertheless continued in 1998:

- The People's Bank of China "issued a circular *ordering* all commercial banks to channel no less than 15 percent of their new loan to residential housing" (*China Daily*, May 8, 1998, italics added).
- "The central bank *requires* urban banks ... to concentrate their credits on the development of small- and medium-sized enterprises" (*China Daily Business Weekly*, June 1, 1998, italics added).
- "The People's Bank of China, the State Economic and Trade Commission, and the State Administration of Taxation ... in a jointly issued circular, said ... that money-losing state-owned enterprises need to be given support to make products that can bring them a profit ... *banks need to provide credit to money-losing enterprises with a revolving line of credit*" (*China Daily*, June 27, 1998, italics added).
- "The People's Bank of China last month issued guidelines urging the financial sector to help boost spending *to ensure the targeted economic growth*" (*China Daily Business Weekly*, July 5, 1998, italics added).
- "Beijing municipal government will soon unveil a package of radical policies designed to support development of small-sized state-owned enterprises ... [These] policies are expected to include *preferential bank loans* and various tax breaks for investors in some enterprises" (*China Daily*, September 9, 1998, italics added).
- "The state-set 8 percent economic growth rate is not only an economic target but also a great political responsibility ... Financial institutions need to know this" [Said in connection with the announcement that the state banks would finance half of the Y 200 billion fiscal stimulus package.] (*China Daily*, September 19, 1998).

### **Box III.2. The Causes and Effects of the Sub-Optimal Investment Scale in China**

In China, capital is not efficiently utilized. Market forces that would otherwise drive firms to strive for economies of scale continue to be fettered by the political structure, creating a trend toward a "miniaturization" of investment projects. Lance Gore of the National University of Singapore in a recent issue of *The China Journal* identified four underlying institutional causes of the sub-optimal scale of investments in China:

- **First, the vertical ties between enterprises and their supervising government agencies effectively block the normal market mechanisms of business expansion**, for the operation of these mechanisms requires the elimination or substantial lowering of the political barriers to factor flows across the national economy.
- **Second, the exponential growth of extra-budgetary funds disperses investment capital.** "Extra-budgetary funds" cover a range of revenues not listed in the state budget, including whatever is left after fulfilling the fiscal or tax-profit contracts, the surpluses under the various profit retention schemes, fees and levies collected by government agencies, revenues generated by legal and illegal business ventures started by government units, and a wide range of funds the sources and purposes of which were pre-designated. In 1978, extra-budgetary funds amounted to 31 percent of the state budgetary funds; by the early 1990s they had grown on par with the state budget. Because they were so widely scattered among the localities, government departments, manufacturing enterprises, and administrative units, their growth represented further dispersion of investment capital and, consequently, the fragmentation of China's investment structure.
- **The third institutional mechanism involves the capture of branches of the state-owned commercial banks by local governments.** The overwhelming majority of China's investment capital is raised through banks. Since the beginning of the reform period, individuals' savings accounts have become the single most important source of investment capital. In 1997, for example, the stock of total bank loans reached Y 7.5 trillion, compared to total fixed asset investment of Y 2.5 trillion. Because local bank branches were under the "dual leadership" of their bank headquarters and the local governments, with the latter controlling personnel appointments and other key aspects of their operations, the branches were in fact heavily swayed by the local governments. Further, because the contract responsibility system introduced into the banking system in 1985 tied the scale of loans to the total deposits the banks generated, the branch banks, often backed by local governments, have tried very hard to keep financial resources within their locality. Thus, with the fragmentation of the banking system along regional lines, the state commercial banks were in fact localized.
- **Finally, the investment capital held by both the central government and the localities has been further dispersed by so-called "fishing" and "reverse fishing."** "Fishing" is a practice in which central agencies (usually the line ministries) intentionally leave large funding gaps in their planned projects in order to lure the localities to fill these gaps with their own capital when they bid for projects for their own districts. It is a strategy the central government has used to remedy its weakened control over investments and to influence the investment behavior of the localities. The higher-level local government units, such as the provinces, in their turn have not only produced their own versions of "fishing" with governments at lower levels, but have also practiced a sort of "reverse fishing" with the central government, largely by deliberately under budgeting for joint projects to force the center to put up more money. These tactics have also added to the fragmentation of national investment.

The State Council on several occasions has issued regulations specifying the minimum size of new investment projects, with little effect. The result is that very few Chinese companies are large relative to producers in other countries, despite the large overall size of China's economy. For example, in 1996 China's 1,700 steel plants produced an average of only 54,000 tons, while most of the world's steel plants were concentrated at the 1-5 million ton and 10-20 million ton levels. The 1.5 million-odd automobiles currently built by China's several hundred domestic producers are less than the output of a single Japanese or U.S. producer (and less than a quarter of Toyota's production alone).

### Box III.3. Duplicated Constructed Explained

Lance Gore of the National University of Singapore in a recent issue of *The China Journal* presents a useful explanation of duplicated construction. He notes the presence of a bureaucratic rivalry within China--which emanates from the reform-era decentralization empowering local governments--with various local officials pitched against one another directly in an intense competition to build the best showcase projects, accrue the most resources, extract the most favorable policy concessions from Beijing, and generate the highest rate of growth for the localities or organizations they represent. Indeed, boosting the overall prosperity of the communities they are in charge of is generally the best way to advance their own careers. This has resulted in widespread duplicated construction and local economies that have tended to become alike.

**Duplicated construction is a phenomenon where many localities rush into the same industry to produce the same products.** It is caused by a combination of factors including a lack of market information, cross-local and cross-organizational emulation in production, as well as low personal risks in bureaucratic decision-making. Private investors generally bear the full risk of their investment decisions, and the waste of resources that results is theoretically minimized, but in investment decisions made by state actors, the neo-classical logic does not necessarily hold--state actors follow a logic of a territorial economy, not an enterprise-level logic of profitability, and as capital-less "capitalists", they generally do not bear the entire risk of their adventures in the marketplace.

There are two facets to this duplicated construction in China:

- On the one hand, localities at the provincial and municipal levels, which control considerable resources and political clout and enjoy access to the world market vie to import state-of-the-art production lines for "hot" consumer items, to such an extent that the production capacities of the new industries quickly exceeded market demand. Since the early 1980s there have been successive waves of such over-investment at the high end of duplicated construction, especially in the home electronics and appliance industries.
- On the other hand, there has been massive low-tech duplication at the lower end. Among lower-level localities and enterprises, where in general resources are more scattered and external access limited, local protectionism and bureaucratic emulation sink much of China's scarce investment resources into duplicated production facilities in massive numbers. This was especially true in the 1980s for the TVEs, which often bought equipment phased out by urban SOEs and hired retired skilled urban workers and technicians who were familiar with the old technologies and equipment.

The authorities have long recognized that small-scale and obsolete rural factories have diverted scarce energy and raw materials away from the large and medium-sized SOEs. During the reform period the government has repeatedly tried to limit the growth of such firms, with little effect as local governments have protected and promoted them. According to the National Bureau of Statistics, in 1996 only 20 percent of China's enterprises had reached world-standard technological levels; the majority were still using technologies of the 1960s and 1970s, and some were stuck with technologies of the 1940s and 1950s.

**The resulting duplicated construction is sustainable only under one condition, which has now virtually disappeared, namely market shortages.** The process of duplicated construction was sustained for a decade or more by pent-up consumer demand as China came out of the Maoist era of chronic shortages. This high demand--and the extraordinary institutional capacity of local bureaucrats to mobilize production to meet it--was perhaps the most important structural condition for the dramatic rise of the TVEs during the 1980s. However, this massive duplication eventually built up to overcapacity, which in turn reduced or even eliminated the profit margins of many enterprises, and elevated market competition to such an intensity that the majority of the old socialist-style enterprises generated by bureaucratic entrepreneurship found it difficult to adjust. As a result, profit margins of many enterprises, particularly SOEs, have plummeted, and whole industries among the SOEs have been operating at a loss since the mid-1990s.

#### **Box III.4. The "Huangpu Army"**

Premier Zhu calls these retired officials trained as inspectors to go out and investigate China's largest SOEs for financial irregularities his "Huangpu Army". The Huangpu Army is a reference to the graduates of a Guangzhou military academy early this century that produced officers for the nationalist army that united the mainland in the 1920s and for the Communist army that defeated it in 1949. His use of the term indicates the importance he places on the inspectors, whom he wants to be China's first independent auditors since 1949.

Their function is to examine the books of SOEs that still account for 60 percent of state enterprise revenue. The first inspectors, all retirees at the rank of vice minister or above, received more than two months of specialized training in auditing, accounting, and financial management at Beijing's prestigious Qinghua University. At their graduation, during which they swore an oath of allegiance to their responsibilities, Mr. Zhu told them that diligence to their duties would earn them a special place in China's history.

Their tasks include inspection of enterprises' books over a three-year period and questioning of staff at all levels and departments. They have the power to recommend dismissal of any senior company executive, including the local Communist Party secretary. They can also recommend bonuses or fines. All inspectors are instructed not to show their reports to the company under investigation, nor can they accept any hospitality, gifts or shares, or receive any benefits for their families or associates.

Accompanied by four experts in accountancy and finance, they began visiting companies in July of last year, and the initial class of 21 delivered its first reports on some of China's largest and best known SOEs--including China Offshore Oil, China Grain & Foodstuffs Import and Export Corp., Huaneng Group, China Unicom, and China Eastern Airlines--in mid-March, and the results were surprising. The inspectors found financial irregularities--including tax evasion, false reporting of profits and losses, fake assets, and management practices in listed companies inconsistent with stock-exchange rules--as well as numerous cases of corruption.

### Box III.5. The Financing Structure of China's Enterprises

Although it is difficult to obtain comprehensive and timely data on the financing structure of enterprises, Jean-Francois Huchet in a recent issue of *China Perspectives* has drawn up useful profiles of the various kinds of enterprises operating in China's economy based on case studies, press reports, and annual reports of listed companies.

**Large SOEs.** While far from being *chaebols*, the 1,000 or so large SOE still represent roughly 60 percent of total industrial assets and provide perhaps a slightly higher percentage of tax revenue. They have availed of all their political connections to gain privileged access to the large state commercial banks and secure all the existing forms of credit (subsidized loans, short-term loans, access to foreign currency for technology imports, etc.). From the early 1990s they have literally taken the stock market by storm and now represent nearly all the companies listed on the domestic stock market, as well as the group of Chinese companies quoted in Hong Kong ("H" shares) and New York ("N" shares). They have also taken advantage of the policy of group creation, which authorized them to set up financial subsidiaries enabling them to raise capital for the group and manage the internal resource flow. An estimated half of the 156 enterprise groups currently authorized by the State Council to do this have set up such financial subsidiaries.

**Red chips.** The red chips, a variation of the large SOEs, are all Hong Kong subsidiaries of the big conglomerates and financial holding companies that are answerable either to the State Council (e.g., CITIC), to the central ministries (e.g., China Resources), or the provincial governments (e.g., the now defunct GITIC). Their spheres of activity stretch from financial services through agri-business to transport. In terms of financing, they have benefited from all the available authorized sources. However, in contrast with the large SOEs, they were authorized, some as early as the mid-1980s, to use the Hong Kong stock market to raise capital to finance the activities of their mainland parents. Some red chips are highly indebted--e.g., Shanghai Industrial Investment, Guangdong Enterprise Holdings, and COSCO--and there has been a rash of recent scandals and controversy regarding their activities.

**Leading companies.** These comprise companies that are dominant in their particular sector. They are sizable, and for the most part remain under state control, but are nevertheless to be distinguished from the large SOEs by their greater profitability and technical efficiency, by a certain managerial independence wrested from their local authorities (who are often the de facto owners), and by their ability to stand up to foreign competition on the domestic market. They are particularly common in light industries, like Haier and Kelon (leaders in household appliances) or Changhong and Konka (leaders in the TV industry). At present, with the exception of a few groups like New Hope in agri-business, few such companies are private. They are often no more than a handful of companies in each sector, and have been able to achieve considerable economies of scale, covering the entire country as well as overseas markets.

In contrast with large SOEs, they were not necessarily considered by the central government as having priority access to subsidies or financing. Competition, rather than state subsidy has pushed them to the tops of their sectors and has had important effects on their financial structure. Indeed, self-financing from trading profits has been the major driving force in their expansion. Their bank indebtedness is low, at between 30-50 percent of assets, much lower than the average for SOEs. They have also sought to make better use of internal financial resources, with joint investment programs among their subsidiaries. For those so authorized, flotation on the stock market has been very beneficial, given the financing needs generated by their rapid growth.

**Small and medium-sized urban SOEs and collectives.** These correspond to the bulk of small and medium-sized urban state and collective enterprises, many of which are in serious financial difficulties. Most of these are being bailed out by directed loans from the state banks and the urban credit cooperatives, often to preserve social stability, given their high share of urban employment. More recently some of them have attempted to recapitalize at the expense of their workers with the issue and compulsory purchase of internal shares by the company's collective.

**Small and medium-sized rural private enterprises and collectives.** These enterprises, which include the bulk of the rural township and village enterprises (TVEs) have been most discriminated against in terms of official financing. Their only available sources of financing have been self-financing and the informal financial channels and, very incidentally, the rural and urban credit cooperatives. National figures on the amount of informal financing are hard to come by, but studies of rural companies indicate that what goes by the Chinese name of *minjian jiedai shichang* (popular credit market, including tontines, loans from private individuals, as well as family help and loans) could represent between a quarter and a third of total financing.

### **Box III.6. Premier Zhu's Annual Work Report to the 1999 National People's Congress**

Premier Zhu in his annual Work Report opening the NPC this past March set out three broad sets of measures to fulfill his pledge to turn the state sector around by the end of next year:

- **First, redundant construction activity must be stopped and enterprise restructuring and reorganization accelerated.** To this end, the continued investment in excess productive capacity by local governments should cease, and commercial banks should stop lending to such projects. In addition, the restructuring programs in the textile, coal, metallurgical, petrochemical, building materials, machine building, electronics, and light industrial sectors should be continued to further reduce existing excess capacity. In addition, small enterprises that are technologically backward, inefficient, and polluting that produce inferior products should be eliminated. Finally, in line with the principle of breaking up monopolies and encouraging competition, technologically advanced enterprise groups should be formed through association, merger, and reorganization.
- **Second, the basic needs of laid off workers (*xiagang*) should continue to be guaranteed and assistance should continue to be provided to help them find them new jobs.** Efforts in the area initiated during 1998 should be continued and success of these efforts will hinge on the provision of adequate funding. In this regard, local governments are to restructure their expenditures and give top priority to funding for this purpose. In addition, there will be financial support in the form of increased transfer payments from the central government to localities that could not afford to finance an adequate social safety net from their own resources. Further, vocational training should be strengthened, relations with original enterprises severed following re-employment, continued welfare benefits provided to those unable to find employment after three years, and pension payments made regularly and arrears cleared.
- **Third, functional separation of government from enterprises should be continued, the supervisory system improved, and the leadership of enterprises consolidated and improved.** Local governments are to carry out the same restructuring that had been carried out at the central government level in 1998, cutting the direct administrative links between government agencies and enterprises. In addition, the supervisory inspection system should be continued to strengthen supervision of enterprises and protect the safety of state-owned assets. More competent people should be chosen to head enterprises, and their performance should be more closely supervised. Leaders of enterprises recording large losses because of poor management will receive a warning the first year and be dismissed in the second year if the situation persists. Meanwhile, those whose enterprises yield good economic returns and make great contributions to society will be rewarded.
- **Finally, unified accounting and modern enterprise management systems should be established in all SOEs, and their technological development and competitiveness enhanced.** The policy of releasing small enterprises would also be continued, without undue reliance on direct sales, and fraudulent practices stopped. Policies and measures to encourage and support the development of enterprises under other forms of ownership, including individual and private ownership (see below), should be adopted.

Table III.1. China: State-Owned Enterprise Indicators, 1985-98 1/

	1985	1990	1991	1992	1993	1994	1995	1996	1997	1998
<b>I. Number of enterprises</b> (In thousands)										
State-owned enterprises	...	...	...	205.4	280.4	224.9	305.0	260.8	254.0	249.0
Agriculture	...	...	...	12.9	15.8	17.6	...	4.1	3.9	3.7
Industry	...	...	...	76.3	73.3	72.3	...	75.6	72.5	69.8
Construction	...	...	...	1.6	2.1	3.6	...	6.7	7.1	8.0
Services	...	...	...	114.5	189.3	131.5	...	16.3	16.9	20.0
Centrally administered	...	...	...	...	75.4	19.9	...	16.2	18.1	19.0
Locally administered	...	...	...	...	204.9	205.0	...	244.6	236.0	230.0
<b>II. Fixed assets</b> 2/ (In billions of yuan)										
State-owned enterprises	800.5	1535.2	1785.6	2054.6	2514.6	3300.6	4259.5	5837.0	6617.9	7314.5
Agriculture	33.9	56.8	63.4	70.3	79.8	94.9	123.2	143.3	53.4	56.7
Industry	518.2	978.8	1137.8	1302.7	1559.0	1925.6	2573.3	3641.8	4137.4	4719.3
Construction	22.4	38.5	42.0	43.5	57.9	80.8	111.4	127.4	154.2	182.9
Services	225.9	461.1	542.5	638.0	818.0	1199.3	1451.7	134.9	164.0	214.7
Centrally administered	...	...	...	...	...	...	...	2737.2	3137.7	3392.5
Locally administered	...	...	...	...	...	...	...	3099.8	3480.1	3922.0
<b>III. Employment</b> (In millions of employees)										
State-owned enterprises 1/		77.1	79.1	79.6	79.2	81.0	81.2	72.0	70.5	69.2
Agriculture	7.3	7.4	7.3	7.2	6.7	6.5	6.3	3.7	3.4	3.1
Industry	38.2	43.6	44.7	45.2	45.0	43.7	44.0	42.0	40.1	38.9
Construction	5.8	6.2	6.4	6.8	6.6	8.2	8.2	4.6	4.6	4.8
Services	17.1	19.9	20.7	20.5	20.9	22.6	22.6	1.8	1.9	2.0
Centrally administered	...	...	...	...	...	...	...	19.4	19.3	18.7
Locally administered	...	...	...	...	...	...	...	52.6	51.2	50.5
<b>IV. Gross output</b> (In billions of yuan)										
State-owned enterprises										
Industry	630.2	1306.4	1495.5	1782.4	2272.5	2620.1	3122.0	2836.1	2902.8	2981.0
Construction	47.5	93.5	106.2	143.2	205.5	303.4	367.0	416.0	452.7	523.7

Source: National Bureau of Statistics; State Equity Statistics and Evaluation Department of the Ministry of Finance; and staff estimates in italics.

1/ The aggregation method was changed in 1996.

2/ Fixed assets are at original value.

Table III.2. China: State-Owned Industrial Enterprises Indicators, 1985-98

	1985	1990	1993	1994	1995	1996	1997	1998
<b>I. Number of enterprises 1/</b>								
	(In thousands)							
Total industrial enterprises	5185.3	7957.8	9911.6	10017.1	7341.5	7986.5	7922.9	7858.8
State-owned	93.7	104.4	104.7	102.2	118.0	113.8	98.6	84.2
Non-state owned	5091.6	7853.4	9806.9	9914.9	7223.5	7872.7	7824.3	7774.6
of which independent accounting 2/	372.0	417.1	449.2	465.2	510.4	506.4	468.5	430.0
State-owned	69.8	74.8	80.6	79.7	87.9	87.0	74.4	60.5
Large	...	...	3.8	4.0	4.7	4.9	4.8	4.7
Medium	...	...	10.4	10.5	11.0	10.8	10.1	9.0
Small	...	...	66.4	65.2	72.2	71.2	59.5	46.8
Non-state owned	302.2	342.3	368.6	385.5	422.5	419.5	394.1	369.5
<b>II. Fixed assets (original value) 2/</b>								
	(In billions of yuan)							
Industrial fixed assets	688.6	1439.0	2581.8	3344.1	4498.9	5202.7	5957.0	6560.4
State-owned enterprises	595.6	1161.0	1906.6	2310.2	3093.6	3476.5	3835.1	4122.0
Large	...	...	1219.6	1541.3	2085.2	2387.3	2685.1	2923.3
Medium	...	...	344.8	410.7	557.3	600.7	619.1	633.8
Small	...	...	342.1	358.2	451.0	488.5	530.9	564.9
Non-state owned	93.0	278.0	675.2	1033.9	1405.3	1726.2	2121.9	2438.6
<b>III. Employment</b>								
	(In millions)							
Total industrial employment	83.5	112.3	118.2	120.7	123.1	127.7	130.5	132.8
State-owned enterprises	38.2	43.6	45.0	43.7	44.0	42.8	40.4	38.0
Non-state owned	45.3	68.7	73.2	77.0	79.1	85.0	90.1	94.8
Total urban industrial employment	55.6	63.8	66.3	65.8	66.1	64.5	62.2	60.0
State-owned enterprises	38.2	43.6	45.0	43.7	44.0	42.8	40.4	38.0
Non-state owned enterprises	17.4	20.1	21.3	22.1	22.1	21.7	21.8	22.0
of which independent accounting 2/	60.8	81.5	85.7	83.5	85.8	85.4	84.4	82.5
State-owned enterprises	36.9	40.7	42.6	42.6	42.6	41.4	39.4	36.5
Non-state	23.9	40.8	43.2	40.9	43.2	44.0	45.0	46.0
<b>IV. Gross output 3/</b>								
	(In billions of yuan)							
Gross industrial output	971.6	2392.4	4840.2	7017.6	9189.4	9959.5	11373.3	12987.8
State-owned enterprises	630.2	1306.4	2272.5	2620.1	3122.0	2836.1	2902.8	2970.9
Non-state owned	341.4	1086.0	2567.7	4397.5	6067.4	7123.4	8470.5	10072.6
of which independent accounting 2/	794.0	1868.9	3969.3	5135.3	5494.7	6274.0	6835.3	7805.6
State-owned enterprises	565.7	1257.0	2208.8	2530.1	2589.0	2728.9	2785.9	2851.4
Large	...	...	1251.9	1505.8	1590.7	1728.2	1843.4	1966.3
Medium	...	...	521.1	553.5	530.2	522.8	487.5	454.6
Small	...	...	435.8	470.8	468.0	477.9	454.9	430.5
Non-state owned	228.3	611.9	1760.5	2605.2	2905.7	3545.1	4049.4	4954.2
<b>V. Value added</b>								
	(In billions of yuan)							
Industrial value added	344.9	685.8	1414.4	1936.0	2471.8	2908.3	3258.2	3354.1
State-owned enterprises	288.0	466.2	749.1	917.6	1082.6	1193.2	1291.9	1300.6
Non-state owned	56.8	219.6	665.3	1018.4	1389.2	1715.1	1966.3	2053.5
Of which independent accounting 2/	325.9	629.8	1284.3	1470.0	1544.6	1802.6	1983.5	2802.5
State-owned enterprises	258.6	448.6	728.1	790.3	830.7	874.2	919.3	1248.2
Non-state owned	67.4	181.2	556.2	679.7	713.9	928.4	1064.2	1554.3

Source: National Bureau of Statistics and staff estimates (in italics).

1/ Figures for state-owned enterprises compiled by the State Statistical Bureau reflect a different aggregation methodology than that used by the Ministry of Finance in Table 1.

2/ For enterprises at the township level and above with independent accounting systems.

3/ Accounting methodology was changed in 1995.

Table III.3. China: Relative Shares of State Industrial Enterprises, 1993-98 1/

	1993	1994	1995	1996	1997	1998
<b>I. Number</b> (SOE as a share of the total)						
Total	17.9	17.1	17.2	17.2	15.9	<i>14.3</i>
Light industry	18.1	17.3	17.5	17.4	16.1	<i>14.5</i>
Heavy industry	17.7	17.0	16.9	17.0	15.7	<i>14.2</i>
Large	83.3	77.3	73.0	70.1	66.7	<i>62.2</i>
Medium	73.6	69.2	66.2	64.1	60.5	<i>56.0</i>
Small	15.4	14.7	14.8	14.8	13.4	<i>11.9</i>
<b>2. Gross output value</b> (SOE as a share of the total)						
Total	55.6	49.3	47.1	43.5	40.8	<i>36.4</i>
Light industry	42.2	36.4	35.0	31.4	28.3	<i>24.2</i>
Heavy industry	64.7	58.7	56.2	52.6	50.1	<i>45.3</i>
Large	84.9	77.1	72.9	69.9	68.2	<i>63.2</i>
Medium	69.4	61.8	58.4	54.8	49.6	<i>42.6</i>
Small	25.0	20.6	19.5	16.8	14.4	<i>12.3</i>
<b>3. Value-added</b> (SOE as a share of the total)						
Total	56.7	53.8	53.8	48.5	46.3	<i>42.0</i>
Light industry	42.9	40.0	38.3	34.9	32.7	<i>29.1</i>
Heavy industry	65.3	62.6	62.6	57.6	55.5	<i>50.8</i>
Large	86.7	80.3	77.5	76.0	73.9	<i>68.3</i>
Medium	70.7	64.2	61.8	57.9	53.6	<i>47.1</i>
Small	25.3	22.3	20.5	17.6	15.8	<i>13.5</i>
<b>4. Fixed assets 2/</b> (SOE as a share of the total)						
Total	73.8	69.1	66.1	66.8	64.4	<i>59.0</i>
Light industry	53.7	50.0	49.6	48.2	45.0	<i>39.9</i>
Heavy industry	81.8	76.8	73.4	74.3	72.1	<i>66.5</i>
Large	91.0	84.9	81.4	82.5	80.3	<i>76.6</i>
Medium	77.4	73.6	72.3	71.0	67.5	<i>61.0</i>
Small	43.0	36.9	35.4	33.4	31.3	<i>27.9</i>
<b>5. After-tax profits</b> (SOE as a share of the total)						
Total	51.0	46.1	40.7	27.7	25.1	<i>21.6</i>
Light industry	21.5	18.0	19.8	-3.7	8.3	<i>7.8</i>
Heavy industry	60.2	58.2	50.1	41.9	34.3	<i>26.7</i>
Large	73.4	67.8	64.0	53.2	52.9	<i>50.0</i>
Medium	47.8	19.4	-18.0	-553.5	-302.3	<i>-320.0</i>
Small	21.4	-0.5	-11.5	-20.1	-21.2	<i>-30.0</i>

Source: National Bureau of Statistics and staff estimates in italics.

1/ Data for enterprises at the township level and above with independent accounting systems.

2/ Fixed assets are at original value.

Table III.4. China: Industrial Enterprises Growth Indicators, 1993-98

(Percent change over previous year)

	1993	1994	1995	1996	1997	1998
<b>I. Number of enterprises</b>						
Total industrial enterprises	15.1	1.1	-26.7	8.8	-0.8	-0.8
State-owned	1.4	-2.4	15.5	-3.6	-13.4	-14.6
Non-state owned	15.3	1.1	-27.1	9.0	-0.6	-0.6
of which independent accounting 1/	10.1	3.6	9.7	-0.8	-7.5	-8.2
State-owned	8.8	-1.1	10.3	-1.0	-14.5	-18.7
Large	...	5.1	16.9	5.6	-3.0	-2.1
Medium	...	0.9	4.5	-1.5	-6.6	-10.9
Small	...	-1.7	10.8	-1.4	-16.5	-21.3
Non-state owned	10.4	4.6	9.6	-0.7	-6.0	-6.2
<b>II. Fixed assets (original value) 1/ 2/</b>						
Industrial fixed assets	12.9	8.0	18.8	9.1	13.3	11.6
State-owned enterprises	6.2	1.1	18.3	6.0	9.1	8.9
Large	...	5.4	19.5	8.0	11.3	10.3
Medium	...	-0.7	19.9	1.7	1.9	3.7
Small	...	-12.7	11.2	2.2	7.5	7.8
Non-state owned	37.2	27.7	20.1	15.9	21.6	16.4
<b>III. Employment</b>						
Total industrial employment	2.2	2.1	2.0	3.8	2.2	1.8
State-owned enterprises	-0.4	-2.8	0.6	-2.7	-5.5	-5.9
Non-state owned	3.8	5.1	2.8	7.4	6.0	5.2
Total urban industrial employment	0.1	-0.7	0.5	-2.4	-3.6	-3.5
State-owned enterprises	-0.5	-2.9	0.6	-2.7	-5.6	-5.9
Non-state owned enterprises	1.3	3.9	0.1	-1.9	0.1	1.1
of which independent accounting 1/	6.8	-2.6	2.7	-0.4	-1.2	-2.2
State-owned enterprises	0.2	0.0	0.0	-2.7	-5.0	-7.3
Non-state	14.1	-5.2	5.5	1.9	2.4	2.2
<b>IV. Gross output</b>						
Gross industrial output	27.3	24.2	20.3	16.6	13.1	10.7
State-owned enterprises	5.7	6.5	8.2	5.1	3.8	4.6
Collective enterprises	35.0	24.9	15.2	20.9	10.2	11.6
Individual-owned enterprises	66.2	56.3	51.5	20.0	15.4	28.4
Others	92.5	74.3	37.2	23.8	30.2	17.6
<b>V. Value added</b>						
Industrial value added	20.1	18.9	14.0	12.5	11.1	8.9
State-owned enterprises	...	5.5	7.2	6.4	5.4	4.9
Collective	...	21.4	15.8	17.4	11.7	8.7
Others	...	28.0	19.0	13.1	13.4	12.8

Source: National Bureau of Statistics and staff estimates in italics.

1/ For enterprises at the township level and above with independent accounting systems.

2/ Real growth rate of fixed assets has been deflated by implicit GDP deflator.

Table III.5. China: State-Owned Enterprise Assets and Liabilities, 1993-98 1/

(In billions of dollars)

	1993	1994	1995	1996	1997	1998
<i>State-owned enterprises 2/</i>						
Assets	5955.1	7449.3	...	11899.7	13908.4	<i>15443.4</i>
Liabilities	4267.5	5299.1	...	7830.4	9049.6	<i>9929.1</i>
Ratio	(71.7)	(71.1)	...	(65.8)	(65.1)	<i>(64.3)</i>
<b>Industry</b>						
Assets	3481.4	4189.7	...	6015.5	7220.8	<i>8234.2</i>
Liabilities	2456.2	2970	...	3858.7	4569.3	<i>5140.2</i>
Ratio	(70.6)	(70.9)	...	(64.1)	(63.3)	<i>(62.4)</i>
<b>Construction</b>						
Assets	167.5	231.6	...	491.5	587.8	<i>667.8</i>
Liabilities	134.7	192.9	...	389.4	460.8	<i>518</i>
Ratio	(80.4)	(83.3)	...	(79.2)	(78.4)	<i>(77.6)</i>
<b>Agriculture</b>						
Assets	248.3	310.5	...	116.4	132.4	<i>143.1</i>
Liabilities	181.6	229.1	...	90.99	102	<i>108.6</i>
Ratio	(73.1)	(73.8)	...	(78.2)	(77.0)	<i>(75.9)</i>
<b>Services</b>						
Assets	205.789	271.75	...	261.5	319.1	<i>369.9</i>
Liabilities	149.5	190.71	...	149.7	176.8	<i>198.4</i>
Ratio	(72.6)	(70.2)	...	(57.2)	(55.4)	<i>(53.6)</i>
<i>Industrial SOEs with independent accounting systems 3/</i>						
Assets	3262.6	3844.7	4747.2	5275.5	5910.8	<i>6291.5</i>
Liabilities	2201.4	2610.4	3114.9	3432.4	3831.5	<i>4063.2</i>
Ratio	(67.5)	(67.9)	(65.6)	(65.1)	(64.8)	<i>(64.6)</i>
<b>Heavy industry</b>						
Assets	2370.7	2838.8	3500.0	3907.0	4451.0	<i>4817.2</i>
Liabilities	1527.7	1834.0	2195.6	2425.8	2788.9	<i>3046.0</i>
Ratio	(64.4)	(64.6)	(62.7)	(62.1)	(62.7)	<i>(63.2)</i>
<b>Light industry</b>						
Assets	891.9	1005.9	1247.2	1368.7	1459.7	<i>1478.9</i>
Liabilities	673.7	776.4	919.3	1006.7	1042.6	<i>1025.8</i>
Ratio	(75.5)	(77.2)	(73.7)	(73.5)	(71.4)	<i>(69.4)</i>
<b>Large enterprises</b>						
Assets	1869.1	2361.1	2989.6	3422.3	3976.0	<i>4388.3</i>
Liabilities	1173.9	1498.0	1861.1	2092.1	2429.1	<i>2679.4</i>
Ratio	(62.8)	(63.4)	(62.3)	(61.1)	(61.1)	<i>(61.1)</i>
<b>Medium enterprises</b>						
Assets	710.6	779.3	945.1	1001.4	1024.9	<i>997.5</i>
Liabilities	526.8	589.8	677.1	724.0	740.3	<i>719.1</i>
Ratio	(74.1)	(75.7)	(71.6)	(72.3)	(72.2)	<i>(72.1)</i>
<b>Small enterprises</b>						
Assets	682.8	704.2	806.4	852.0	909.9	<i>923.1</i>
Liabilities	500.7	522.6	576.7	616.3	662.1	<i>675.7</i>
Ratio	(73.3)	(74.2)	(71.5)	(72.3)	(72.8)	<i>(73.2)</i>

Source: State Equity Statistics and Evaluation Department in the Ministry of Finance; the National Bureau of Statistics; and staff estimates in italics.

1/ Including both fixed and liquid assets, liquid and long-term liabilities.

2/ For state-owned enterprises, statistical coverage has been adjusted after 1995.

3/ For enterprises at county level and above with independent accounting system.

Table III.6. China: Indicators of Industrial Profitability, 1985-98 1/

	1985	1990	1993	1994	1995	1996	1997	1998
(In thousands)								
Total number of industrial enterprises	372.1	417.1	449.0	465.2	510.4	506.4	468.5	425.5
of which loss-making	40.4	87.9	86.7	93.0	127.9	111.3	<i>116.8</i>	<i>119.1</i>
(in percent)	10.9	21.1	19.3	20.0	25.1	22.0	<i>24.9</i>	<i>28.0</i>
Number of state-owned industrial enterprises	69.8	74.8	80.6	79.7	87.9	87.0	74.4	60.9
of which loss-making	...	...	...	24.6	29.7	31.2	<i>31.4</i>	<i>30.5</i>
(in percent)	...	...	...	30.9	33.8	35.9	<i>42.2</i>	<i>50.1</i>
(In billions of yuan)								
Total industrial enterprises								
Fixed assets (original value)	688.6	1439.0	2581.8	3344.1	4498.9	5202.7	5957.0	6560.4
Gross output	870.1	1606.8	3411.7	4415.0	5494.6	6274.0	6835.3	<i>7805.6</i>
Sales	680.9	1679.3	3808.4	4239.9	5316.4	5796.9	6345.1	<i>6835.4</i>
Sales cost	527.0	1225.8	2994.8	3368.1	4304.6	4706.6	5163.4	<i>5840.5</i>
Sales less costs	153.9	453.5	813.6	871.8	1011.9	1090.3	1181.7	<i>994.9</i>
Pre-tax profits (net)	165.7	194.6	392.4	493.5	505.0	514.7	574.0	<i>477.6</i>
After-tax profits (net)	92.9	56.0	160.2	179.7	163.5	149.0	170.3	<i>147.3</i>
Taxes	72.7	138.6	232.1	313.9	341.5	365.7	403.7	<i>330.3</i>
Losses of loss-making	4.1	45.4	63.9	77.2	119.9	143.1	158.7	<i>179.2</i>
State-owned industrial enterprises								
Fixed assets (original value)	595.6	1161.0	1906.6	2310.2	3093.6	3476.5	3835.1	<i>4122.0</i>
Gross output	656.7	1081.0	1899.0	2175.2	2586.3	2728.9	2785.9	<i>2851.4</i>
Sales	...	...	2264.3	2209.0	2610.3	2716.4	2798.6	<i>2895.9</i>
Sales cost	...	...	1753.6	1720.4	2069.1	2163.7	2241.3	<i>2435.2</i>
Sales less cost	...	...	510.7	488.6	541.2	552.6	557.3	<i>460.7</i>
Pre-tax profits (net)	133.4	150.3	245.5	287.6	287.4	273.7	290.7	<i>239.6</i>
After-tax profits (net)	73.8	38.8	81.7	82.9	66.6	41.3	42.8	<i>25.8</i>
Taxes	59.6	111.5	163.7	204.7	220.9	232.4	247.9	<i>213.9</i>
Losses of loss-making	3.2	34.9	45.3	48.3	64.0	79.1	83.1	<i>90.6</i>
Non-state industrial enterprises								
Fixed assets (original value)	93.0	525.8	675.2	1033.9	1405.3	1726.2	2121.9	<i>2438.4</i>
Gross output	213.4	525.8	1512.7	2239.8	2908.3	3545.1	4049.4	<i>4954.2</i>
Sales	...	...	1544.1	2030.8	2706.1	3080.5	3546.5	<i>3939.5</i>
Sales cost	...	...	1241.2	1647.7	2235.4	2542.8	2922.1	<i>3405.3</i>
Sales less cost	...	...	302.9	383.2	470.7	537.7	624.4	<i>534.2</i>
Pre-tax profits (net)	32.3	44.3	146.9	205.9	217.6	241.0	283.3	<i>238.0</i>
After-tax profits (net)	19.1	17.2	78.5	96.8	96.9	107.7	127.5	<i>121.5</i>
Taxes	13.2	27.1	68.4	109.1	120.7	133.3	155.8	<i>116.5</i>
Losses of loss-making	0.8	10.5	18.6	29.0	55.9	64.0	75.6	<i>88.6</i>
Total industrial enterprises (As a percent of gross output)								
Sales less cost	17.7	28.2	23.8	19.7	18.4	17.4	17.3	<i>12.7</i>
Pre-tax profits	19.0	12.1	11.5	11.2	9.2	8.2	8.4	<i>6.1</i>
After-tax profits	10.7	3.5	4.7	4.1	3.0	2.4	2.5	<i>1.9</i>
Taxes	8.4	8.6	6.8	7.1	6.2	5.8	5.9	<i>4.2</i>
Losses	0.5	2.8	1.9	1.7	2.2	2.3	2.3	<i>2.3</i>
State-owned industrial enterprises								
Sales less cost	...	...	26.9	22.5	20.9	20.2	20.0	<i>16.2</i>
Pre-tax profits	20.3	13.9	12.9	13.2	11.1	10.0	10.4	<i>8.4</i>
After-tax profits	11.2	3.6	4.3	3.8	2.6	1.5	1.5	<i>0.9</i>
Taxes	9.1	10.3	8.6	9.4	8.5	8.5	8.9	<i>7.5</i>
Losses	0.5	3.2	2.4	2.2	2.5	2.9	3.0	<i>3.2</i>
Non-state industrial enterprises								
Sales less cost	...	...	20.0	17.1	16.2	15.2	15.4	<i>10.8</i>
Pre-tax profits	15.1	8.4	9.7	9.2	7.5	6.8	7.0	<i>4.8</i>
After-tax profits	9.0	3.3	5.2	4.3	3.3	3.0	3.1	<i>2.5</i>
Taxes	6.2	5.2	4.5	4.9	4.1	3.8	3.8	<i>2.4</i>
Losses	0.4	2.0	1.2	1.3	1.9	1.8	1.9	<i>1.8</i>

Source: State Statistical Bureau and staff estimates (in italics).

1/ Data for enterprises at the township level and above with independent accounting systems.

Table III.7. China: Industrial SOE Profit Rate by Sector, 1993-97 1/ 2/

(In percent)

	1993	1994	1995	1996	1997
Total	3.7	3.3	2.6	1.5	1.5
Light industry	1.2	1.2	1.2	-0.2	0.6
Heavy industry	4.8	4.2	3.2	2.3	1.9
Large	4.7	5.3	4.5	3.3	3.4
Medium	2.0	0.5	-0.3	-1.5	-2.1
Small	2.9	-0.1	-0.8	-1.7	-2.2
Coal mining and processing	-2.1	-0.7	2.6	2.2	3.1
Petroleum and natural gas extraction	-2.4	10.2	8.4	8.8	10.2
Ferrous metals mining and processing	8.1	-0.7	-3.6	-2.0	-0.5
Nonferrous metals mining and processing	3.8	3.4	5.1	2.4	4.4
Nonmetal minerals mining and processing	2.5	0.3	-0.8	-1.0	-1.6
Other minerals mining and processing	2.3	1.0	2.8	0.7	-1.7
Logging and transport of timber and bamboo	7.4	5.1	3.8	1.2	0.4
Food processing	0.5	0.7	-0.1	-3.8	-3.8
Food manufacturing	-1.3	-1.5	-0.4	-1.5	-0.9
Beverage manufacturing	3.9	1.6	2.4	2.5	5.2
Tobacco processing	4.7	9.8	12.8	10.1	9.8
Textile industry	-2.1	-0.9	-3.3	-5.9	-4.4
Garments and other fiber products	2.2	1.1	-0.9	-0.8	-1.5
Leather, furs, down and related products	-3.2	-3.8	-3.6	-5.7	-6.0
Timber processing, bamboo, cane, palm fiber and straw products	2.4	-3.3	-4.9	-4.7	-5.2
Furniture manufacturing	0.2	0.5	-0.5	-1.3	-2.7
Papermaking and paper products	-0.3	-2.9	1.7	0.5	-2.1
Printing and record pressing	4.6	1.7	1.6	2.0	2.8
Stationery, educational and sports goods	2.3	1.7	0.9	-0.2	-0.7
Petroleum processing and coking products	5.2	2.3	3.5	2.2	2.2
Raw chemical materials and chemical products	0.6	0.9	2.5	1.7	-0.3
Medical and pharmaceutical products	5.3	2.8	2.8	1.7	2.4
Chemical fibers	5.0	-0.1	1.6	-2.3	-1.7
Rubber products	1.4	-0.6	-0.4	-0.1	-0.1
Plastic products	0.8	-1.2	-0.5	-1.1	-1.5
Nonmetal mineral products	8.8	3.6	-0.1	-3.4	-4.3
Smelting and pressing of ferrous metals	9.3	7.9	4.5	1.8	0.6
Smelting and pressing of nonferrous metals	2.8	2.5	4.0	-0.6	-0.5
Metal products	2.9	0.8	-1.2	-2.5	-3.2
Ordinary machinery manufacturing	3.4	1.1	0.4	-1.4	-1.8
Special purpose equipment manufacturing	1.9	-0.4	-0.8	-2.0	-1.8
Electric equipment and machinery	4.3	1.8	1.1	0.4	0.6
Electronic and telecommunications	3.0	1.1	0.0	-0.2	-0.9
Electronic and telecommunications	1.2	2.3	3.0	2.4	3.7
Instruments, meters, cultural and official machinery	0.2	-2.1	-1.8	-4.4	-4.7
Other manufacturing	-5.6	0.2	-2.5	-3.4	-4.0
Electric power, steam and hot water production and supply	10.4	11.4	6.8	10.3	7.3
Gas production and supply	-6.5	-10.5	-7.0	-12.0	-6.6
Tap water production and supply	15.3	9.4	9.9	7.1	5.0

Source: National Bureau of Statistics.

1/ Data for enterprises and the township and above level with independent accounting systems.

2/ Profit rate is the ratio of after-tax profits to gross output.

## **An Update of Selected Sectoral Restructuring Programs**

### **Textiles**

The State Council introduced a three-year textile sector pilot restructuring program beginning in 1998. By reducing obsolete production capacity by 10 million spindles (a quarter of all textile spindles) and through laying off 1.2 million workers (a third of total employment), the aim is to return the chronically loss-making textile industry to modest profitability within three years. The program got off to a good start in 1998: the plan was to eliminate 4 million spindles and lay off 600,000 excess workers, but 5.12 million spindles were idled (enterprises receive a subsidy from the budget of Y 3 million for every 10,000 spindles destroyed) and 660,000 redundant workers laid off. However, the sector's losses were reduced by Y 2.6 billion in 1998, slightly less than the targeted Y 3 billion.

The target for 1999 is to eliminate another 9.5 million spindles and lay off another 1.1 million workers, while reducing enterprise losses by a further Y 3 billion. The major restructuring focus this year is to further deepen the policies implemented from last year, including encouragement of mergers and acquisitions, and bankruptcy of inefficient and technologically outmoded enterprises. More effective penetration of international markets, technological updating, and product innovation are also being emphasized to arrest the decline in export performance. However, more difficulties are expected this year as most of the spindles to be eliminated are still in operation, and most of the workers targeted for layoffs are concentrated in the cash-strapped central region.

### **Coal**

China produced 1.2 billion metric tons of coal in 1998, down 130 million tons or 9.8 percent from 1997, and laid off 390,000 workers from state mines. Nevertheless, large state coal mines still suffered Y 3.7 billions in losses last year. Oversupply in both domestic and international markets, combined with dwindling demand, has reduced profitability and exports. The market oversupply is attributed to the large numbers of small and low technology illegal mines; it is estimated that about 50 percent of national coal production came from these mines in 1998.

At a meeting of the State Council in mid-November 1998, it was decided to overhaul the coal industry by shutting down thousands of inefficient and small mines, and laying off large numbers of workers. Current plans are to close 25,800 small mines by the end of this year to reduce production by at least 250 million tons; 15,000 small coal mines were already closed in the first four months of this year. The government also aims to reduce industry losses by 50 percent and lay off an additional 400,000 workers from key state coal mines this year. At the same time, the government will invest Y 15 billion and implement 282 technical upgrading projects in the industry to improve its efficiency, and boost exports to 38.5 million tons in 1999 from 32 million in 1998.

Following the institutional restructuring last year, significant changes have occurred in the administrative mechanism of coal industry. The administration of 94 key national coal mines and 206 related state services (such as research and development and infrastructure development)--with total assets of Y 237.9 billion, 3.2 million current and 13.3 retired workers--was transferred from the Ministry of the Coal Industry to local governments. At the same time, loss subsidies, value-added tax rebates, and interest-subsidized loans continued to be offered from the central budget. Assistance was also provided from the central government budget to SOEs with difficulties in providing old-age pensions to retired workers and subsistence allowances to laid-off workers.

In March 1999, the China Coal Industry Association (CCA) was officially launched in Beijing. With the former China Coal Industrial Enterprise Management Association as its core, CCA was the result of a merger with 11 other associations. The goal is for it to become a broad institution covering all the fields of the coal industry, including promoting scientific management, improving market order and enlarging foreign cooperation and exchanges, etc. CCA will strive to launch industrial research projects and provide information and consultation services to the authorities and enterprises; it will also give priority to drafting a series of industrial regulations concerning quality, technology, and management standards.

## Steel

The steel industry managed to remain profitable in 1998, despite the slump in exports, strong competition in the domestic market, and declining price levels. It was estimated that the number of enterprises suffering losses greater than Y 50 million was reduced from 13 in 1997 to 4 or 5 in 1998, while enterprises that continued to make losses reduced them significantly. It is estimated that annual growth of steel output of 2 percent is sufficient to support overall GDP growth of 8 percent, but in recent years the steel industry has grown at an average rate of 5-6 percent, far exceeding actual demand, resulting in oversupply and declining prices. From 1993 to 1998, output value has increased by 27.4 percent, but industry profits have dropped from Y 29.4 billion to Y 2.3 billion.

The industry aims to arrest the decline in profitability in 1999, and an output ceiling 10 percent less than the 1998 level has been set for the industry to stabilize prices. The total production capacity will be reduced this year to about 11.8 million tons, and no new production licenses will be issued for 3 years. Key large and medium state enterprises have been asked to cut the production of products with low demand in the market or with low profitability, and reduce the inventories by 30 percent. Those who fail to do so will be identified by the State Metallurgic Administration Bureau and as a kind of sanction, their short-term loan quota will be cut by the banks. With the 40 biggest steel manufacturers producing nearly 90 percent of the output, the target of output reduction should be fairly

easy to achieve. The steel industry is targeting a total profit of Y 5 billion in 1999, with all of the 46 key loss-making SOEs in the industry returning to profitability.

Restructuring will be accelerated to eliminate outmoded production capacity and technology. The Metallurgic Administrative Bureau will also shut down small enterprises, in particular those that are technologically inefficient and heavy polluters. The industry will also continue to take full advantage of the stock market to raise funds for restructuring. In 1998, the six already listed and six newly listed steel companies raised Y 10.7 billion in 1998 through new share issues, and will continue to raise funds on the market to facilitate the introduction of modern management mechanisms. Four to five additional companies plan to be listed on the stock market and the total amount of fund raised in 1999 will be no less than that of the last year. The establishment of the Baoshan Steel Co., a merger of Baoshan Steel, Shanghai Metallurgic Shareholding Co., and Shanghai Meishan Co, was another significant development in the industry. The new group will possess 20 percent of the assets of the metallurgy industry, and contribute about 15 percent of total steel output.

### **Aviation and related industries**

The Aviation Industries of China (Avic), the backbone of the country's aircraft manufacturing industry, is planning a restructuring program to split itself into two large corporate groups, both of which will engage in the production and sale of military and civilian aircraft, and non-aeronautical products. But concerns have been raised about possible problems with the split, including how to deal with redundant workers and the debts of loss-making enterprises, and how profitable and indebted companies will be divided between the two groups. With 100 large and medium-sized enterprises, 30 research institutes and 7 key state laboratories operating under its umbrella, Avic has so far rolled out 15,000 military and civilian aircraft of 27 types, and 54,000 aero engines of 25 types as well as a side variety of other equipment. Eight Avic enterprises have been listed on domestic and international stock markets, raising capital of Y 1.7 billion and HK\$ 460 million in the process.

A proposal for restructuring has been submitted to the State Council for final approval. It is proposed that Avic's administrative functions be handed over to the State Commission of Science, Technology and Industry for National Defense, which is not to interfere in the operations of the new enterprises. If this proceeds as expected, the two groups will have the right to operate independently. The move is part of the largest-ever round of industrial regrouping ever attempted in China, and affects enterprises in a range of industries such as aerospace, aircraft manufacturing, nuclear power, and shipbuilding. This large-scale corporate reorganization into two large vertically integrated entities reflects the central government's objective to create an efficient and competitive business environment.

As for the civil aviation service industry, despite significant government attempts to provide a boost, some of China's best known carriers have plunged into the red. Industry

losses in the first half of 1998 reached Y 3 billion, and they are estimated to have been even higher in the second half of the year. China's airlines share a common burden of overcapacity, inefficiency, and sluggish consumer demand. Fare wars and half-empty flights, previously unknown in China, have become common. Increased foreign competition has also eroded revenue and profits.

To prod the industry's recovery, airline regulator Civil Aviation Authority of China (CAAC) in February of this year stopped what had become rampant ticket-price discounting. Airlines can now have their licenses suspended for unauthorized discounts on published fares. The move followed CAAC's freeze on new aircraft deliveries until 2002--China will still take the 43 aircraft scheduled for delivery this year, to be offset by sales, leases, or retirement of older planes--aimed at keeping debt service costs down and slow the growth of new capacity. The CAAC is also considering a cut in the fee added to tickets for infrastructure development from the current 6 percent on international flights and 10 percent on domestic flights, and will eliminate 5 percent of its domestic flights beginning on May 1. The cutbacks affect 15 of the 24 domestic airlines, and will eventually lead to the elimination of 95 routes currently being flown.

### **Sugar**

More than 90 percent of state-owned sugar refiners have been loss making in recent years, with losses reaching Y 3 billion in 1997-98. As is the case in other industries, these problems stem from over investment, large numbers of sub-optimal producers, and outdated refining technology. The average sugar refining enterprise produces only 1,300 metric tons of output per day, 1/5 to 1/8 of the world average, and utilizes production technology from the 1960s. In light of these problems, the sugar industry was identified by the Light Industry Administration Bureau earlier this year as a key industry for restructuring. To this end, hundreds of small sugar producers will be shut down, and total production capacity of 300 thousand metric tons will be eliminated in the coming year. In addition, other small refiners will be merged with larger firms to reduce the excessive fragmentation of producers, and production technology will be upgraded.

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## IV. THE INSOLVENCY FRAMEWORK IN CHINA<sup>1</sup>

### A. Overview

1. This note provides a general description and assessment of the existing insolvency framework in China. Although it is based on a review of a variety of Chinese laws and regulations that cover this area, the focus is on the Law of the People's Republic of China on Enterprise Bankruptcy (for trial implementation) of 1986, which applies to state owned enterprises, as modified in certain cities by the State Council Notices of 1994. The focus arises from the economic significance of applying insolvency principles to state-owned enterprises in China.<sup>2</sup> Indeed, while a substantial overhaul of the insolvency system is under consideration, to be fully effective it will need to be closely linked with other elements of economic and social reforms. For example, the timing of this overhaul may need to take into consideration the degree of progress that has been made in establishing a formal safety net to address the consequences of the application of strong and predictable insolvency rules. The references to general insolvency principles contained in this note draw on the recently published staff paper.<sup>3</sup>

2. The note does not discuss in detail a number of related legal and institutional issues which play a major role for the proper functioning of an insolvency system. For example, adequate accounting rules ensure transparency and therefore give the relevant parties in the insolvency system (the creditors and the independent administrator) a basis to make informed decisions as to whether, for example, the financial status of the company justifies rehabilitation or liquidation.

### B. Legal Framework

3. Insolvency procedures, in order to be effective, generally require a legal framework which provides a sufficient degree of certainty and predictability by addressing a number of issues: the categories of debtors that will be subject to the insolvency procedures, when

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<sup>1</sup>This chapter was principally prepared by Boyko Dimitrachkov (ext. 37768).

<sup>2</sup>The note also reviews (i) the relevant provisions of the Civil Procedure Law of the People's Republic of China (the "Civil Procedure Law") which regulates the insolvency of incorporated private businesses and "apply by reference" a number of the substantive provisions of the SOE Law, (ii) the Bankruptcy Regulations of the Shenzhen Special Economic Zone on Companies with Foreign Investment (the "Shenzhen Law"). It is recognized that there may be other rules at the national or regional level that are part of China's legal framework for insolvency.

<sup>3</sup>*Orderly and Effective Insolvency Procedures: Key Issues*, International Monetary Fund, 1999.

insolvency proceedings may be commenced, to what extent a debtor should be displaced from the management of the business, to what extent creditors' actions would be stayed, whether and how a rescue may be attempted, and priority of distribution in case of liquidation, among others.

4. China's legal framework in the area of insolvency is a segmented one. Most importantly in that regard, the SOE Law sets forth rules that are exclusively applicable to state-owned enterprises. Accordingly, before assessing the substantive provisions of the SOE Law, a threshold question is whether such special treatment is justified or, alternatively, whether SOEs should be subject to the same rules as those applicable to all enterprises. This is of particular relevance given the fact that staff understands consideration is being given to the enactment of a comprehensive insolvency law in China.

5. As a general matter, while specialized insolvency regimes may be appropriate for individuals and certain highly regulated enterprises (such as financial institutions and public utilities), government ownership of an enterprise does not, in and of itself, provide a basis for such treatment. Indeed, subjecting a state-owned enterprise to the provisions of the general insolvency law can serve the useful purpose of sending a clear signal to creditors that public support for the enterprise will not be unlimited. While this approach also means subjecting the enterprise to the discipline that the general bankruptcy law imposes, the rigor of this discipline can be appropriately modulated through the design of the insolvency law. More specifically, and as has been demonstrated in other countries, safeguards can be put in place to protect the interests of the debtor enterprise (and its employees) through the incorporation of well-designed rehabilitation provisions (which, as will be discussed below, are not adequate under the existing law). In fact, from the perspective of the government, an effective rehabilitation procedure can provide a very cost-efficient means of restructuring state-owned enterprises because these rules effectively require creditors to contribute to the necessary financing.

6. It should be emphasized that well-designed rehabilitation provisions—even if they are relatively pro-debtor—will not impede the flow of credit, provided that the law is applied with adequate transparency and predictability. Such transparency and predictability will require both specificity in the legislative provisions, minimal governmental interference in their implementation, and timely disclosure of material information by the institutions involved to creditors. They will also require the development of an independent and qualified institutional infrastructure, including qualified professional administrators and, most importantly, a well-trained and independent judiciary.

### C. Commencement

7. The determination of which entities are eligible to be subjected as debtors to a country's general insolvency law is a key threshold issue and has important implications for a country's economy. For example, to the extent the law excludes certain entities or provides for their differential treatment, these entities may not be subject to the discipline imposed by an effective insolvency regime or may not be able to take advantage of the protection it affords.

8. An equally important issue is what specific criteria must be satisfied before the proceedings can commence. A criterion that is relied on extensively—and which is consistent with the overall objectives of insolvency—is one that allows for commencement when the debtor has ceased to meet its liabilities as they become due. Reliance on this 'general cessation of payments' or 'illiquidity' test is designed to activate the proceedings sufficiently early in the period of the debtor's financial distress. An alternative approach, more appropriate for liquidation proceedings, is the 'balance sheet' test which requires that the value of the debtor's liabilities exceeded its assets.

#### Scope of coverage

9. The type of debtors that are covered under the SOE Law relates to the general design of the insolvency framework, discussed above. Even if China is to retain a segmented framework, it is critical that the law provide adequate notice to creditors as to which debtors are to be subject to the law. As noted earlier, predictability is essential. Article 3 of the SOE Law requires significant improvement in this regard. A determination of whether an enterprise falls under the first category of excluded enterprises (“[public utility enterprises and] enterprises which have an important relationship to the national economy and the peoples livelihood for which the relevant government departments grant subsidies or adopt other measures to assist in the repayment of their debts”) will generally require information that a creditor will not have. Moreover, the provision seems to exclude from the scope of insolvency even enterprises the full repayment of whose debts is not secured<sup>4</sup> thus leaving creditors with no legal recourse. With respect to the second category of excluded debtors, the text suggests that guarantees obtained after the commencement of insolvency would result in the enterprise being excluded. If this is correct, such an *ex post* determination serves only to create uncertainty as to whether any insolvency proceeding, once opened, will be allowed to be pursued. Moreover, the use of guarantees as an alternative will only protect creditors' interests if the guarantor is reliable.

10. Finally, the SOE Law applies to “enterprises owned by the whole people” (Article 2) and the Civil Procedure Law covers all enterprises “with a legal person status” (Article 199). While the distinction is clear in cases of enterprises that are wholly-owned by the people, a

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<sup>4</sup>“...to assist the repayment of debts...”, Article 3, paragraph 2(1).

question arises as to the law applicable to legal entities that are partially owned by the people. Given the differences in the priority rules for distribution between the SOE Law and laws applicable to the private sector (discussed below), this lack of clarity is of significance.

### **Conditions for commencement**

11. Although there is some ambiguity in the text, the criterion for commencing a proceeding under the SOE Law appears to be that of illiquidity (inability to pay debts as they fall due) which, if correct, is an appropriate commencement criterion. In comparison, the Shenzhen Law relies on a combined illiquidity and stringent balance sheet test (the creditor must first show illiquidity but the court can only declare bankruptcy if debts due exceed assets), which will be very difficult to apply in practice.

12. The SOE Law, Shenzhen Law, and Civil Procedure Law all allow for proceedings to be commenced by either the debtor or the creditor, which is appropriate. However, despite this positive aspect, the SOE Law does not contain mechanisms that are likely to produce early debtor petitions, which is critical if rehabilitations are to be successful: the SOE Law does not appear to impose liabilities on the management of an enterprise if it fails to initiate proceedings when the commencement criterion is met. Moreover, a debtor may file only with the approval of the governmental department supervising its activities. The existence of a rule providing for some governmental involvement with respect to SOEs in China is understandable but the granting of such broad administrative authority to override economic necessities is not desirable. Moreover, as will be discussed below (III.1), giving the government such broad authority raises issues of conflict of interest since in many cases the government, through state-owned banks, would also be a major creditor.

13. Another deficiency is that, as discussed below, the SOE Law only allows debtors to initiate rehabilitation proceedings in response to the commencement of a general proceeding by a creditor. The Shenzhen Law is stronger in this respect, as it allows debtors to file for rehabilitation and to do so without having to make any showing of financial distress.

### **D. Consequences of Commencement**

14. Three of the critical issues that must be addressed following commencement of any insolvency proceeding are (i) the degree to which the debtor is divested of control over the enterprise, (ii) the scope of the stay to be imposed on creditor actions against the assets of the enterprise, and (iii) the powers of the liquidator to avoid pre-commencement transactions in an effort to maximize and consolidate the pool of debtor's assets.

### **Debtor control**

15. In circumstances where the proceedings are commenced by the creditor, the SOE Law gives the debtor three months to decide whether to initiate a rehabilitation proceeding. While this is not objectionable (the laws of some other countries also provide for an initial observation period), the problem is that, during this period, the management will be in a position to dissipate assets. In some respects, this problem is addressed in the Opinions' requirement that, upon commencement, the debtor ceases to make debt repayments and that any payments in the ordinary course of business be approved in advance by the court. However, reliance on the court may create delays and some creditors may be concerned that the court's determinations will not always be entirely independent (see discussion below). For these reasons, it would be preferable for an independent administrator to be appointed immediately after commencement and that this administrator be given the authority to oversee all transactions and operations during the initial period. As discussed below, this problem also arises during the period of rehabilitation proceedings, which does not provide for any oversight by an independent administrator. (In comparison, the Shenzhen Law permits a maximum period of twenty days after initiation before appointment of an independent oversight committee in both liquidation and rehabilitation proceedings.)

16. Moreover, while some form of oversight is installed once bankruptcy is actually declared, the persons that fulfill this purpose under the SOE Law do not appear to be in a position to do so in an independent manner. Specifically, the SOE Law provides for management of a bankrupt enterprise's business by a 'liquidation team'. The liquidation team is responsible for matters related to liquidation of the company, including custody, organization, appraisal, disposition and distribution of the bankruptcy property. The team's members are to be designated by the court, from among the superior department in charge of the enterprise, government finance departments, and other relevant departments and 'professional personnel'.

17. Given the imperative of providing for a liquidation procedure that is applied in an impartial and predictable manner, creditors will be very concerned about the degree of governmental participation on the liquidation team for bankrupt SOEs, in light of the significant conflict of interest issues that can arise in such an arrangement. First, the government's role as a stakeholder and even quasi-manager of a bankrupt SOE could affect the liquidation team's ability to exercise the objectivity and independence needed for efficient appraisal and disposition of assets. Governmental participation also raises creditor treatment issues, as the government will likely be a significant creditor of many SOEs, while government agencies (especially the superior department in charge of the enterprise) are likely to have had pre-proceedings relationships with some of the bankrupt enterprise's creditors. Additional areas that will give rise to conflict of interest issues relate to remuneration of the liquidation team, and liability of the team in the event of any breach of the applicable standards of care. The above concerns are partially alleviated by the Opinion's provisions that the committee may hire outside professionals and any of its actions that damage the interests of creditors would be subject to judicial review.

### **Stay on creditor actions**

18. The SOE Law and the Civil Procedure Law impose a stay on civil enforcement which seems to encompass foreclosure actions initiated by secured creditors; the Opinions (Section 39/2/) prescribe that “the creditor of a loan secured may not exercise priority rights after the case has been accepted but before insolvency is declared.” It is not clear, however, whether the rule applies generally or only in the context of rehabilitation as its position suggests (in the chapter “Reconciliation and Reorganization”).

19. If secured creditors are not included in the stay, neither the initial ‘observation’ period of three months nor the rehabilitation provision will be effective. If a secured creditor is able to foreclose upon its collateral upon the commencement of an insolvency proceeding, the ability of the enterprise to continue to operate—and therefore to be rehabilitated—is severely undermined. Of course, the degree to which this will present an actual problem in China will depend on whether secured creditors, are in fact, able to successfully foreclose upon collateral without unreasonable delays in the existing legal environment.

20. If the SOE Law is intended to apply to secured creditors, as the Opinion suggests, it is important that the law require that measures be taken to ensure that their interests are adequately protected during the period of the stay. Such measures may include payments of interest and compensation for the depreciation of the collateral. In circumstances where the protection cannot be provided, the law should require that the stay be lifted.

### **Avoidance of pre-commencement transactions**

21. The SOE Law and the Shenzhen Law allow for the liquidation team to request the Court to nullify fraudulent and preferential transactions and transfers that took place six months prior to the date on which the proceedings commence. While the categories of transactions and transfers identified in the provision are appropriate, the effectiveness of the provision is reduced by the fact that (at least under the SOE Law) nullification requires approval of the Court. Insolvency laws of other countries often require involvement of the court only in circumstances where the counterparty to the suspect transaction refuses to follow the request made by the liquidator.

## **E. Priority of Distribution**

22. All insolvency laws need to incorporate the principle that, for purposes of determining the priority of distribution of the proceeds of the estate, creditors should be ranked by categories. Normally, preference is given to secured creditors, administrative expenses associated with the insolvency proceedings (court, liquidator’s and experts’ fees, for example), post-petition financing, and certain ‘privileged’ types of creditors (employees, the tax office, for example). The inclusion of ‘privileged’ creditors for social or political reasons should be limited to the extent possible since they generally weaken the effectiveness and efficiency of insolvency proceedings.

23. The provisions regarding the priority of distribution of the assets of the enterprise following liquidation set forth in the SOE Law and Shenzhen Law are generally appropriate, with important exceptions. Priority is given to secured claims, followed by administrative expenses (which could be clarified to include post-petition financing, see below), including retained workers' salaries and labor insurance, workers' wages, taxes and unsecured bankruptcy claims, in that order. The decision to grant secured claims and administrative expenses the highest priority is commendable. However, the State Council Notices (which apply to major industrial cities and regions) also appear to require that proceeds following liquidation also be used to resettle workers and that such resettlement should take absolute priority, including over proceeds to secured creditors. The rule undermines the protection of secured creditors. Moreover, the proceeds from the disposition of SOEs' land use rights are to be used to cover resettlement costs first; this provision effectively nullifies mortgagees' rights thus making land mortgages a very unattractive form of security.

24. One way of reconciling the competing objectives of maintaining social stability and effective creditors' protection would be to impose a limit (as a function of workers' wages or the value of the estate, or both) on the total amount to be spent on resettlement.<sup>5</sup> If resettlement costs are to rank higher than secured claims, it is important this priority be limited in some manner. Protecting the interest of secured creditors is imperative if future financing is to be encouraged on an affordable basis.

25. In addition, the SOE Law does not appear to give priority to creditors who are counterparties to contracts that have been continued by the liquidation team. In other countries where the liquidator is given the authority to continue contracts, the law requires that the counterparty have a priority claim with respect to any damages suffered following the decision to continue the contract. This provides an important means of inducing new financing once the proceedings commence.

26. A related issue is the valuation of foreign currency-denominated claims. The Shenzhen Law (Article 38) specifies that such claims are converted in local currency as of the time of declaration of bankruptcy. The SOE Law and the Opinions, however, are silent. For purposes of predictability and creditors' protection (especially the protection of foreign creditors, whose claims would normally be in foreign currency), it is preferable to have a rule on the subject. One option would be to follow the Shenzhen example and prescribe conversion as of the time of declaration of bankruptcy. An alternative approach would be to assess the value of such claims twice—at the time of commencement of the proceedings (for purposes of voting), and at the time of distribution.

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<sup>5</sup>It is noted that there is a limit on the total amount of a single worker's compensation: three-times the average salary for the preceding year in the region/city where the debtor is located (State Council's Supplementary Notice of 1997, Section 5).

## F. Rehabilitation Provisions

27. As noted in the Introduction, appropriately designed rehabilitation provisions can provide an effective means of rescuing—and improving the viability of—troubled enterprises in a manner that ensures that creditors contribute to the cost of the rescue in question. Creditors will only be willing to participate in this process, however, if they are given some degree of control over the process and government interference is kept to a minimum.

28. Assessed on the basis of the above criteria, the rehabilitation procedures could be improved in a number of important respects.

### Commencement

29. Under the SOE Law, rehabilitation proceedings cannot be initiated by either the debtor or creditor by themselves. Rather, reorganization is triggered only if (i) a creditor has petitioned for bankruptcy (i.e., liquidation) of the enterprise and (ii) the enterprise's superior department in charge within three months thereafter apply for reorganization. Accordingly, when an enterprise files a voluntary insolvency petition, the only outcome is liquidation. This is the case irrespective of whether the company is viable and there is otherwise a commercial basis upon which the company and its creditors could fashion a rehabilitation plan. In contrast, the Shenzhen Law allows for debtors to file for rehabilitation without having to demonstrate illiquidity.

30. At least on its face, the above aspect of the SOE Law could significantly undermine rehabilitation efforts, as it not only fails to provide affirmative incentives for early filing, but it actually provides significant reason for the enterprise never to initiate proceedings. It should be noted that the chances of a successful rehabilitation increase if the proceedings are commenced during the early stages of the enterprise's difficulties. Since the management of the enterprise is in the best position to understand the problems of the enterprise, it is therefore critical that it be given the option of filing for rehabilitation.

31. If the SOE Law is to be amended to allow debtors to initiate rehabilitation proceedings even in the absence of an insolvency petition filed by a creditor, as suggested above, it is important that the commencement criterion be relaxed so as to allow the debtor to file *before* reaching a stage of illiquidity, consistent with the objective of having rehabilitation commence before the problems become too acute.

### Debtor control

32. As noted earlier, during the reorganization period, the enterprise's existing management remains in charge of the company, subject to the superior department in charge's role in supervising the reorganization. From a policy standpoint, it is normally preferable in the context of rehabilitation for insolvency law to provide for an arrangement whereby the debtor continues to operate its business on a day-to-day basis, but under the

close supervision of an independent, court-appointed administrator. Such an administrator should be responsible for approving all (or the most significant) transactions conducted by the enterprise.

33. When applying the current SOE Law against this standard, the issue arises of the extent to which the superior department in charge is sufficiently independent for this purpose. Not all aspects of the seemingly complex relationship between an SOE and its superior department in charge are clear. However, it would seem that an agency responsible for pre-insolvency supervision of a company cannot be sufficiently independent—and will not be perceived as sufficiently independent by the creditors—to effectively supervise the operations of the company in a rehabilitation context.

34. In any event, to the extent not already provided for in other general laws governing SOEs, the SOE Law should provide the administrator appointed during the reorganization period (whether the superior department in charge or otherwise) and/or the court with broad authority to remove an SOE's previous management in circumstances where there is evidence of gross mismanagement or misappropriation of assets. As part of this, a process should also be established for creditor participation in the process (e.g., giving creditors the right to petition for removal of management, or to submit their views regarding the appropriate action to be taken.)

35. In contrast, it is noted that the Shenzhen Law provides the independent committee with powers to effectively supervise the actions by the debtor since it, among others, permits the committee to prevent any action that may affect the interests of the creditors and to investigate the operations, management, and assets of the debtor.

#### **The terms of the settlement agreement**

36. The SOE Law provides that, during the rehabilitation proceedings, the company is to prepare draft rehabilitation plan (called a "settlement agreement") and propose it to its creditors. If creditor agreement can be obtained and, by the end of the two year period following the initiation of rehabilitation proceedings, the enterprise is able to pay its debts pursuant to the agreement, the insolvency proceedings are terminated.

37. In order to increase the chances that the rehabilitation achieved will provide long-term viability rather than only a temporary respite, it is important that the relevant laws avoid placing undue constraints on the type of rehabilitation that a company and its creditors can agree to. Consequently, the SOE Law would be undesirably restrictive if it is construed to prohibit all restructuring transactions other than debt rescheduling. It is not clear how this provision is interpreted in practice; the only guidance is the Opinions' clarification that the plan must specify the sources of capital for debt repayment, and the method and term of debt repayment (Section 34). As a result, the provision could be read as limiting the debtor's ability to propose a rehabilitation plan that contemplates any debt transaction other than a rescheduling (i.e., the requirement that the plan identify the time frame within which debts

will be repaid implies that plan cannot provide for alternatives to repayment such as debt write-offs, debt-equity conversions, and similar transactions). Even if the Opinions could be construed as allowing alternative methods of repayment, those alternatives should be specified in order to enable the choice of an optimal one. With respect to debt-equity swaps, it is recognized that limitations may need to be retained on such transactions with respect to SOEs unless the authorities are willing to use the insolvency process as a means of achieving privatization.<sup>6</sup> Debt write-offs, however, should not be restricted. In that regard, it is noted that the Shenzhen Law specifically anticipates debt write-offs.

### **Creditor protection**

38. It is not clear whether dissenting and secured creditors are adequately protected in reorganization proceedings under either the SOE Law or the Shenzhen Law. For example, as discussed below, secured creditors do not vote in the creditors' meeting unless they abandon their claim to security; consequently, most secured creditors would likely not have an opportunity to vote on the enterprise's settlement plan. The law does not expressly address the issue of whether a settlement plan can alter their legal rights. The Opinions, however, grant secured creditors certain protection by stipulating that the repayment of debt secured with property and for which security rights have not been renounced may not be restricted by the plan (Section 39). At the same time, it prohibits secured creditors from enforcing security rights before the declaration of bankruptcy. While such a stay is justified in the context of rehabilitation, it should be modulated by protecting secured creditors' rights in an adequate manner during the course of the rehabilitation (payment of interest or compensation for the depreciation of collateral, for example).

39. As a general rule, if a rehabilitation plan can be approved and enforced upon dissenting and secured creditors who do not agree to it, the insolvency law should require that the plan contain provisions that give adequate protection to such creditors (e.g., by specifying minimum standards the plan must meet, or by giving the court authority to reject plans that fail to protect the interests of creditors who have not agreed to it). Both the Shenzhen Law and the SOE Law appear deficient in this regard, as they impose no substantive requirements the plan must meet. At a minimum, the Laws should provide that dissenting creditors and secured creditors (to the extent they can be affected by the plan) should receive at least as much as they would have received under liquidation; with similar effect, the Laws could also confirm the authority of secured creditors to exercise their foreclosure rights after the proceedings terminate.

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<sup>6</sup>Although this is a complicated and largely untried strategy in China, certain progress has been achieved lately. For example, the new legal regime for asset management companies grants them such rights with respect to the recapitalization of state-owned banks and the restructuring of their defaulted borrowers.

40. With respect to approval of the settlement agreement, the SOE Law provides that it is to be reported to the congress of the staff and workers of the enterprise and that “the opinion of such congress shall be heeded”. If the term “heeded” means that the law gives the workers an effective veto over a rehabilitation plan, this will severely constrain the types of rehabilitation that can be undertaken. In any case, the term conveys a certain level of ambiguity which creates uncertainty as to the powers of workers and their procedural impact.

#### **Avoidance of pre-commencement transactions**

41. The only pre-commencement avoidance powers in the SOE Law apply in the context of liquidation. (In contrast, the powers in the Shenzhen Law appear to embrace both liquidation and rehabilitation). The lack of such powers in rehabilitation constitutes a serious deficiency, as avoidance powers that nullify earlier transactions that were fraudulent or preferential can be of critical benefit where an enterprise is undertaking a rehabilitation. In the context of the current Law, rehabilitation avoidance powers would need to include authority for creditors to request the court to avoid such transactions (since the enterprise which remains in charge of the business may be reluctant to pursue a transaction in circumstances where it has a conflict of interest).

#### **Treatment of contracts**

42. The SOE Law appears to address post-commencement termination of contracts only in the context of liquidation. This could be considered a deficiency, as the existence of broad powers to continue beneficial contracts and terminate burdensome ones will significantly enhance the possibility of successful rehabilitation (although aggressive application of such powers can undermine predictability). Contract termination powers would seem especially desirable for enterprises previously subject to governmental and other nonmarket pressures, as these powers would enable the company to shed the vestiges of its nonmarket oriented past and emerge from rehabilitation as a more competitive enterprise. Termination would also be very appropriate in cases of disadvantageous non-arm’s length contracts. The coverage of this issue under the Shenzhen Law is unclear.

#### **Post commencement financing**

43. Given the importance of new financing for an enterprise during reorganization, the chances for successful rehabilitation would be substantially enhanced if the SOE Law and the Shenzhen Law specifically provided for special treatment of creditors providing such financing. At a minimum, this should include the power to give post-petition creditors administrative priority or a security interest on unencumbered assets. In addition, consideration could be given to providing such creditors with priority over other administrative priority creditors. Creditors will only be willing to provide such financing if their priority is clearly specified in the law, which is currently not the case.

## **G. Implementation Issues**

### **Creditors**

44. Creditor confidence in the law will be enhanced to the extent that it gives them adequate opportunity to participate in the process. The SOE Law and the Opinions address the rights and obligations of creditors (who are all members of the “creditors’ meeting” provided for under Articles 13-16 of the Law). All creditors have the right to vote other than secured creditors that do not abandon their priority right to be repaid; the court designates a chair of the creditors’ meeting from among creditors with the right to vote, and calls the first creditors’ meeting within 15 days of expiration of the period for reporting claims. The Law conveys fairly broad powers on the creditors’ meeting, including the right to examine and confirm the amount of claims and whether or not such claims are secured; to discuss and adopt a draft settlement agreement; and to discuss and adopt a plan for the disposition and distribution of bankrupt properties. Creditors meeting resolutions are adopted by a majority of creditors with the right to vote present at the meeting, provided the amount of their claims comprise more than half of the total unsecured claims (or two-thirds of the total unsecured claims in the case of a draft resolution adopting a draft settlement agreement).

45. The creditors’ meeting provisions of the Law raise concerns in two key areas. First, the Law makes no provision for the creation of creditors’ committees or for the payment of their expenses by the estate. In cases where there are a large number of creditors, a creditors’ committee empowered to act for all creditors in an advisory capacity can provide coherence and efficiency to the process; facilitate decision making (by both the creditor body as a whole and the court); play a key role in forging creditor agreement on the features of a rehabilitation plan; and assist in increasing the flow of information from the debtor. Moreover, while the Law does not prohibit creditors’ committees, its silence on the issue—and especially its silence as regards the estate’s responsibility for costs of the creditors’ committee—is likely to discourage the formation of creditors’ committees.

46. Second, the broad powers the Law gives creditors’ meetings to determine the validity of claims seem to have significant potential for abuse, as such claim determination (which is made by vote of a majority of creditors) can be used as a means of disadvantaging minority creditors in any case where a majority block of creditors are engaging in concerted action. In most jurisdictions, the insolvency administrator/trustee or the court itself would be responsible for claim validation.

### **The court**

47. The SOE Law provides that bankruptcy cases are under the jurisdiction of the People’s Court in the location of the debtor (Art. 5) and the Opinions detail that rule (Sections 1 and 2). Appeals are allowed only where the court dismisses a petition for the commencement of bankruptcy proceedings. All other rulings are subject to review by the

same court. The Shenzhen Law provides that jurisdiction is vested with the Intermediate People's Court of the Shenzhen Municipality.

48. Insolvency proceedings should be conducted under the authority of a court of law where judges will, at a minimum, be required to adjudicate disputes between the parties on factual issues and, on occasions, render interpretations of the law. The judiciary will only be able to fulfil this function if it is made up of independent judges with particularly high ethical and professional standards. In light of the need to ensure efficiency and the proper exercise of discretion in insolvency proceedings, many countries have established specialized courts (with specially trained judges or experts from the business world) to handle either commercial cases generally or bankruptcy-related cases in particular (including jurisdiction over all matters that have an impact on the estate). China may wish to consider the feasibility of establishing such a specialized court structure at least as part of its long-term insolvency reform goals.

## V. THE EVOLUTION OF URBAN LABOR MARKETS<sup>1</sup>

### A. Introduction

1. The efficient utilization of labor resources is crucial to achieving high and sustainable economic growth in China. This chapter presents the major changes in China's labor system since the opening up of the economy in the late 1970s, and discusses the impact of those changes on the development of urban labor markets. While the process of marketization of goods exchange has received a great deal of attention,<sup>2</sup> the steps in the marketization of the labor market are less well known. The pre-reform allocation of labor was characterized by direct allocation of jobs and administrative control of wages; employers had very little control over their work force or their wage bill, and employees had little control over where they worked. In addition a large surplus rural labor force was barred from migrating to the urban areas.

2. Opening up has gradually brought a number of changes to the structure of labor relations in the state sector, in particular in the erosion of lifetime employment, and in the implementation of an incentive wage scheme. However, while the reforms have achieved a degree of decentralization of labor management in the state-owned enterprises (SOEs) and the urban collectively-owned enterprises (COEs), labor market discipline is still lacking in a number of important respects, as evidenced by persistent high average wages despite low productivity and wage compression in the SOE sector. The driving force for reform has been the growth of the nonstate sector, where labor allocation and wages are determined by market forces to a much greater degree, leading to higher productivity and higher wages. The development of the more liberalized nonstate sector labor market has had some adverse consequences for the SOEs as labor mobility between sectors was liberalized, contributing to a fall in relative labor productivity in the SOE sector, and growing financial losses. The implication for policy is that the introduction of further market discipline in the state sector labor system should be an important component of the steps in SOE restructuring.

3. The chapter is organized as follows. The next section describes the labor allocation and wage system that prevailed prior to the start of reforms, and identifies the main systemic problems. Section C describes the key changes in labor policy since the start of reforms, including the development of a demand for labor by the emerging nonstate sector, and documents the effects of those policies on labor market outcomes. Section D draws out the implications of the differential development of labor relations in the state and nonstate sectors.

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<sup>1</sup>This chapter was prepared by Russell Krelove (ext. 38692).

<sup>2</sup>See, for example, Chapter III.

## **B. Labor Allocation in the Command Economy—The Labor Plan and Wage Plan**

4. In the 30 years between the founding of the PRC and the dawn of reforms, a tightly controlled system of administrative labor allocation and wages evolved in China's urban areas, accompanied by strong restrictions on rural to urban labor mobility.<sup>3</sup> The major components of the system were an annual labor plan, which allocated available new urban workers to enterprises, and a wage plan that controlled absolute wage levels and the wage distribution. Both individual enterprises and workers were denied meaningful participation in employment decisions. While the earliest controls on labor stemmed from interregional imbalances and an overall shortage of skilled workers, a main motivation for the later system was a concern about urban unemployment and unequal urban income distribution. One reason the controls were relatively effective was that urban economic activity was conducted almost entirely by state or collective enterprises. A private economy was allowed, but it was tiny (and declining) on account of restrictions limiting hiring to immediate family members.

5. In the urban areas, jobs came to be allocated to new workers by government labor bureaus on the basis of an annual labor plan approved by the appropriate central or provincial planning agencies. All jobs at SOEs and COEs are allocated through the labor bureaus. Broad manpower plans were calculated on the basis of projected labor supply and demand, by region and by functional department, taking into account enterprises' requests for additional labor. Numerical quotas were then formulated for each enterprise, in principle based on estimated production quotas and given labor input coefficients. These quotas were mandatory for all SOEs as well as for COEs managed by higher level governments. The central ministries took responsibility for allocating tertiary graduates and demobilized soldiers, the strategically important groups, to specific enterprises. Other vacancies were allocated by local rather than central labor bureaus. Once hired, it was almost impossible to lay off or discharge a worker, and it was almost impossible for a worker to change jobs.

6. Wages, like commodity prices and other factor prices, were set by the state, usually fixed for long periods of time, and placed emphasis on equity as opposed to efficiency. Enterprise wage plans were aggregated at various levels, and together constituted the national wage plan, with the wages prevailing in individual enterprises depending on their supervisory agencies. Employees were classified into three main groups, workers, cadres (bureaucrats, or managers) and professionals. The wage plan assigned a wage table to each group, with an attached grading system. Typically, workers had 8 grades, professionals around 17 grades, and cadres around 20 grades. The setting of the wage grade was based upon an individual's personal endowments, in particular the level of education and work experience. The distribution of wages across workers tended to be more compact than the distribution of skills, experience and human capital levels, and there was almost no link between a worker's pay and his or her performance.

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<sup>3</sup>Howard and Howard (1995) point out that the Soviet Union abandoned such a restrictive system in the 1930s.

7. Wage increases were allocated according to government regulations, and wages tended to be frozen for very long periods.<sup>4</sup> Average wages also varied according to the size of enterprise, with employees of large and medium enterprises (typically run by central authorities) receiving higher wages than those of small enterprises. Many COEs used similar wage scales which, though not state mandated, needed to be approved by local labor bureaus, and wages were almost always set below those of the state enterprises. In addition wage districts were established in an attempt to compensate for cost of living differences across regions. Wage levels tended to be low, set to meet the basic needs for food and clothing, with enterprises expected to meet other requirements, for example, housing health and child care, pensions, and certain subsidized foods.<sup>5</sup>

8. Land reform and cooperativization in the countryside following the founding of the PRC aggravated an already serious rural labor surplus. This, combined with relatively high urban wages, presented strong pressures for migration into cities. With the goal of avoiding perceived problems of excess urban migration experienced by other developing countries, effective barriers to rural-to-urban migration were erected. In January 1958, the National People's Congress promulgated the Household Registration Provision, which in effect identified the portion of the population entitled to live in cities. Household registration (hukou) anchored people to specific domiciles. Other regulations made it illegal for rural residents to travel outside their villages without a police permit. In addition, a system of grain and edible oil rationing was introduced for all nonagricultural residents (most of whom lived in cities, and had urban registration). The remainder of the population, classified as agricultural, bore responsibility for growing its own food. With rations limited to urban residents and private sales at reasonable prices unavailable in the cities, it became extremely difficult for a rural migrant to maintain extended unauthorized residence in an urban area. Finally, the labor plan helped ensure that urban job-seekers were given priority over rural residents in urban employment.

9. To sum up, the pre-reform labor allocation system was characterized by administrative wage setting and a system of lifetime employment that relied on administrative job assignment, accompanied by enterprise-based, nontransferable social security benefits. The system contributed for most of the period to low urban unemployment and the maintenance of urban stability, and a more equal income distribution, but it also produced extreme allocative inefficiencies. Systemic problems included the following: surplus labor in

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<sup>4</sup>Between 1957 and 1997 the authorities authorized only two wage increases (in 1963 and 19872), and those only for selected categories of workers.

<sup>5</sup>Individual enterprises had more control over the allocation of these in-kind benefits than over the wage tables, and there is evidence that in-kind benefits (e.g. the quality of the housing allocated) were used to some extent as incentive devices for workers.

enterprises<sup>6</sup>; poor (and irreversible) matching of workers' preferences and skills with jobs; guaranteed lifetime employment, which removed an important mechanism to control shirking and low productivity; the wage grade system did not closely link remuneration to actual labor productivity (both within grades and across grades) leading to an egalitarian wage structure; the centralized wage management allowed no room for enterprise participation in wage setting; and there was a large buildup of surplus labor in the countryside, and a lack of labor mobility.<sup>7</sup>

### C. Key Components of the Labor Market Reforms<sup>8</sup>

10. The authorities began to address the systemic problems in the labor allocation process in the late 1970s, also motivated in part by concern about increasing urban unemployment.<sup>9</sup> Since that time there have been a series of reforms that have increased the autonomy of both enterprises and workers, and have improved their incentives. Milestone events in the reforms were the National Work Conference on Labor Issues in 1980; wage reforms introduced in 1985; new regulations on the implementation of the contract system, hiring and firing, and unemployment insurance promulgated in 1986 and 1987; and the introduction of a new Labor Law in 1994. In general, the approach has been cautious and gradual, due mainly to concern about exacerbating urban unemployment pressures. Administrative allocation of workers to jobs under the labor plan has been gradually diminished, and state enterprise and collective management acquired more control over recruitment, promotion and reallocation of workers. Lifetime employment was phased out for new workers, replaced by fixed term renewable

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<sup>6</sup>As in other socialist shortage economies, there was an incentive for enterprises to hoard labor, that could be used to help relieve periodic bottlenecks in the supply of inputs.

<sup>7</sup>Since urban worker layoffs were essentially avoided, there was little need to develop a social safety net for the unemployed. More recently, with the increase of layoffs associated with accelerated SOE restructuring, a tiered approach to aiding the unemployed is being implemented; see the discussion in the forthcoming Review of Economic Developments. Another systemic problem was the restriction on labor mobility arising from employer-provision of housing. This is currently being addressed, through the privatization of housing and the development of housing markets. See Fleisher, Yong and Hills (1997).

<sup>8</sup>The discussion in this section follows Coady and Wang (1998), Hu (1994), Ikegami (1994), Knight and Song (1999), Meng and Kidd (1997), and Sabin (1995).

<sup>9</sup>The number of urban unemployed was increasing in the late 1970s from a number of sources, including the unauthorized return to the cities of young people sent to work in the countryside during the Cultural Revolution.

contracts, and limited bonuses in wages were introduced.<sup>10</sup> At the same time growth of the nonstate sector was promoted and thrived in an environment of relatively free labor market relations, made possible in part by the freedom granted to workers to choose their job. In addition the controls on rural-urban migration were relaxed, helped by the elimination of rationing and controls on access of transportation, so that rural labor became a crucial marginal source of workers in the urban areas.

### **Relaxation of the labor plan**

11. In the summer of 1980, China's first national work conference on labor issues officially announced a new labor market strategy, introducing more flexibility in labor allocation methods. Under the strategy, referred to as the three linkages policy, urban job-seekers were permitted to find work in the state, collective, or newly-recognized private sector through any of three avenues: through the labor bureaus (as before); organizing group employment, and their own independent efforts. At the same time enterprises were granted more autonomy in their hiring decisions.

12. Under the new system economic and planning authorities continued to formulate a labor plan, and numerical quotas remained binding for individual enterprises. But rather than unilaterally allocating all new workers to urban enterprises—with the exception of college graduates and demobilized soldiers, who remained under state allocation—labor bureaus began to “introduce” job seekers to hiring units. Along with this change, enterprises became more involved in evaluating and hiring employees, although labor bureaus retained some control over hiring decisions.

13. For their part, prospective workers could search for jobs through labor bureaus, other employment agencies, or directly to enterprises. The introduction at this time of fairly standardized examinations for job applicants made the recruitment process more efficient. In some cases, these are conducted by enterprises themselves, while in others, labor bureaus organize a city-wide examination for all applicants seeking jobs in the state sector. In addition, labor bureaus may require that enterprises hire only job seekers with urban household registration or from a particular geographic area.

14. At the same time new institutions emerged that aided the allocation of labor by diversifying employment channels. Important among these were the Labor Employment Service Enterprises (LESEs) which mainly function to funnel workers into the urban collective sector. These were initially established by local governments in the late 1970s to

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<sup>10</sup> These reform measures have been characterized as smashing the “three irons”: the iron rice bowl (guaranteed job assignment, housing, pension, medical and other benefits); the iron chair (permanent job position, with no layoff risk); and iron wages (uniformly distributed, fixed wage payments that are unlinked with job performance and productivity).

train the jobless, especially young people entering the job market, and help them find work; often the LESEs create the jobs directly by establishing small-scale collectives. The growth of LESEs was encouraged by government in the 1980s by granting them preferential tax treatment, and SOEs began to set up LESEs as vehicles to employ redundant labor and provide jobs for children of employees.

15. In addition to LESEs, a number of other types of employment agencies emerged in the last part of the 1980s, designed to aid the job allocation process. These include the "labor markets" established by city or district labor bureaus, that, for a one-time fee, provide a setting where firms in all sectors and job aspirants are brought together. Offering a similar range of services for skilled workers are the "personnel markets" set up and managed by the central Ministry of Personnel.

### **Dual track development—the emergence of the nonstate sector**

16. China's state-owned sector played a dominant role prior to the initiation of reforms, especially in the highly centralized urban economy, accounting for three quarters of China's gross industrial output, and for half of nonagricultural employment (Table V.1). The SOEs and the urban collectives (at that time for the most part subject to the same controls as the SOEs), together accounted for over 2/3 of employment. With the introduction of reforms, the government, while committed to establishing market-oriented mechanisms, was by no means prepared to accept massive unemployment and the associated social and political risk that would arise from a fast imposition of market discipline and hard budget constraints on the SOEs. Instead a cautious and gradual approach to enterprise reforms was taken, with the aim of striking the right balance between improving enterprise efficiency and minimizing the social cost of restructuring. The key component of this approach was the promotion of economic activities outside the state sphere, that is, to allow new firms that were more autonomous from the state to enter the market.<sup>11</sup> Much of the growth of the economy in the reform period came from the nonstate sector, so that by 1997 the share of nonagricultural employment accounted for by the SOEs totaled just 22 percent. At the same time the share accounted for by the urban cooperatives fell by half, to about 9 percent, while the private sector (including domestic private enterprises as well as foreign-funded enterprises (FTEs) and joint ventures) share grew from practically nothing at the start of reforms to 11½ percent of total employment. The growth of the rural township and village enterprises (TVEs) was also strong during the period, with their share of employment rising from 23 percent to almost 40 percent. Altogether, the nonstate sector accounted for almost 80 percent of employment in 1997.

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<sup>11</sup>One motivation for this approach may have been the rising unemployment in the urban areas along with the realization that the state enterprises, already carrying significant surplus labor, could not absorb the new workers. See Sabin (1995).

17. While large urban collectives supervised by governments at higher levels characterized the urban collective sector at the dawn of reform,<sup>12</sup> the reform period was dominated by the growth of small collectives set up by state-owned enterprises or run by lower level agencies, and often with private sector participation. This shift in composition was encouraged by a number of policies. Early in the reform period collectives were allowed to accept investment from individuals as well as from state entities. Financial incentives were provided through the tax system. In addition, the efficiency of operations was promoted by implementing regulations allowing more autonomy in production and sales decision, hiring and firing, and wage determination. In 1984, a contractual responsibility system was introduced for retaining profits to improve incentives. Also allowed was the practice of leasing urban collectives out to private individuals and groups. This liberalization culminated in a set of regulations issued by the State Council in 1991. These provided a broad definition of "collective ownership" which grants collective status to any enterprise in which private individuals own no more than 49 percent of total assets, and were given the right to pay dividends.<sup>13</sup> They were also given autonomy in production decisions and in wage determination. Thus, the sector has come to be characterized by relative flexibility in labor conditions.

18. Foreign investment into China grew quickly following the decision to re-open the country to foreign capital in 1979, aided by tax breaks and preferential regulatory treatment. While initially FFEs were made subject to administrative controls over employment and wages,<sup>14</sup> over time they have gained more autonomy. In 1986 regulations granted the FFEs the right to determine the size of their labor force, to hire and fire both managers and workers, and to set the form and level of wages. Many of the remaining restrictions relating to labor issues were removed in 1988. A particularly important development was the legitimization of the FFE's practice of recruiting and managing its workers without restraints of the residency registration system (see below); as a result personal mobility between the rural and urban areas was enhanced. The result of these developments was strong growth in employment in the sector.<sup>15</sup>

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<sup>12</sup>At that time jobs in urban collectives were less desirable than SOE jobs, as wages were lower (by 20 percent on average) and nonwage benefits were less comprehensive.

<sup>13</sup>It is reported that private businesses register themselves as urban collectives, to enjoy certain preferential tax and financial policies.

<sup>14</sup>Employment conditions were made subject to administrative approval. In addition salaries were to be set at 120–150 percent of the salaries in comparable SOEs.

<sup>15</sup>One motivation for the practice of "round tripping," whereby domestic state enterprises and collectives disguise new investment as foreign by funneling it through affiliated offshore entities, is to take advantage of the more liberal labor and wage regime.

19. Just prior to the adoption of reforms, as a matter of policy the private sector was kept very small, made up mainly of self-employed workers, most of whom were involved in small-scale commercial activities. In a significant reversal of this policy, the private sector began to be encouraged discretely in the late 1970s, in a few regions on an experimental basis. Then, in 1980, a national work conference on employment gave official approval to the growth in private activity, stating in its report that the sector should be developed, and called on local officials to eliminate policies that discriminate against private business. Other important developments occurred at the Third Plenum of the Twelfth Central Committee in October 1984, which called for deepening of economic reforms and offered strong support to the development of the private sector; in 1992 following Deng Xiaoping's southern tour, when local governments across the country announced special incentives for private businesses; and at the Fourteenth Communist Party Congress later that year when most restrictions on private industrial production and marketing were removed.

20. The growth of the private sector was aided by a number of factors. While initially private sector wages were subject to controls, in practice it was too difficult for the authorities to monitor the wage structures in much of the private sector, and they were essentially market determined. This flexibility was legitimized by regulations promulgated in 1988, that permitted large private businesses to determine their own wage and profit distribution systems. With regard to employment, private firms eventually acquired the legal right, first granted to FFEs, to recruit employees without restraints of the residency registration system. In addition, employment terms and conditions were subject to negotiation, and specified in renewable labor contracts (see below). Another change that was important for the ability of the private sector (and more generally the nonstate sector) to acquire skilled labor was the freedom that state sector workers gained to shift their employment to the nonstate sector.

21. The TVEs are owned by local governments, and under the planned economy they served as subcontractors for state enterprises or produced crafts. With the introduction of the production responsibility system in agriculture, a large amount of labor became surplus, and TVEs became the enterprise form most favored by local officials to absorb the surplus. Their chief competitive advantage is the flexibility of the rural labor markets. Almost all workers are short-term contractors or seasonal laborers, who receive no permanent job guarantee. Firms have the power to adjust the workforce in response to changing market conditions. In addition, wages are flexible and market-determined, and there is the possibility of a close link between pay and performance. In addition, enterprises provide few social services directly to their employees (most rural residents already occupy a home). Thus, the rapid growth of jobs in TVEs during the 1980s and 1990s was forged largely by market forces with little government oversight.

### **Introducing more flexibility in labor allocation: the labor contract system**

22. A potentially important step toward greater labor market flexibility was taken when the labor contracting system was introduced, under which all new employees who are included in state labor and wage plans would be hired on a contractual basis.<sup>16</sup> The experimental rules of the labor contract system first introduced in 1983 with the “Temporary Regulations on the Use of Labor Contracts in State-Owned Enterprises” were adopted by the State Council in 1986.<sup>17</sup> Growth in the share of employees under contract was moderate however through the second half of the 1980s and the early 1990s (Table V.2). The move toward contracts was given new impetus with the introduction of further reforms in 1994 (following the decisions adopted at the third plenum of the 14th Central Committee of November 1993) that introduced total labor contracting. As a consequence, between 1994 and 1997, the share of workers under contract has doubled, to over half of urban employees. The growth in contractals was strongest in the SOEs and the collectives.<sup>18</sup> Private enterprises (domestic and foreign) were more advanced in the use of contracts,<sup>19</sup> but the proportion of contractals rose strongly since 1994 here also, to cover about 2/3 of total employees by 1997. This partly reflects the fact that employment has been growing fastest in the private sector.

23. The introduction of labor contracts marked a shift from permanent job offering to more flexible contracting, breaking away from the system of lifetime tenure with its potentially distorted work incentives. Restrictions on movement of employees across firms were removed in an attempt to reduce the scale of mismatch inherent in the pre-reform system. Enterprises now had more autonomy over hiring and dismissal decisions. Associated with this autonomy was an increased prevalence of market mechanisms such as interview and firm-specific tests and exams aimed at identifying and screening potential employees. In

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<sup>16</sup>The reform has been characterized as replacing the ‘iron rice bowl’ with a ‘clay’ one for new employees. Permanent employees hired before 1986 retained their lifetime tenure.

<sup>17</sup>The regulations gave only rough guidelines as to the appropriate contract period for workers, stating that they can be long term (5–20 years) or short term (1–5 years). Howard (1991) reports that in Shenzhen and Guangdong, the majority of contracts were short term, of 1–3 years, while in Beijing they were usually for 5 years.

<sup>18</sup>The increase in the share of contractals understates the degree of flexibility now possessed by SOE and COE managements, as even permanent employees can now increasingly be laid off, under the xiagang system. See “People’s Republic of China: Recent Economic Developments” (forthcoming).

<sup>19</sup>As discussed earlier, foreign funded enterprises has given the right to hire on a contractual basis much earlier, and the right came to be extended to the domestic private sector.

addition, as mentioned in the previous section, the new system also increased workers' employment options.

24. On the other hand, there is little direct evidence that the introduction of the labor contract system has increased mobility between firms. There is a sense that in practice labor mobility is low, although it is more common among the young and more educated employees. This reflects in part the slow pace of reforms in other areas such as housing, pensions, health care, and the social safety net.

25. Despite the move toward increased management autonomy and the contract system, surplus labor persists in the state sector, and the system remains far removed from the free labor mobility in a market economy. There are a number of reasons for this. First, a large proportion of state sector employees retain lifetime tenure.<sup>20</sup> Second, many SOEs, comfortable with the tradition of bearing responsibility for maintaining jobs, have been reluctant to lay off employees; rather they have sought to create service-sector subsidiaries to re-employ surplus workers. Third, until recently firms faced restrictions on terminating expiring contracts.<sup>21</sup> Fourth, insolvent state enterprises have been supported by direct and indirect government subsidies to avoid bankruptcy and widespread layoffs.

#### **The evolution of rural-urban migration**

26. As discussed above, in the central planning period, the movement of labor was tightly controlled. This was achieved through a combination of a household registration (hukou) system, rural commune controls, and food rationing. Over the course of the reform period, and especially since the mid-1980s, the obstacles to rural-urban migration have declined somewhat. This has occurred as the result not of the abandonment of official restrictions on migration, but rather of reforms in both the countryside and cities, including the elimination of the communes and urban food rationing, which have transformed existing economic incentives and constraints. In particular, in the period since urban residents have been given more freedom to choose their jobs, migrants tend to fill those jobs that urban workers shun.

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<sup>20</sup>However, lifetime tenure has been eroded as enterprises have in the last several years gained the right to lay off permanent employees, while they are required to establish so-called "re-employment centers" for those laid off that provide retraining and job search assistance, and pay unemployment benefits. If the laid off employee remains unemployed after three years, the employer can now sever the relationship.

<sup>21</sup>Employers were obligated to try to find another position for the employee they were seeking to release, to provide vocational training, and at least two other job offers, before being allowed to let the employee go. Now, employers must merely submit a list of planned layoffs to the local labor bureau. See U.S.-China Business Council (1999).

27. Rural to urban migrant workers comprise two main groups; those who become permanent urban residents by changing their registration, and those who do not. The first group is strictly controlled and makes up a large part of the annual new urban employment under the labor plan (Table V.3). These figures indicate that whereas in 1980 rural residents who were allowed to change their registration made up 14 percent of new entrants into permanent urban employment, that had risen to 30 percent in 1996, and has remained over 27 percent of the total each year since 1993. These numbers demonstrate the significant impact rural migration has had on the expansion of the permanent resident urban labor force.

28. These data exclude a much larger pool of rural labor working in the cities but who maintain their rural residency status. These migrants officially remain temporary members of the urban workforce, even though they may be long-term urban residents. Because they live away from their place of permanent residence, these migrant workers and their families make up China's "floating population" of urban transients, the numbers of which are difficult to determine but which have been estimated to total 60-80 million persons.<sup>22</sup>

29. It remains difficult for these workers to acquire permanent urban residence status. As a result of their concern about maintaining the stability of urban life, officials at various levels have attempted to exert some degree of control over rural to urban labor flows. At the national level, besides controlling the number of rural residents who can change their hukou (as discussed above), the government regulates the recruitment of rural contract workers by SOEs. These regulations specifically require all such workers be registered with local officials. But most of the measures designed to stem the flow of rural migrants have been taken by city governments themselves. Local registration and licensing requirements (that do not confer urban resident status) for migrants are common,<sup>23</sup> as are restrictions placed on enterprises on the hiring of rural laborers. Generally, rural workers are permitted only in the residual urban jobs that are difficult to fill with urban residents. These tend to be the lowest-wage, lowest skill, least pleasant jobs, and without health, education, pension or housing benefits. In addition to the migrants who are registered locally, there are unregistered migrants who work in the informal sector.<sup>24</sup> The severity of local restrictions on both types of migrants ebbs and flows, depending on labor market conditions in the city, but there is also a trend toward greater tolerance of migration. This may represent a growing realization that flows have become more difficult to control, due to strong economic forces, including policies that have spurred the process of urbanization and industrialization, as well as a

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<sup>22</sup>World Bank (1997).

<sup>23</sup>In Chongqing and Beijing, for instance, regulations require farmers to find jobs through the city's labor bureaus and to pay a substantial monthly "management" fee (Sabin (1995), p. 243).

<sup>24</sup>Migrants with local registration tend to work in the SOEs, collectives and jointly-owned enterprises.

realization of the economic benefits conferred by the migrants. This trend suggests that rural-urban migration will continue to exert a strong influence on urban labor market outcomes.

### **Increased flexibility in wages**

30. The pre-reform wage system in the state sector suffered from a severe lack of effective work incentives. In addition, the rigid, centralized wage management through the wage plan allowed no scope for enterprise participation in wage setting. Thus wage policy was an area identified as one of the first targets of reforms. Wage policies were allowed to be more flexible, and bonuses, once condemned as capitalist, were re-introduced in 1978 as a component of workers' total compensation. The SOEs were granted discretion in determining the amount of bonus to be paid to individual workers, and were encouraged to link pay to performance. Wage gaps were permitted to widen, reflecting job performance differentials as well as seniority and education.

31. The reforms were implemented in three stages. The first set of reforms, begun in 1978, allowed firms to reinstitute bonus systems, subject to a ceiling related to the total wage bill, and piece-rate wages. In addition, enterprise profit retention and tax systems began to be implemented, that converted the enterprise's centrally fixed total wage quota into a flexible total wage bill depending on profitability, with firms being allowed to retain part of their profits to provide workers with bonuses and to contribute to their employees' welfare system. Initially, bonuses were restricted to a maximum of 5 percent of the total payroll. This ceiling, however, was eliminated gradually. The second set of reforms, begun in 1985, built on the earlier reforms, attempting to forge a more direct link between an individual's wages and labor productivity within the firms.<sup>25</sup> The incentives mechanisms adopted varied among regions and across industries, but of the wide range introduced, the basic wage-plus-bonus system became the most used. The basic wage component of wage payments remained subject to the wage plan and other state restrictions.<sup>26</sup> The third set of reforms accompanied the introduction of the new Labor Law in 1994, and were in many respects refinements of the previous schemes, that in principle embodied increased management autonomy in wage

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<sup>25</sup>Besides the microeconomic goals of decentralizing wage decisions and improving the incentive properties of wages, the reforms were motivated by the macroeconomic goal of restraining what were seen to be excessive and inflationary wage increases in the state sector.

<sup>26</sup> Basic wages follow the old wage system with a separate wage matrix for cadres, professionals and workers, and with grades or ranks within each matrix in principle reflecting skills and qualifications. There is in addition a position component of the wage that is intended to reflect the degree of responsibility inherent in the job, working conditions and work load. In addition there are allowances for transport costs and other work-related expenditures.

determination.<sup>27</sup> But in addition, concerned by the rate at which wages were rising, the authorities introduced new controls on increases in bonuses, with the intention of restraining increases in wages below the rate of increase of profits, and other indicators of firm performance. This involved a shift from control of the overall wage fund to control of wages actually paid out.

32. A major effect of the reforms was a significant increase in the importance of bonuses in total wages (Table V.4). For all enterprises, the share of bonuses rose from 2 percent of the wage bill at the start of reforms in 1978, to about 16 percent in 1997, with a high of 22 percent realized in 1993. The pattern is similar for the various types of ownership, with bonus shares being uniformly highest in the private sector and uniformly lower for the collectives. In 1997 bonuses constituted 19 percent of total wages in the private sector, about 16 percent in the SOEs and 12 percent in the collectives. The effect of the 1994 reforms on bonuses is clearly apparent in the table, where the share of bonuses fell on average by 30 percent by 1997. This was occurring at the same time that average real wages continued to rise strongly (Table V.5).

33. The evidence is mixed on whether the wage reforms have altered wage determination processes and worker incentives in state enterprises sufficiently to generate more efficient market outcomes.<sup>28</sup> It has been argued that egalitarian practices have persisted in wage determination, in the form of a relatively equal distribution of bonus funds among workers, independent of individual performance. A loose connection between bonus level and performance may also reflect difficulty in monitoring individual effort. Other evidence (reviewed in Section D below) indicates that significant gaps between wages and productivity persist in the state sector. The effects of the 1994 reforms have not yet been subjected to the same degree of analysis. While the share of bonus in the average wage has fallen sharply since the reform, it is possible that the reforms have had their intended effect of inducing improved efficiency of the wage system by increases incentives at the margin.

#### **D. Implications: Wages, productivity and subsidies in the SOE sector**

34. This section brings out one set of implications of the developments described above for the performance of the SOE sector, specifically arising from the differential development of labor flexibility in the state and nonstate (especially private) sector over the reform period. While average wages are high in the state sector, wage determination processes have led to a compression of the wage distribution, leading to pay levels lower than productivity for the

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<sup>27</sup>Managers now have greater autonomy over allocation to and promotion within the standard basic wage matrices, even though the matrices themselves continue to be set by central and provincial governments.

<sup>28</sup>See the evidence presented in Coady and Wang (1998); Groves et al. (1994); Knight and Song (1999); Meng and Kidd (1997); and Sabin (1995).

most highly skilled and most productive workers. While this system may be motivated by concerns over equity, it has had some deleterious effects on efficiency, when it interacts with the relative flexibility of movement of labor between the state and nonstate sectors that have formed part of the reforms. In particular, those workers whose pay is compressed have an incentive to move to the nonstate sector, where wages are adjusted to more closely match productivity. Conversely, workers in the state sector whose wages are higher than their productivity have no such incentive. A result of this sorting process is an increasing gap in average labor productivity between the state and nonstate sectors. Accompanying this process is a continuing deterioration in the performance of the state sector, with the accompanying need for direct or indirect subsidies from government.

35. Evidence suggests that wages-rates across different skill and education levels in the state enterprises are compressed, and the degree of compression has increased over time (Table V.6). The table presents indices of the relative wages of managers, engineers, workers, and staff from a survey of 769 SOEs.<sup>29</sup> The data indicate that in 1980 (before reforms began), the wage of engineers was only 21 percent higher than an unskilled worker's wage, while managers were paid 10 percent more than workers and staff 2 percent more. Moreover, despite the labor market reforms of the 1980s, the wage differentials mostly decline, so that engineers in 1989 are paid only 7 percent more than unskilled workers, managers 4 percent, and staff 6 percent.<sup>30</sup> The compressed wage schedule has persisted into the 1990s.<sup>31</sup>

36. As discussed earlier, average wages are consistently higher in the private sector (Table V.5). Along with these higher wages, the private sector has higher labor productivity, consistent with the superior incentive structure resulting from the greater flexibility to link wages with performance (Table V.7). This greater productivity can come about through two processes, first, by greater effort extended by workers as earnings respond to output, and, second, by attracting more productive workers from the state sector where the wage distribution is compressed. Table V.7 shows that output per worker was almost three times as high in the private sector than in the SOEs in 1997, and about 30 percent higher in the

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<sup>29</sup>The survey results are found in F. Dong, and Z Tang, "Studies of Institutional Changes in China's State Enterprises, (1995), (in Chinese), and reported in Gordon and Li (1999).

<sup>30</sup>Using this data, Gordon and Li estimate that the value of the marginal products of each of these occupational groups varied much more than wages. While the average wage was about Y 2,400, the estimated marginal product of engineers was Y 13,300, high school graduates was Y 8,700, and the marginal product of workers with less education was close to zero.

<sup>31</sup>Knight and Song (1999) report on the results of another survey, that showed that in 1995 the average wage of managerial and technical staff was 42 percent higher than for production workers, while the wage of skilled workers was 24 percent higher, and the wage of supporting workers was 9 percent less. Note that the wage compression in SOEs is similar to one of the effect of labor unions that has been demonstrated in a number of countries.

collectives. Moreover the productivity gap has been widening over the period of reforms. The gap between the private and state sector stood at only about 40 percent in 1985, while labor was only half as productive in the collective sector in that year. In fact, this data understates the gap in labor productivities, as the state sector continues to have preferential access to bank loans (through the state commercial banks) and land, so that production there is more capital and land intensive.<sup>32</sup>

37. Accompanying the relative fall in labor productivity and high average wages in the SOE sector is a loss of competitiveness. Losses of loss making enterprises have increased substantially over the reform period, especially since 1989 (Table V.8). Real losses per SOE worker have more than quadrupled in real terms since the opening up of reforms, increasing from Y 320 per SOE worker in 1978, to Y 1,416 per worker in 1997, and tripled since 1989. In the period, total losses have risen to account for almost 1/3 of the SOE wage bill—the losses of course would represent a larger proportion of the wage bill of the loss-making SOEs. This represents a sizable subsidy to labor in the state-owned sector. With the government as owner of the SOEs (and the state commercial banks), these losses must ultimately appear in the fiscal accounts.

38. With the wage structure distorted in this way, managers of state enterprises have an incentive to hire more skilled workers and lay off unskilled workers as budget constraints are tightened. However, as discussed above, the authorities maintained substantial direct controls over SOE employment for most of the reform period. This control was relaxed somewhat starting in the mid-1990s when enterprises were allowed to increase lay offs to reduce surplus labor. There is some evidence that those who are being laid off are the workers who benefit most from the wage compression. A survey of laid off workers in 1997 showed that over 60 percent had only middle school diplomas, while only 0.2 percent of laid off workers had advanced engineering diplomas.<sup>33</sup>

### **E. Conclusions and Challenges Ahead**

39. Labor market reforms implemented since the late 1970s have increased the autonomy and potentially improved the incentives of managers and workers. Administrative allocation of urban workers to jobs has been gradually diminishing, and enterprise managers have acquired more control over recruitment and employment. The data suggests that state sector

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<sup>32</sup>Note that Table V.7 shows that real labor productivity has increased in all sectors since the opening up. For the SOE sector this is due to capital deepening and also from productivity gains arising from the reforms that have been implemented.

<sup>33</sup>Reported in Hishida (1998). The survey also showed that over 90 percent of laid off workers were married (consistent with the policy of keeping when possible one adult employed in a household), and that the average age of laid off workers was 32 years old, with about 60 percent below age 35.

managers used the greater autonomy to strengthen workers' incentives. Lifetime employment has been phased out for new workers; by 1997 contract workers, on fixed term renewable contracts, represented over half of urban employees, up over 400 percent since the start of the decade. Wage bonuses had become more prevalent, and the migration of rural residents to urban enterprises has gathered momentum and is now substantial.

40. However, there are still a number of difficult challenges ahead to expand the role of market forces in labor allocation and rewards in the state sector. While the labor contracting system dominates at the margin, there is little evidence that contract renewal is related to performance. With regard to pay, while a larger proportion of the wage bill depends on performance of the firm, evidence suggests that there is a weak link between individual wages and performance. This reflects the fact that administrative intervention still has a significant effect in determining labor market outcomes, motivated by a concern to avoid a large increase in urban unemployment or inequality in income distribution.

41. Wages have been kept high in the state sector despite weak productivity, and the wage structure has been compressed. As labor mobility has increased at the same time that a more flexible private sector has been allowed to develop, incentives have been created for the more skilled and more productive to move to the private sector where wages are more closely aligned with performance. This sorting of workers contributes to deteriorating financial results for the SOEs, and can act as a significant constraint on reform. The analysis suggests that more emphasis could be placed on wage reform in the SOEs, reducing the emphasis on layoffs as the major adjustment mechanism. The scope for (average) wage reductions in the state sector (direct, or indirect, through reduction in nonwage benefits, including housing subsidies) as a substitute for layoffs should be investigated and exploited. In addition, the analysis suggests that, with the current wage structure, the laid off are dominated by those who are the least productive and skilled (who are relatively the most overpaid in the state sector), underscoring the need for an emphasis on retraining the unemployed. This will have to be accompanied by wage increases for the skilled, to make SOEs competitive in hiring with the nonstate sector. As Table V.7 indicates, the gains in productivity from these reforms are potentially quite large.

42. Improved labor market functioning will ultimately benefit the nonstate sector, especially small enterprise, which has become the engine of employment growth in the economy, both directly, through better matching of workers and jobs, and indirectly, through lower taxes, that are currently used to support an inefficient labor allocation in the state sector.

Table V.1: China: Shares of Total Nonagricultural Employment, by Ownership, 1978-97. 1/

(In percent)

	State-owned enterprises 2/	Nonstate Sector		
		Urban Collectives	Private 3/	TVEs 4/
1978	...	16.6	0.1	22.9
1980	49.7	17.9	0.6	22.2
1985	39.4	16.8	2.5	35.3
1990	30.4	14.8	3.5	38.6
1991	30.1	14.5	3.9	38.6
1992	27.4	13.0	4.0	38.1
1993	25.5	11.3	5.5	41.2
1994	25.1	10.8	7.6	39.5
1995	24.1	9.9	9.2	40.3
1996	23.0	9.0	9.9	40.5
1997	21.8	8.7	11.4	39.2

Source: State Statistical Bureau, China Statistical Yearbook, various years; and staff calculations.

1/ Total nonagricultural employment is the sum of urban employment and TVE employment.

2/ Data for 1980 and 1985 refer to industrial state owned enterprises.

3/ Includes foreign-funded enterprises, joint ventures, and individual businesses.

4/ Township and Village enterprises

Table V.2. China: Trends in Contract Labor by Ownership Type, 1983-97.

	1983	1985	1990	1991	1992	1993	1994	1995	1996	1997
	(in millions of employees)									
Total	0.65	4.09	17.02	19.72	25.41	31.23	38.39	60.96	75.8	77.08
State-owned enterprises	0.57	3.32	13.72	15.89	20.58	23.96	28.53	43.96	55.49	55.57
Urban Collectives	0.08	0.72	2.87	3.23	3.99	5.26	6.45	11.49	13.94	14.24
Other	...	0.05	0.43	0.6	0.84	2	3.41	5.51	6.37	7.27
	(in percent of employees in the sector)									
Total	0.6	3.3	12.1	13.6	17.2	21	25.9	40.9	51.1	52.6
State-owned enterprises	0.6	3.7	13.3	14.9	18.9	21.9	26.2	40.1	50.7	51.6
Urban Collectives	0.3	2.2	8.1	8.9	11	15.5	20.1	37.4	47.2	50.5
Other	...	11.4	26.3	28	29.8	37.4	45.6	62.8	67.6	67

Source: State Statistical Bureau, China Statistical Yearbook, 1998.

Table V.3. China: New Urban Employees, by Source, 1980-97.

	Total New Employment	Urban Labor 1/	Rural Labor 2/	Graduates 3/	Other
(In millions of workers)					
1980	9	6.2	1.3	0.8	0.7
1985	8.1	5	1.5	0.9	0.7
1990	7.9	3.4	1.2	1.7	1.6
1991	7.6	3	1.4	1.7	1.6
1992	7.4	3	1.6	1.9	0.9
1993	7.1	2.9	1.9	1.9	0.4
1994	7.2	2.8	2	2	0.4
1995	7.2	2.7	2.2	2.1	0.2
1996	7.1	2.6	2.1	2.1	0.3
1997	7.1	2.6	1.9	2.3	0.4
(Share of total new employment, in percent)					
1980	100	69	14	9	8
1985	100	62	19	11	9
1990	100	43	15	22	20
1991	100	39	18	22	21
1992	100	41	22	26	12
1993	100	41	27	27	6
1994	100	39	28	28	6
1995	100	38	31	29	3
1996	100	37	30	30	4
1997	100	37	27	32	6

Source: SSB, China Labor Statistical Yearbook, 1998.

1/ Remanent urban residents.

2/ Permanent rural residents (with agricultural status).

3/ Graduates from univerisities, specialized and technical schools.

Table V.4. China: Bonuses as a Share of the Total Wage Bill, 1978-97. 1/

Year	Total	SOEs	Nonstate Sector	
			Collectives	Private
(In percent)				
1978	2	2.4	...	...
1980	9.1	9.7	6.5	...
1985	15.1	14.5	16.8	22
1990	18.2	19.1	14.6	20.9
1991	18.9	19.9	14.6	19.6
1992	20.8	22.2	15.1	20.7
1993	22.2	23.3	16.6	25.5
1994	17.9	17.9	15.3	24.2
1995	16.3	16.8	13.6	21.7
1996	15.4	16.1	12.5	19.9
1997	15.6	15.7	12.2	19.2
(In yuan)				
Memorandum items:				
Average wage, 1997	6,470	6,747	4,512	8,789
o/w:bonuses	1,009	1,060	548	1,689
allowances 2/	1,445	1,681	703	1,017

Source: State Statistical Bureau, China Labor Statistical Yearbook, 1998; and China Statistical Yearbook, 1998.

1/ Bonuses include payments to workers for output beyond labor quota, for profit-sharing, and for extra work.

2/ Refers to payments to offset the impact of inflation, and to compensate for employment expenses.

Table V.5. China: Average Annual Wages, by Ownership Type, 1980-98.

	1980	1985	1990	1991	1992	1993	1994	1995	1996	1997	1998
	(In yuan)										
All Industry	762	1,148	2,140	2,340	2,711	3,371	4,538	5,500	6,210	6,470	6,897
State-owned enterprises	803	1,213	2,284	2,477	2,878	3,535	4,797	5,625	6,280	6,747	7,159
Collectives	623	967	1,681	1,866	2,109	2,592	3,245	3,931	4,302	4,512	4,625
Private sector	...	1,436	2,987	3,468	3,966	4,966	6,303	7,463	8,261	8,789	8,587
	(In percent of average wage in state sector)										
All Industry	95	95	94	94	94	95	95	98	99	96	96
State-owned enterprises	100	100	100	100	100	100	100	100	100	100	100
Collectives	78	80	74	75	73	73	68	70	69	67	65
Private sector	...	118	131	140	138	140	131	133	132	130	120
	(Annual percentage change, at current prices)										
All Industry	14.1	17.9	10.6	9.3	15.9	24.3	34.6	21.2	12.9	4.2	6.6
State-owned enterprises	13.9	17.3	11.1	8.5	16.2	22.7	35.8	17.3	11.6	7.4	6.1
Collectives	14.9	19.2	8	11	13	22.9	25.2	21.1	9.4	4.9	2.5
Private sector	...	37	10.3	16.1	14.4	25.3	26.9	18.4	10.7	6.4	-2.3
	(Annual percentage change, at constant prices)										
All Industry	6.1	5.3	9.2	4	6.7	7.1	7.7	3.8	3.8	1.1	7.2
State-owned enterprises	6	4.8	9.7	3.2	7.0	5.7	8.7	0.4	2.6	4.2	6.7
Collectives	6.9	6.6	6.6	5.6	4.1	5.9	0.2	3.7	0.6	1.7	3.1
Private sector	...	22.5	8.9	10.5	5.3	7.9	1.5	1.4	1.7	3.2	-1.7
Memorandum item:											
GDP growth rate	7.8	13.5	3.8	9.2	14.2	13.5	12.6	10.5	9.6	8.8	7.8

Sources: State Statistical Bureau (SSB), China: Statistical Yearbook; Labor Statistical Yearbook, and data provided by the authorities.

Table V.6. China: Wage Structure in SOEs, 1980-89 1/

	Workers	Engineers	Managers	Staff
1980	100	121	110	102
1983	100	121	115	101
1984	100	112	106	96
1986	100	114	110	97
1987	100	114	109	94
1988	100	108	108	102
1989	100	107	104	106

Source: F. Dong and Z Tang, "Studies of Institutional Changes in China's State Enterprises, " (1995), (in Chinese); reported in Gordon and Li (1999).

1/ Average annual wage, relative to wage of workers.

Table V.7. China: Real Industrial Output per Worker, by Ownership Type, 1975-97 1/

	All industry	SOEs	Nonstate sector	
			Collectives 2/	Private
(In yuan)				
1975	7,722	10,135	...	...
1980	8,952	12,081	6,549	...
1985	12,372	16,080	8,206	22,762
1990	17,408	18,039	14,258	41,465
1991	28,704	32,304	20,664	67,699
1992	34,338	36,074	27,004	82,992
1993	47,824	49,151	36,796	92,943
1994	49,187	40,908	46,135	99,834
1995	56,082	43,262	52,270	121,814
1995 3/	53,397	42,107	48,160	134,392
1996 3/	61,941	45,906	58,084	135,529
1997 3/	72,044	51,346	66,685	144,709
(As percent of output per worker in state sector)				
1975	76	100	...	...
1980	74	100	54	...
1985	77	100	51	142
1990	97	100	79	230
1991	89	100	64	210
1992	95	100	75	230
1993	97	100	75	189
1994	120	100	113	244
1995	130	100	121	282
1995 3/	127	100	114	319
1996 3/	135	100	127	295
1997 3/	140	100	130	282

Source: SSB: China Industrial Economic Statistical Yearbook, 1998.

1/ For enterprises at township level and above, with independent accounting systems. Data for 1975 - 1990 in constant prices of 1980. Data for 1991-1997 in 1990 prices.

2/ Pre-1985, covers only urban collectives.

3/ Calculations according to new method.

Table V.8. China: Implicit Subsidies to Labor in State Enterprises, 1978-97

	SOE losses 1/ (In billions of yuan)	Loss per SOE worker (Yuan, current prices)	Real loss per worker (Yuan, 1992 prices)	Loss/Wage Bill (In percent)
1978	4.21	127	321	20.1
1979	3.64	113	267	15.4
1980	3.43	103	237	12.5
1981	4.60	132	297	16.0
1982	4.76	133	294	15.7
1983	3.21	88	190	10.2
1984	2.66	73	144	6.9
1985	3.24	85	160	7.1
1986	5.45	138	242	9.8
1987	6.10	149	221	9.6
1988	8.19	194	243	10.3
1989	18.02	422	517	19.7
1990	34.88	799	952	33.8
1991	36.70	821	928	31.9
1992	36.93	875	875	27.6
1993	45.26	1,006	826	27.9
1994	48.26	1,104	791	24.0
1995	63.96	1,455	983	26.4
1996	79.07	1,849	1,240	30.5
1997	83.10	2,057	1,416	32.1

Source: SSB, China Statistical Yearbook, various years; SSB, China Industrial Economic Statistical Yearbook, 1998; and staff calculations.

1/ Total losses of loss-making enterprises.

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## VI. PENSION REFORM ISSUES IN CHINA<sup>1</sup>

### A. Introduction<sup>2</sup>

1. China's pension system was founded in the 1950s and has developed largely along the lines of state industry in the following decades. It is predominantly a pay-as-you-go, defined benefit system designed to cover state owned enterprise (SOE) workers, although some employees of collectively owned enterprises (COEs) have been covered as well. For demographic as well as macroeconomic reasons, however, the authorities have begun to move toward a three pillar system with elements of funding during the 1990s. However, this process is complicated by the relatively extreme degree of decentralization built in to the existing structure, and by horizontal imbalances across China's provinces caused by the fact that much of the loss making state owned industry is located in a few regions, such as the northeast, where the proportion of the aged is also high.

2. This paper is aimed at accomplishing several tasks. First, a brief review of the development of China's pension system is presented in section B, followed by a discussion in section C of the current reforms which began to be introduced during the 1990s. Finally, in section D, some fiscal and macroeconomic considerations are presented, more as a way of raising important questions that will have to be addressed by the authorities than as a means of answering them at this stage.<sup>3</sup>

### B. Early Pension Reform in China

3. China's pension system was set up in the context of labor insurance regulations issued in February 1951 as part of the creation of an all-encompassing benefit system for SOE employees. Apart from civil servants, only urban workers, and of these predominantly SOE employees, were covered, and their benefit claims were managed largely by the firms in which they worked. No standard regulations in the pre-reform period existed for workers in the collectively owned sector, where benefits tended to be below those in the SOE sector. Workers in the private sector had no formal coverage.

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<sup>1</sup>This chapter was prepared by Thomas Richardson (ext. 36258).

<sup>2</sup>It should be noted that the pension system in China is highly fragmented and decentralized, making it exceptionally difficult, even for China, to assess the status of pension developments for the country as a whole. Some of the information below is therefore based on studies done in selected provinces or cities, and may not reflect nationwide trends.

<sup>3</sup>Despite the fact that rural workers made up over 70 percent of the labor force in 1998, the focus in this paper is on the urban retirement system; the status of rural retirees is only discussed in passing here. For more information, see World Bank (1997b).

4. In the state sector, males retired at age 60 after working for at least 25 years, 10 of which had to be at the final work unit which would pay the pensions; females retired at age 55, after working for at least 20 years, again, 10 of which had to be at the final work unit. Benefits ranged from 35 to 60 percent of the "standard wage" (equal to base wage plus supplements based on seniority and rank). Employers contributed 3 percent of total wages as the labor insurance fund and they kept 70 percent of this amount for benefits the firm administered itself (under the guidance of the All-China Federation of Trade Unions), transferring the remainder to higher levels of government, which implicitly guaranteed all benefits.<sup>4</sup>

5. Minor reforms to the system were implemented in 1953, 1955 (when a separate system for government employees was established) and 1958 (when coverage was extended to firms with fewer than 100 workers). During the Cultural Revolution the All-China Federation of Trade Unions was abolished, and all previously accumulated balances were diverted to other uses, effectively decapitalizing a system that was already somewhat underfunded. Local labor bureaus were made responsible for supervising pension payments, which were devolved to the enterprises, thereby ending any pooling.

6. By the beginning of China's remarkable period of economic growth in 1978, the number of retirees had reached 3.14 million, while 95 million employees were covered, implying a system dependency (employees to retirees) ratio of over 30. In 1978, a set of amendments was introduced that significantly loosened eligibility rules for pension recipients. The number of years required for eligibility fell to 10 years for both males and females, none of which had to be at the current work unit, while benefits were increased to 60-90 percent of standard wages. These changes caused a sharp jump in the number of retirees, which almost doubled by 1979, and sharply worsened pension system finances, as expenditures doubled as well over 1978 levels.

7. In subsequent years, as Table VI.1 shows, the combined effect of these reforms and demographic trends was significant. The number of retirees rose by 4.7 times in the years from 1978 to 1984, while pension expenditures grew from 2.8 percent of the urban wage bill to 10.6 percent. As a result the system dependency ratio fell from 30.3 workers per retiree in 1978 to 7.5 in 1985. These demographic trends, coupled with China's early economic reforms, led to pressures for reform, which were first implemented in 1984, when some cities were allowed to experiment with pension pooling. In order to enhance labor mobility and to diversify risk, enterprises put a portion of total wages, at a rate determined locally, into a fund managed by a local old age insurance bureau. The pressure for a pension system compatible with labor mobility arose in response to creation of the labor contract system in the 1980s, though the dispersion of pension pooling arrangements has been quite gradual in the years since then.

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<sup>4</sup>See World Bank (1997b). Until February 1969, the budgets of enterprises and governments were not separate, making the guarantee explicit. See Song and Chu (1997).

Table VI.1. China: Dependency Ratios and Average Wages, 1978-98

	<u>Number of retirees (million)</u>				<u>Ratio of Employees to Retirees</u>			
	Total	SOEs	COEs	Other	Total	SOEs	COEs	Other
1978	3.1	2.5	0.3	...	30.3	26.2	68.3	...
1979	6.0	4.7	1.2	...	...	...	...	...
1980	8.2	6.4	1.8	...	12.8	12.6	13.6	...
1981	9.5	7.4	2.1	...	...	...	...	...
1982	11.1	8.7	2.5	...	...	...	...	...
1983	12.9	10.2	2.8	...	...	...	...	...
1984	14.8	10.6	4.1	0.0	...	...	...	...
1985	16.4	11.7	4.7	0.1	7.5	7.7	7.1	8.8
1986	18.1	13.0	5.0	0.1	7.1	7.2	6.9	9.2
1987	19.7	14.2	5.4	0.1	6.7	6.8	6.5	12.0
1988	21.2	15.4	5.7	0.1	6.4	6.5	6.2	12.1
1989	22.0	16.3	5.6	0.1	6.2	6.2	6.2	13.2
1990	23.0	17.2	5.7	0.1	6.1	6.0	6.3	14.9
1991	24.3	18.3	5.9	0.1	6.0	5.8	6.2	17.3
1992	26.0	19.7	6.1	0.2	5.7	5.5	5.9	16.6
1993	27.8	21.4	6.0	0.4	5.4	5.1	5.7	13.1
1994	29.3	22.5	6.2	0.6	5.1	4.8	5.2	12.5
1995	30.9	24.0	6.2	0.7	4.8	4.6	5.0	12.2
1996	32.1	25.2	6.2	0.8	4.6	5.9	4.8	11.6
1997	33.5	26.4	6.2	0.9	4.4	4.1	4.5	11.8
1998	...	...	...	...	...	...	...	...

	<u>Number of staff and workers</u>				<u>Average wage of staff and workers (yuan)</u>			
	Total	SOEs	COEs	Other	Total	SOEs	COEs	Other
1978	95.0	74.5	20.5	0.0	615	644	506	...
1979	...	...	...	...	...	...	...	...
1980	104.4	80.2	24.3	0.0	762	803	623	...
1981	...	...	...	...	...	...	...	...
1982	...	...	...	...	...	...	...	...
1983	...	...	...	...	...	...	...	...
1984	...	...	...	...	...	...	...	...
1985	123.6	89.9	33.2	0.4	1148	1213	967	...
1986	128.1	93.3	34.2	0.6	1329	1414	1092	...
1987	132.1	96.5	34.9	0.7	1459	1546	1207	...
1988	136.1	99.8	35.3	1.0	1747	1853	1426	...
1989	137.4	101.1	35.0	1.3	1935	2055	1557	...
1990	140.6	103.5	35.5	1.6	2140	2284	1681	...
1991	145.1	106.6	36.3	2.2	2340	2477	1866	...
1992	147.9	108.9	36.2	2.8	2711	2878	2109	...
1993	148.5	109.2	33.9	5.4	3371	3532	2592	4966
1994	148.5	108.9	32.1	7.5	4538	4797	3245	6303
1995	149.1	109.5	30.8	8.8	5500	5625	3931	7463
1996	148.5	109.5	29.5	9.4	6210	6280	4302	8261
1997	146.7	107.7	28.2	10.9	6470	6747	4512	8789
1998	...	...	...	...	...	...	...	...

Sources: China Statistical Yearbook 1998, tables 5-6,24,27, and China Social Insurance Yearbook 1997, table 7-9.

Note: Includes employees of Civil Affairs Departments and support departments.

8. In 1986, limited pooling was established at the municipal level for SOE workers as a general policy. Separate city level pension pools were set up for contract and permanent workers, with the former making individual contributions, while the latter initially did not. Pooling was extended to collectively owned enterprises in the late 1980s, with firms in other ownership categories being gradually brought into pension pools on an ad hoc basis. In 1991, employees in all covered firms were mandated to make individual contributions in addition to the enterprise contribution, and for the first time experiments were permitted with individual pension accounts. At the same time, the authorities' goal of creating a three-tier pension system was first stated consisting of a basic benefit, a supplementary pension benefit offered by the enterprise, and a voluntary tier based on individual savings.<sup>5</sup> Separately, pooling arrangements were established for employees in 11 government-run sectors of the economy (such as the aviation and metallurgical industries) outside any local government pooling arrangements.

### C. Reforms in the 1990s

9. By 1991, 2270 cities and counties had established pension pools, covering over 72 million employees, while 1,076 cities and counties had pension pools for collective enterprises. By 1994, nearly all cities or counties had created local pension pools or were participating in higher level pension pools at the province level. The forms this pooling took initially varied greatly from place to place, reflecting explicit government policy of promoting pilot projects and experimentation. For example, in Zhuzhou, Hunan Province, a contribution rate of 18-21 percent for employers, and 3 percent for employees, was set, while in Bingzhou Prefecture, Shandong Province, the fixed contribution amount varied in steps according to the standard wage. Early pension pooling began in Fujian and in Jiangxi, where in July 1992 enterprises began to contribute 23 percent of the pre-tax sum of wages and pensions to the local social security bureau, while employees paid 3 percent of their standard wages, deducted from their payrolls.<sup>6</sup>

10. However, China's one child policy, established in the 1970s, and the increases in life expectancy that occurred as a result of economic growth and higher living standards, meant that China's population was aging very rapidly, a fact that policy makers realized would put pressure on the retirement insurance system. Indeed, in China the "1-2-4" problem is commonly referred to as a way of describing the circumstance of a single working adult supporting two parents and four grandparents. By 2020, the share of people over 60 in the

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<sup>5</sup>World Bank (1997b), p. 17.

<sup>6</sup>Song and Chu (1997).

population will reach a level that is not significantly different from their share in the populations of OECD countries in 1990, as the following table suggests.<sup>7</sup>

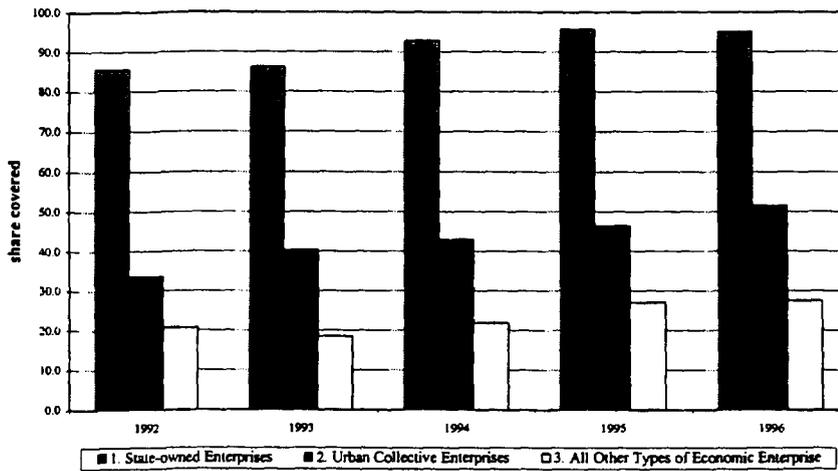
**Table VI.2. China: Share of Population Over 60, 1990-2050**

Country	1990	2000	2010	2020	2030	2050
China	8.9	10.2	12.0	16.0	21.9	26.1
India	6.9	7.5	8.3	10.3	13.1	20.4
Korea	7.7	10.7	13.9	19.5	25.5	29.8
Malaysia	5.7	6.5	8.0	11.0	14.5	22.1
Japan	17.3	22.7	29.0	31.4	33.0	34.4
OECD average	18.6	20.0	23.2	26.9	30.8	31.

Source: World Bank (1997b), p. 14.

11. In addition to this long run problem, policy makers in China understood in the early 1990s that in the short run they would have to face the problem of pension obligations of SOE retirees in the context of the reform of the state enterprise sector itself. Although under socialism it was possible, due to the lack of separation of enterprise and government accounts, to subsidize SOE retirees via the finances of the firm, once reforms began to take hold, those SOEs with large contingents of retired former workers were handicapped in competing with other enterprises, some of which were not and never had been state owned, and who had less if any retiree burden.

**Chart VI.1. China: Pension Coverage Ratio of Employees by Ownership, 1992-96**



Although the share of SOE employees covered by basic pension insurance was high from an early stage of China's reforms, the proportion of employees of other ownership types who are covered has markedly increased during the 1990s. (See Chart VI.1 and Tables VI.3-VI.6.) That this has happened despite relatively

<sup>7</sup>However, it took most of the OECD countries 80-100 years to double the proportion of their population over 60; China will do so in about 34 years. (World Bank (1997b), p. 14.)

Table VI.3. China: Number of Retired Employees Participating in Basic Retirement Insurance by Ownership, 1992-98 1/

	1992	1993	1994	1995	1996	1997	1998
Total	16.8	18.4	20.8	22.4	23.6	...	27.3
1. State-owned Enterprises	13.4	14.5	16.7	17.9	17.6	...	...
2. Urban Collective Enterprises	3.4	3.8	3.9	4.3	4.7	...	...
3. All Other Types of Economic Enterprise	0.0	0.1	0.2	0.3	0.3	...	...

Source: China Social Insurance Yearbook 1997, table 2-12, and MLSS.

1/ Note that rows do not add for 1996.

Table VI.4. China: Number of Employees Participating in Basic Retirement Insurance by Ownership, 1992-98

	1992	1993	1994	1995	1996	1997	1998
Total	77.7	80.1	84.9	87.4	87.6	...	...
1. State-owned Enterprises	65.4	65.9	70.6	71.3	70.4	...	...
2. Urban Collective Enterprises	11.8	13.9	13.2	13.7	14.6	...	...
3. All Other Types of Economic Enterprise	0.6	1.0	1.6	2.4	2.6	...	...
o/w: Foreign-Invested Enterprises	0.3	0.6	1.0	1.4	1.7	...	...

Source: China Social Insurance Yearbook 1997, table 2-6, and MoLSS.

Table VI.5. China: Coverage Ratio of Employees Participating in Basic Retirement Insurance by Ownership, 1992-98

(percent)	1992	1993	1994	1995	1996	1997	1998
Total	68.1	70.0	74.7	76.9	78.4	...	...
1. State-owned Enterprises	85.6	86.2	92.9	95.8	95.1	...	...
2. Urban Collective Enterprises	33.7	40.5	43.0	46.5	51.5	...	...
3. All Other Types of Economic Enterprise	20.6	18.5	21.9	27.0	27.5	...	...
o/w: Foreign-Invested Enterprises	21.3	21.3	24.2	25.0	31.9	...	...

Source: China Social Insurance Yearbook 1997, table 2-7.

Table VI.6. China: System Dependency Ratio by Ownership, 1992-98

(number of workers per pensioner)	1992	1993	1994	1995	1996	1997	1998
Total	4.6	4.4	4.1	3.9	3.7	...	...
1. State-owned Enterprises	4.9	4.5	4.2	4.0	4.0	...	...
2. Urban Collective Enterprises	3.5	3.7	3.4	3.2	3.1	...	...
3. All Other Types of Economic Enterprise	16.0	7.8	8.7	9.3	7.5	...	...

Source: China Social Insurance Yearbook 1997 and Fund staff calculations

uncertain benefits and high contribution rates suggests that the authorities recognize the need to expand coverage of younger, relatively better paid employees as a means of addressing the demographic trends noted above.

### The 1995 reform

12. These considerations meant that, by the early to mid 1990s, policy makers understood that a thorough reform of the pension system was unavoidable, culminating in the reaffirmation in 1995 of the basic three tier approach of previous reforms. Although the goal was to create a unified system by 2000, the 1995 decision stated that city and prefecture governments were to choose from two models for the basic pension tier, in effect creating further incentive for local governments to establish a system designed to maximize local control over the pension system and pension funds.<sup>8</sup> Because the current system is evolving on the basis of the 1995 reform, it will be useful to describe the system it was meant to create.

13. Of the two models, **plan I** was based somewhat more on individual accounts than social pooling. Under this plan, contributions to individual accounts were to predominate, being based on contribution rates of approximately 16 percent made up of three parts:

- An individual contribution of 3 percent of individual wages;
- And enterprise contribution of 8 percent of individual wages<sup>9</sup>; and
- An enterprise contribution of 5 percent of the average local wage.

The individual contribution was subject to a floor of 60 percent of the local average city wage (which defined the minimum benefit at retirement), and a ceiling of 200-300 percent of the city average wage, determined locally. An employee who contributed for 15 years would be entitled to a monthly pension benefit equal to 1/120 of the total reserve accumulated on his or her individual account, with the social pool covering benefits to be paid after 10 years.<sup>10</sup> For those who retired before contributing for 15 years, the accumulated pension reserve would be paid out in a lump sum at retirement. In either case, upon death any sums left on the individual account were to be inheritable.

14. By contrast, **plan II** was geared more toward social pooling. It therefore had a vesting period of only 10 years, after which an employee would be eligible for a social pension equal to 20-25 percent of the local average wage, a premium pension equal to

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<sup>8</sup>World Bank (1997b), p. 17.

<sup>9</sup>The individual contribution rate was gradually to be increased to 8 percent, with the enterprise contribution rate to fall correspondingly.

<sup>10</sup> If life expectancy at age 60 is 16 years, this implies an interest rate of 4.5 percent.

1-1.4 percent of the base wage for each year of contribution, and an individual account which could be drawn as a lump sum or an annuity. In addition, a supplementary social pension subsidy was to be phased out over time. Contribution floors and ceilings were to be set basically as in plan I, while—also like in plan I—transitional arrangements were to apply to workers who were not fully covered by the new system.

### The 1997 reform

15. The State Council promulgated Decision No. 26 on July 16, 1997 to rationalize and give new impetus to the pension reforms. (See State Council (1997).) The goal was to move toward a uniform national system that is closer to plan I than to plan II. This is to be accomplished first by capping enterprise contribution rates at 20 percent, in light of the high degree of variability that had developed across provinces. The enterprise contribution rate—which includes both the allocation to individual accounts and to the social pool—is to be set at the provincial level, and exceptions to the cap can be granted by the Ministries of Finance and Labor if the number of current retirees is very large. Individual contribution rates are to be set at the provincial level as well, but not below 4 percent.

16. Contributions to individual retirement accounts are to equal 11 percent, with the employee contribution rates set at 4 percent and the enterprise contribution rates set at 7 percent, initially. Every other year the individual rate is to increase by one point simultaneous with a commensurate drop in the enterprise rate, until individuals contribute 8 percent. The sums in individual accounts are to earn interest at the corresponding bank deposit rate, and are meant to be both portable across provinces and inheritable.

**Table VI.7. China: Contribution Rates Under SC Document No. 26, 1998-2004**

	1998	2002	2004
Enterprise contributions, o/w:	20	18	16
Social pool	13	13	13
Individual account	7	5	3
Individual contribution	4	6	8
Total	24	24	24

17. Eligibility for a basic pension is established, as in plan I above, after 15 years of contributions for those who start working after 1997. The basic pension consists of a subsistence pension and the individual account pension, where

- The **base pension** is equal to 20 percent of the previous year's average wage in that province, district or city, depending on the level of pooling, and
- The **individual account pension** is equal to a monthly sum equal to 1/120 of the amount in the individual account.

18. Those who retire before implementation of the 1997 reform are to be paid according to the older regulations, which basically meant a social pension with an 80 percent

replacement rate. Those who retire with 15 years of contributions, but who started to work before promulgation of the 1997 reform, are subject to a transition scheme. Although the details are still unclear, it seems likely that, in addition to the base pension and their (insufficient) individual account pension, they are to get a transitional pension calculated on the basis of the base pension and financed out of local pension funds (pools).<sup>11</sup>

19. The 1997 reform mandated that over time coverage is to be extended to all urban and township enterprises, including the self-employed. When provincial level pooling has been achieved throughout the country, the 11 industries under state control—which have their own, separate, pension pools—were to be merged into the social pools. Pension contributions are to be invested in state bonds or kept in special accounts in the state banks, although a small reserve should be held aside in the amount of two months' payments.

20. The 1997 reform was a significant advance in many respects, and it represents a good foundation on which to build a modern pension system in China. It aims at nationwide unification of the mandatory pension tier, to be accomplished gradually, and, in targeting a replacement rate of around 50-60 percent of average wages, it avoids overly generous pension benefit commitments.<sup>12</sup> Further, the document aims gradually to expand coverage of the mandatory pension system to sectors of the urban workforce not presently covered, including in particular the relatively well-paid employees of foreign funded enterprises.

21. However, the 1997 reform did not deal with the pension status of civil servants, who are now covered under a separate system. More importantly, the document is not clear as to the mechanism by which the existing individual accounts—which are essentially “notional” in that relatively few reserves have been accumulated—will be converted into funded accounts. This transitional financing problem—while subject to enormous uncertainties given the data available—could eventually undermine the planned pension reform, and is discussed in more detail below. Finally, apart from indicating that any balances accumulated are to be invested in government bonds, the regulation did not specify the investment strategy to be followed or the precise mechanism for converting the implicit pension debt built up under the previous pay-as-you-go regulations.

### **Current status of reforms**

22. Although progress toward creation of a modern and equitable pension system that will meet China's needs has been made, many analysts have noted that significant shortcomings remain to be addressed.

23. **Modest accumulated reserves.** Despite the fact that a commitment to create a multi-tiered pension system has been in place for almost a decade, as Table VI.8 below suggests,

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<sup>11</sup>Leckie (1999) pp. 30-31.

<sup>12</sup>Zhang (1998) reports that the target replacement ratio would be 58 percent.

Table VI.8. China: Pension Funds Revenue and Expenditures, 1991-97

	(In billions of yuan)			(In percent of GDP)		
	Revenue	Expenditure	Cumulative Reserve	Revenue	Expenditure	Cumulative Reserve
1991	29.5	24.7	4.8	1.4	1.1	0.2
1992	37.7	32.6	5.1	1.4	1.2	0.2
1993	49.7	45.2	4.6	1.4	0.1	0.1
1994	67.9	62.4	5.4	1.5	0.1	0.1
1995	94.3	83.0	11.4	1.6	0.2	0.2
1996	118.3	101.4	16.8	1.7	0.2	0.2
1997	136.4	124.9	11.5	1.8	0.2	0.2

Source: Ministry of Finance.

relatively limited progress has been made in building up pension reserves to match the large stock of accumulated pension liabilities. In practice, this has meant that China's individual retirement accounts to date are largely notional, making portability across provinces (and even within provinces, to the extent that provincial level pooling has not been achieved) difficult, if not impossible. In practice, it seems that many provinces and municipalities are using mandatory pension contributions to the second pillar as a means of funding pillar I social pensions (reportedly as well as non-pension obligations).<sup>13</sup>

24. **Limited pooling and the growth of pension arrears.** One important shortcoming is therefore the limited extent of pooling, which still applies at the provincial level for only some of China's provinces.<sup>14</sup> The autarkic pension regime that this type of system implies has meant that horizontal imbalances were sure to arise, as in fact they did during 1998. A number of provinces experienced pension arrears, leading to social dislocations and even sporadic unrest. By mid-1998, the level of pension arrears had reached over Y 3 billion, and were only cleared when local governments, in some cases with the assistance of the central budget, made supplementary transfers to pension funds to clear the arrears.

25. The cause of the pension arrears is not precisely clear, although it appears to have been connected particularly with imbalances which arose in the eleven industries subject to special, separate pension pooling regulations. These industries are those firms under the following agencies:<sup>15</sup> Ministry of Railways; Ministry of Information Industry;<sup>16</sup> Ministry of Water Conservancy; Ministry of Electric Power; Ministry of Communications; General Bureau (former Ministry) of Coal Industry; China Building Construction Co.; China Petroleum and Natural Gas Company; People's Bank of China (e.g., banking system); China Civil Aviation Bureau; and Bureau of Nonferrous Metals.

26. While some of these sectors were undoubtedly profitable, others were under significant financial pressure, particularly as the state-owned commercial banks came under pressure in early 1998 to base lending to SOEs on a purely commercial matter.<sup>17</sup> The firms which were having particularly severe problems, and which therefore were generating the

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<sup>13</sup>Leckie (1999) p. 31. Zhang (1998) reports that it is still "almost impossible to transfer the accounts between provinces."

<sup>14</sup>Zhang (1998) reports that, by end-1998, only 11 provinces had set up pools at the province level.

<sup>15</sup>See State Council (1998).

<sup>16</sup>Formerly the Ministry of Posts and Telecommunications.

<sup>17</sup>Some analysts have suggested that loans from the state commercial banks have been easier to obtain for SOEs which have pension arrears, which creates the adverse incentive for enterprises to intentionally run such arrears.

bulk of the pension arrears, tended to be concentrated in the coal, ferrous metallurgy and railroad industries. Although data for 1997 or 1998 are not available, some information on finances of the pension systems of the eleven industries in 1996 is presented in Tables VI.9 and VI.10, when the average contribution rate was 19.4 percent, of which 2.1 percent was the employee contribution. Moreover, for these three industries, the contribution rate was well above 20 percent, indicating an underlying imbalance in their finances.

27. The persistence of the problem with pension arrears gave rise by mid-1998 to pressure to accelerate consolidation of these pension systems in the local government pension pool. A document issued by the State Council in August aimed to consolidate firms under the above 11 agencies into the general provincial level pooling arrangements.<sup>18</sup> By end-1998, these firms were to be fully integrated into the provincial pools. Indeed, reflecting the urgency with which this merger was to be completed, by September 1, 1998, local government social insurance agencies were to be collecting pension contributions and paying pension benefits for all eleven sectors.

28. Note that the eleven sectors had significantly different pension contribution rates than was the case for the system as a whole. Although the August 1998 measure specifies that the contribution rates for these sectors should be brought into conformity with those which apply to other enterprises, this is only to be done gradually. Thus, enterprises in the coal industry, the aviation bureau, and the banks will have five years to adjust their contribution rates—which, at over 25 percent, are higher now for the coal industry, and lower for aviation (under 11 percent) and the banks (3 percent)—while other sectors will have three years to adjust. Nevertheless, the authorities acknowledge that the process of merging these sectoral pension pools into the broader social pools will present a number of challenges, not least of which will be auditing and control of the financial accounts of the sectoral funds, which were outside the purview of the Ministry of Labor and Social Security until August 1998. Partly as a way to get control over the flows in and out of the industrial pools, and to prevent the growth of pension arrears among SOEs in other sectors, by end-1999, about 60 percent of all pension payments will be processed through the banking system (up from just over 40 percent at end-1998<sup>19</sup>). Finally, by 2000, apart from the transitional arrangement for the eleven industries, contribution rates for all other enterprises in the provincial pools are to be making contributions at a single rate.

29. **Contribution rates and compliance** The level of contribution rates which prevailed in 1998 was broadly in conformity with the 1997 reform, in that enterprises contributed, on average, just over 20 percent of the wage bill (Table VI.11), while employees contributed

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<sup>18</sup>It may be noted, however, that Document No. 26 of 1997 had indicated that consolidation of the eleven industries would take place only after provincial pooling had been more or less accomplished.

<sup>19</sup>During 1998 pension payments for all provincial pools were shifted to the banking system.

Table VI.9. China: Pension Finances in 11 Industries under Government Planning, 1996

(In billions of yuan)

	Total	SOEs	COEs	Other
<b>Total revenues, o/w:</b>	29.818	29.778	0.017	0.023
Employers	23.291	23.259	0.013	0.019
Employees	2.841	2.834	0.004	0.004
Other	3.686	3.686	0.000	0.000
<b>Total expenditures, o/w:</b>	25.985	25.975	0.008	0.002
Retirement expenses	23.990	23.980	0.008	0.002
Administrative expenses	0.167	0.167	0.000	0.000
Other	1.829	1.829	0.000	0.000
<b>Surplus at End of Period</b>	8.680	8.627	0.025	0.028
<b>Memo items:</b>				
Employees (thousands)	14.0	13.9	0.1	0.0
Retirees (thousands)	3.8	3.8	0.0	0.0
Dependency ratio (employees / retirees)	3.6	3.6	42.0	34.6
<b>Total Wages (billion yuan)</b>	134.9	134.5	0.3	0.1
<b>Effective contribution rate (%), o/w:</b>	19.4	19.4	5.7	23.8
Employers	17.3	17.3	4.4	19.7
Employees	2.1	2.1	1.3	4.1

Source: China Social Insurance Yearbook 1997, tables 2-69,70.

Table VI.10. China: Basic Retirement Insurance in 11 Industries under Government Planning, 1996

(In billions of yuan, except as indicated)

	Employees (thousands)	Retirees (thousands)	Total Wages	Revenues	Expenditures	Surplus at End of Period	Average contribution rate (%)	Dependency ratio (employees / retirees)
Total	13958.1	3830.4	134.9	29.8	26.0	8.7	19.38	3.6
Ministry of Railways	3325.1	1080.7	33.8	7.2	6.6	0.9	21.18	3.1
Ministry of Posts and Telecommunications	1008.5	260.7	11.4	2.8	2.0	2.3	19.73	3.9
Ministry of Water Conservancy	33.9	10.0	0.3	0.1	0.1	0.0	20.53	3.4
Ministry of Electric Power	1491.3	366.4	15.8	2.9	2.7	0.7	18.13	4.1
Ministry of Communications	309.0	66.7	4.4	0.7	0.4	0.6	15.42	4.6
Ministry of Coal	3272.2	1197.6	23.0	8.7	8.0	1.1	25.28	2.7
China Building Construction Co.	125.6	34.6	1.1	0.2	0.1	0.1	15.35	3.6
China Petroleum and Natural Gas Company	1466.7	255.7	16.9	3.0	2.7	0.6	17.34	5.7
People's Bank of China	1985.2	242.1	20.0	2.7	2.0	1.7	12.86	8.2
China Civil Aviation Bureau	115.3	6.7	1.7	0.2	0.1	0.2	10.87	17.2
China Nonferrous Metals Company	825.2	309.2	6.4	1.4	1.4	0.3	22.42	2.7

Source: China Social Insurance Yearbook 1997, tables 2-68.

Table VI.11. China: Pension Fund Average Statutory Contribution Rates and Compliance, 1998

Province	Total	Employer	Employee	Compliance Rates 1/
<b>National average</b>	<b>24.4</b>	<b>20.5</b>	<b>3.9</b>	<b>90.2</b>
Beijing	23.0	18.0	5.0	98.0
Tianjin	26.0	21.0	5.0	95.0
Hebei	23.0	19.5	3.5	90.0
Shanxi	21.5	18.3	3.2	83.5
Inner Mongolia	24.0	21.0	3.0	88.0
Liaoning	28.0	24.0	4.0	88.5
Jilin	29.0	24.0	5.0	85.0
Heilongjiang	26.0	23.3	2.7	80.0
Shanghai	29.5	24.5	5.0	99.0
Jiangsu	22.5	18.0	4.5	91.0
Zhejiang	24.5	20.5	4.0	95.0
Anhui	21.0	18.0	3.0	84.0
Fujian	26.0	21.0	5.0	96.0
Jiangxi	23.0	20.0	3.0	88.0
Shandong	24.0	20.0	4.0	92.0
Henan	23.0	20.0	3.0	86.0
Hubei	22.0	18.0	4.0	88.0
Hunan	23.0	19.0	4.0	85.0
Guangdong	21.0	16.0	5.0	90.0
Guangxi	20.0	16.0	4.0	86.0
Hainan	19.0	16.0	3.0	78.0
Chongqing	23.0	20.0	3.0	78.0
Sichuan	24.0	21.0	3.0	84.0
Guizhou	25.0	22.0	3.0	95.0
Yunnan	28.0	24.0	4.0	92.0
Tibet	17.0	16.0	1.0	79.0
Shaanxi	22.0	19.0	3.0	90.0
Gansu	25.5	21.5	4.0	95.0
Qinghai	23.5	20.5	3.0	74.0
Ningxia	18.5	15.5	3.0	80.0
Xinjiang	29.0	25.0	4.0	90.0

Source: Ministry of Labor and Social Security

1/ Note that the staff has some uncertainty as to how these compliance rates were calculated.

just under 4 percent. The highest contribution rates seemed to be in those regions, like Shanghai, Tianjin and Fujian Provinces, which have experienced rapid economic growth and have large elderly populations. Compliance rates, however, have started to fall in recent years, from around 93 percent in the mid-1990s to just over 90 percent in 1998. Compliance rates have been particularly low in poorer regions, like Chongqing, Heilongjiang, and Tibet. Some observers have suggested that compliance rates could be significantly lower, perhaps in the range of 80 percent.<sup>20</sup>

30. It is worth noting that pension fund contributions are only one of many levies on payroll in China, and that the overall burden of taxes on labor is quite high by international standards. In addition to the personal income tax (PIT) and contributions for pension benefits, employers and in some cases employees are required to make a number of other contributions for medical care, unemployment, disability and maternity insurance, and also for housing and other benefits (Table VI.12). Overall, the weight of these various contributions is thought by many to be a significant deterrent to full tax compliance, as well as a noticeable drag on the ability of the private sector legally to absorb the share of labor being shed by state firms in the context of SOE reform.

**Table VI.12. China: Total Payroll Tax Rates in Selected Cities, 1998 1/**

Category	Low rate	High rate
Pension: employer	19.0	24.5
Pension: employee	5.0	6.0
Medical: employer	5.5	6.0
Medical: employee	1.0	2.0
Maternity	0.6	1.0
Unemployment	0.7	2.0
Disability	0.5	1.5
Housing	5.0	10.0
Total (excluding PIT)	37.3	53.0

1/ Based on Beijing, Shanghai and Guangzhou cities, as of end-1998. See Leckie (1999).

31. **Coverage.** Partly in response to weakening compliance, and due to the increasing demographic burden that aging implies for China's pension system, in early 1999 the State Council issued an order mandating that coverage of the urban pension system be extended to firms of all ownership types, including not only state and collectively owned firms, but also foreign funded, private and other urban firms, and even—if local officials deem it advisable—the self-employed. This step was intended to cover the shortfalls in pension finances in some locations which arose during the course of 1998, and which would otherwise have occurred in 1999 as the eleven industrial pools, several of which were not solvent on their own, were merged with the local pools. Note that this order, which is aimed

<sup>20</sup>Leckie (1999), p. 14.

at securing more revenue to the social insurance system, applies as well to the unemployment and medical insurance systems, specifying that contributions for all three forms of social insurance should be combined and harmonized (possibly under the control of the State Administration of Taxation, if local officials agree). Penalties for late payment, for example, are reaffirmed at the rate of 0.2 percent per day, and other collection and enforcement measures are detailed in the regulation.<sup>21</sup>

32. **Looking to the future.** A number of analysts have noted that, over the medium term, without significant reform China's pension system will be financially insolvent at current rates of contribution and replacement. For example, the World Bank noted in 1996 that, in the absence of reform, the current largely pay-as-you-go system would require contribution rates of over 39 percent by 2033—and even higher in provinces with heavy dependency ratios (e.g., the rate would have to rise to 42 percent for Shenyang).

33. The authorities are aware of these trends, and are concerned as well that contribution rates could be raised to unsustainable levels in order to guarantee solvency. For example, in order to ensure that the pension system is fully financed during the transition period, some have proposed that the average employer contribution rate not be reduced from 20 percent to 16 percent as the employee rate increases to 8 percent. Further, because they tend to be younger and better paid, it is expected that broadening coverage of the urban pension system to include employees in private and foreign funded enterprises, as well as the self-employed, will help to offset the transition costs under State Council Document No. 26. Over time, it may be necessary as well to consider some other, more traditional measures designed to consolidate the pension system finances—such as increasing retirement ages or reducing eligibility for certain classes of workers who can now retire early.

#### **D. Macroeconomic and Fiscal Considerations**

##### **Fiscal sustainability**

34. China could face severe fiscal sustainability pressures if aggressive efforts are not undertaken to reduce the losses building up in the SOE sector, which are now financed by loans—some of which have an explicitly quasi-fiscal nature—from the banking system. These pressures, coupled with the debt stock that is building up on the budget as a result of recent efforts aimed at fiscal expansion for macroeconomic reasons, will give rise to a need for fiscal consolidation in China in the years ahead, despite the country's need for significant new infrastructural and social spending on items like health, education, roads and railways, telecommunications, water conservancy, electrification and the environment.

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<sup>21</sup>Leckie (1999), p. 15, reports that compliance had suffered due to the lack of a legal framework to enforce payroll tax compliance.

35. On top of these demands, China has adopted a pension reform which emphasizes prefunding for the second pillar in the form of individual accounts that will place additional demands on the fiscal system for a transition period. The size of these transition costs is characterized by what is known as the implicit pension debt (IPD), which is the present value of current and future pension commitments of the existing pay-as-you-go system. These costs, which need to be met at the same time as resources are building up in the individual accounts, has been estimated to be as much as 50-60 percent of current GDP in China.<sup>22</sup> Note that China's IPD, while large, is not excessively so; similar calculations for Turkey yield a debt of 72 percent of GDP, and 187 percent for Brazil.<sup>23</sup>

36. Ignoring this contingent liability, however, would hamper SOE reform, as the transition costs would remain at the enterprise level. On the other hand, were this transitional debt to be recognized explicitly by the Chinese authorities, say in the form of bonds issued to current workers who will not contribute long enough to vest in the new, three tiered system, then China's debt stock would grow substantially, placing an additional burden in the form of interest costs on a fiscal system that is already coming under considerable pressure to service the existing debt stock.

### **Pensions and saving**

37. Some analysts have suggested that China has a window of opportunity to establish a pension system with significant elements of funding and which will, it is hoped, lead to significantly higher rates of aggregate savings and therefore growth. Indeed, drawing on work done in Latin America and elsewhere, some have argued that the creation of a funded pension system can generate substantially higher rates of savings, and therefore economic growth. The literature on pension plans and savings is extensive, but draws mostly on the experience of OECD countries, and especially the United States. For the most part, these studies suggest the following:<sup>24</sup>

- Introduction of a public pension scheme where there was none tends to depress savings moderately, though this relation is not terribly robust;
- The growth and development of private pension schemes tends to increase savings, insofar as other private savings tends to fall by less than new private schemes increase;

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<sup>22</sup>World Bank (1996).

<sup>23</sup>Kane and Palacios (1996) p. 38.

<sup>24</sup>See Mackenzie, Gerson and Cuevas (1997).

- Replacing a pay-as-you-go pension scheme with a defined-contribution system (as in Chile) can raise aggregate savings, particularly if the transition is financed by means of a fiscal contraction;
- Adding a second, defined-contribution tier to a public pension system (as in China) is unlikely to increase savings if it is financed by diverting contributions from the current pay-as-you-go system; and
- A conventional public pension reform (e.g., raising retirement ages and reducing replacement ratios) will increase aggregate savings.

38. In China, some, including the World Bank, have argued that moving toward a funded system could generate substantial additional savings, and thereby fuel growth, at the same time that demographic trends leading toward eventual shortfalls could be avoided. Feldstein (1998) has argued in addition that payroll tax rates, which are unquestionably very high in China, could be reduced if accumulated pension savings were to be invested in productive assets, rather than much lower yielding government bonds.

39. Others, however, have argued that China already saves a tremendous portion of current output, and that the banking system is relatively ineffective in promoting efficient intermediation. (See Aaron (1998).) As a result, it could be argued that the promotion of increased savings is perhaps not as important in China as, say, guaranteeing effective provision of pension benefits to workers under the defined benefit social tier—something that is likely to require more traditional pension reforms (lowering replacement rates, increasing retirement ages, etc.). However, Heller and Symansky (1997) suggest that aging trends in East Asian countries, including China, could lead to lower rates of savings over the medium term. In this regard, then, China may be expected increasingly to resemble countries with higher standards of living, and also lower savings rates.

### **E. Conclusion**

40. Above all, pension reform is important in China as a means of securing an adequate living standard to the elderly. Given China's gradual urbanization, as well as demographic and economic trends such as the aging of the population and the rapidly diminishing state share of the economy, modernization and expansion of the pension system is unavoidable. The authorities have taken a number of bold steps during the past decade to do so, but as noted above, a number of important challenges remain.

41. In order to meet these challenges, the authorities will need to take a number of decisions that are both politically and technically difficult. In order to do so, they will need to have reliable, timely and accurate information on the extent of pension reform to date,

which means that the current system for reporting, collecting and dissemination of statistical and legal information will need to be strengthened.<sup>25</sup>

42. Even with reliable information, however, it will be important to ensure that progress is made over the coming years in the following areas:

- Unifying contribution rates, as well as funds management and record keeping, at the provincial level, and perhaps eventually at the national level, as a means of promoting labor mobility and eliminating currently severe distortions in the tax system;
- Designing and publicizing a clear mechanism to finance the transition costs associated with settling the implicit pension debt (This could have to involve some elements of traditional pension reform, like reductions in benefits, as noted above.); and
- Ensuring that the funds accumulated in individual or social pools are managed in a prudentially appropriate fashion.

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<sup>25</sup>Heller (1997) makes the point that accurate information on pensions and aging is a serious concern in several Asian countries, and that it should be a high priority for modernization.

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## VII. THE DEVELOPMENT OF CHINA'S STOCK MARKET<sup>1</sup>

### A. Overview and Summary

1. After a lengthy period of experimentation with various types of shareholding systems (Box VII.1), China in late 1990 became the first transition economy to introduce a formal stock exchange. While the stock market has been reasonably successful at raising capital in recent years (Chart VII.1), total domestic market capitalization was only 25 per-cent of GDP at end-1998 (Chart VII.2), and the ownership and governance structures of China's large state-owned enterprises (SOEs) have not been appreciably changed. China in fact is the only transition economy to have established a stock market without simultaneously moving to privatize its state enterprises. Further, with very few exceptions, China's rapidly growing private sector has not been allowed either to list or to assume majority control of listed enterprises through market takeover. Indeed, of the 851 domestically-listed companies at end-1998, only about 30 are considered to be outside the state-owned sector.<sup>2</sup>

2. The authorities' objective in establishing the stock market is to use it as a means to tap China's vast pool of individual savings to help modernize the management and governance of large SOEs.<sup>3</sup> However, access to the market has been strictly controlled, and approvals for new listings have been granted as much for policy and political considerations as for market fundamentals or the future business prospects of enterprises. This has left the market scattered with poorly-performing companies, which has until very recently eroded investor confidence, exerting downward pressure on share prices (Chart VII.3). In line with the desire to maintain state ownership, the majority of shares have remained in the hands of state institutions and are effectively removed from active secondary trading, sharply restricting market liquidity and distorting market forces.

3. At the same time, an inconsistent patchwork of market rules and regulations and competing regulatory authorities resulted in lax prudential supervision, making the securities markets highly vulnerable to fraud and scandal. Indeed, irregularities among market practitioners and listed companies—e.g., falsification of profit figures, misuse of share proceeds, untimely or nondisclosure of price-sensitive information, insider trading by company officials, and other forms of market manipulation—have been common features of

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<sup>1</sup>This chapter was prepared by Paul Heytens, Deputy Resident Representative. Questions regarding this chapter may be addressed to Bernard Laurens (ext. 36534).

<sup>2</sup>These companies thus represent only about 3 ½ percent of domestically-listed companies and comprise less than 10 percent of current market capitalization.

<sup>3</sup>See the chapter on SOE reform in SM/98/184 for a more detailed description of the authorities' objectives in this regard.

China's securities industry throughout its short history. The recently promulgated Securities Law aims to curb these practices and establish a framework for a sound development of the market. Though the Law does not address many critical issues, not least the segregation of foreign investors into a separate market in part to maintain a closed capital account, it contains many important provisions—such as prohibiting banks and SOEs from speculating on the market, banning brokerage firms from mixing their own and clients' funds to trade shares, and vesting sole regulatory authority over the securities industry in the China Securities Regulatory Commission (CSRC)—that should provide a firm foundation for the future development of the stock market.

4. The purpose of this paper is to provide an overview of the development and main features of China's stock market. The first section describes the listing process and segmented share structure. The next two sections describe the market trading structure and the evolution of the regulatory framework, respectively, while the final section describes and assesses the main features of the new Securities Law.

## **B. Listing Procedures and Share Structure**

### **The selection of listings**

5. The State Council decides the number of enterprises to be listed and the amount of capital to be raised on an annual basis, and then allocates these to the provinces in the form of quotas, taking into account geographical and industry-specific factors. While the Company Law and the State Council Provisional Regulations on Stock Issuance and Exchange provide very general guidelines on eligibility criteria and approval procedures (e.g., the applicant's business must be fall within the scope of national industrial policies, the enterprise must have been profitable for the previous three years, etc.),<sup>4</sup> and certain industries (e.g., defense) are strictly off limits, no guidance is provided to the provinces for choosing among specific enterprises when the number of qualified applicants exceeds the quota. In practice, then, each province has been able to determine its own selection criteria and procedures, which have not been made public.

### **The determination of the offering price**

6. Under the Company Law, two types of offering prices are allowed—at par or above par. Almost all shares have been issued above par, which requires prior approval from the State Council, or its designated authority. The Company Law provides no specific guidance for the determination of above par offer prices, and prices of initial public offerings (IPOs) are generally determined by the CSRC. To ensure that IPOs are successful, prices have

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<sup>4</sup>The CSRC has in addition generally required that every company seeking a listing first take over a financially distressed SOE.

generally been limited to no more than about 15 times earnings, without regard to companies' past financial performance or future business prospects. In practice, this has made IPOs essentially risk free and highly attractive to individual investors as the average secondary market multiple has been several times that level and has driven underwriters to compete fiercely for new listings.<sup>5</sup> This underpricing has effectively resulted in large wealth transfers from stock issuers to the underwriters and investors participating in new share issues, thus increasing the cost of capital for listed companies and contributing to speculative behavior in the primary market, while providing strong incentives for regulators and market participants to compromise the integrity of the listing process.

### **Types of shares issued and their characteristics**

7. Share issues in China are classified and segregated into different types to fit an investor-specific share profile, aimed at preserving the dominance of state ownership in the overall share structure. The various types of shares include Chinese individual shares, foreign person shares, state shares, and state-owned legal person (i.e., corporate and institutional) shares, each of which are subject to a unique set of rules and regulations.

### **Domestically-issued shares<sup>6</sup>**

8. **Chinese individual shares** can be purchased by individual Chinese citizens, and are subdivided into **public shares**, held by individual members of the general public, and **employee shares**, held by employees of the issuing enterprise. These shares are denominated in renminbi (RMB), and are popularly known as **A-shares**. Most A-shares are held by small retail investors, currently estimated at about 40 million, as most institutional investors (e.g., insurance companies and most pension funds) are prohibited from buying shares on the stock market.

9. The transfer of shares to the state is governed by separate Provisional Measures. Under these measures, state-owned shares include **state shares** and **legal person shares**, defined as follows: state shares are shares obtained by an institution on behalf of the state in exchange for a capital contribution on behalf of the state to a company "limited by shares",

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<sup>5</sup>Su and Fleischer (1997) found that on the first day of trading, A-share prices typically rose 11-fold relative to the IPO price, while B-shares have typically risen 1½-fold. Although these multiples have dropped more recently with the decline in market sentiment and share prices on the secondary market, the degree of IPO underpricing has remained sufficiently large to ensure a high degree of interest among market participants for new share issues. It should be noted that IPOs worldwide tend to be underpriced, but the underpricing in China's A-share market is exceptionally large by international standards.

<sup>6</sup>See Appendix I for a description of the legal basis for domestic share holding.

while state-owned legal person shares are shares obtained by a state-owned legal person (i.e., enterprise or institution) in exchange for capital invested by that enterprise in a share-issuing company using state assets to which the enterprise has a legal right to dispose of.<sup>7</sup> Shares held by the state and state-owned legal persons are frequently called **C-shares**.<sup>8</sup>

10. In transferring shares to the state, the intention is to ensure that it retains a controlling interest in listed companies and more generally its predominant position in key sectors of the economy. The secondary market is similarly aimed at preserving majority state ownership in listed companies. To this end, the trading of state shares on the secondary market is prohibited; the trading of legal person shares is technically confined to other legal persons; and members of the general public can only trade shares among themselves. However, in practice transfers of legal person shares to individuals has been allowed on a case-by-case for quite some time, and with increasing frequency. On the basis of these and other trends, the share of state ownership and degree of state control in listed companies does appear to have declined somewhat since mid-1993 (see Box VII.2). In addition, in August 1998 Shanghai Fortune Industrial, a pharmaceutical company, became the first private IPO on the Shanghai Stock Exchange, and steps are now being taken that should open the door for companies outside the state to tap the markets on a wider scale (see Section E below).

11. **Domestically-listed foreign person shares** can be issued by the same group of companies eligible to issue Chinese individual shares, using public flotation to “foreign persons” as defined in the relevant regulations (see Appendix I). Domestically-listed foreign person shares are denominated in RMB, but purchased and sold in foreign currency. Similarly, dividends and other payments related to these shares are denominated in RMB but paid in foreign currency. Such shares must be listed and traded on a Chinese securities exchange, but with the approval of the regulatory authorities may be traded outside of China; warrants and depository receipt certificates based on such shares for trade outside China can also be authorized. All foreign exchange transactions of issuing companies, including receipt of foreign currency proceeds from share issues and payments of dividends to foreigners, are subject to the foreign exchange control regulations administered by the State Administration

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<sup>7</sup>While the meaning of state shares is relatively straightforward, the concept of state-owned legal person shares is peculiar to the public ownership system that has evolved in China. Prior to market-based economic reforms, and before enterprises began being converted into joint stock corporations, state enterprises were required to surrender all their profits to the state. Once reform began, however, SOEs were allowed to retain profits above a pre-specified level that in theory still belonged to the state, but which they had the legal right to dispose of. When SOEs wish to “legally” invest their retained profits in the domestic stock market, they are issued “legal person” shares rather than “state” shares.

<sup>8</sup>Although these two types of state-owned shares are designated as C-shares, such shares along with the A-shares noted above collectively comprise the domestic A-share market.

of Foreign Exchange (SAFE). Such domestically-listed foreign person shares are popularly known as **B-shares**.

### **Shares issued overseas**

12. The Company Law also provides for the listing and flotation of **foreign person shares overseas** by Chinese companies limited by shares, delegating regulatory control for such listings to the State Council. As is the case with domestically-issued shares, overseas-listed foreign person shares are denominated in RMB and payable in foreign currency, as are dividends and other payments. Shares floated and listed in Hong Kong SAR are known as **H-shares**,<sup>9</sup> while similar shares floated on the New York Stock Exchange are called **N-shares**.<sup>10</sup>

13. In addition, there are Special Regulations that explicitly call for preferential treatment of overseas shareholders, granting them rights more in line with those found in mature capital markets, and define more market-oriented corporate governance structures for companies listing overseas.<sup>11</sup> Such companies also have considerably greater autonomy than domestically listed companies in making investment decisions and in issuing corporate bonds. Further, companies listing overseas are free to choose their underwriters, whereas domestic share issues—including of foreign person shares—can only be underwritten by duly approved domestic securities institutions. Finally, overseas listed companies are subject to applicable disclosure laws in the relevant jurisdictions they are listing in in addition to the relevant Chinese laws.<sup>12</sup>

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<sup>9</sup>Other mainland-related companies listed on the Hong Kong Stock Exchange include issuers of “red chip” stocks and issuers of “China concept” stocks. While an issuer of H-shares is incorporated on the mainland and subject to the Company Law of the People’s Republic of China, an issuer of red chip stock is incorporated in the Hong Kong SAR with a state-owned parent company on the mainland, while an issuer of China concept stock is a Hong Kong-based holding company with substantial operational assets and subsidiaries on the mainland.

<sup>10</sup>Note that enterprises frequently list both foreign person and domestic shares. For example, about three-fourths of companies listed on the B-share market also list on the A-share market. In addition, nearly half of the H-share companies have also issued A-shares.

<sup>11</sup>For example, companies listing overseas are managed by shareholder assemblies and boards of directors elected by shareholders, and are subject to independent checks on their financial and managerial affairs by shareholders and employee representatives. Domestic listing requirements are not nearly as stringent.

<sup>12</sup>In practice, this has not led to any conflicts, as disclosure standards in overseas markets are  
(continued...)

### **The economic implications of the segmented share structure**

14. China's hierarchy of shareholders goes against the principle of shareholder equality found in most stock markets worldwide. Attaching a different set of legal rights and market characteristics to different classes of shareholders not based on any sort of economic rationale, such as capital contribution or investment risk, creates broad scope for non-market based behavior. Spillover effects from such practices expose investors to increased levels of uncertainty and hence greater than normal investment risk. In light of this, individual investors have tended to view China's stock market as a vehicle for short-term speculation rather than as a stable source of long-run investment returns.

15. The rigid shareholding system has also removed state shares and legal person shares from active and spontaneous trading, and deprived the state of the economic value provided by a liquid secondary market, thus undercutting the economic performance of state assets and compromising its own ownership interests.<sup>13</sup> When the assets of a state-controlled firm appreciate, the nontradable, majority state shares are effectively transferring part of their appreciated value to the tradable, minority public individual shares, by virtue of the market forces of demand exceeding supply, resulting in reduced values for the illiquid state-owned shares and a windfall for individual shareholders. While the relevant legislation addresses the apparent dilution of state ownership interests caused by the issuance of share warrants, no law has been adopted to address the latent transfer of value from state ownership interests to individual shareholders resulting from the government's self-imposed illiquidity. Among domestically-held shares, analysts estimate roughly 2/3 are held by state actors—either in the form of state or legal person shares—and thus removed from the secondary market, leaving only about 1/3 of domestically-held shares available for active trading. In such circumstances, share prices cannot possibly reflect true market values.

16. Finally, within the various segments of the secondary market, separate sets of supply and demand factors are in play, producing widely divergent price-earnings (P/E) ratios and hence different costs of capital for the same company (Table VII.1 and Box VII.3). Historically, A-shares have traded at large multiples above B, H, and N-shares. This phenomenon of multiple P/E ratios for the same issuer raises both legal and financial issues. From the legal perspective, it requires entrenchment of the segmented share structure to minimize the scope for illegal arbitrage activities. From a corporate finance perspective, firms must take into consideration the P/E ratio of each share type when analyzing their cost of capital. The practice of government selection of listed companies and determination of

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<sup>12</sup>(...continued)

considerably higher than those in mainland China.

<sup>13</sup>However, in June 1999 official news agencies reported that the CSRC was planning to allow some companies to publicly trade state shares and legal person shares.

issue prices also precludes an accurate determination of the economic value of investment projects and distorts the fair pricing of firms, and thus minimizes the stock market's role as a mechanism to allocate scarce capital efficiently.

### C. The Trading Structure

17. The trading of listed securities is governed by the Company Law and the Provisional Regulations on Stock Issuance and Exchange, and is restricted to "securities trading places which are established in accordance with the law". The trading of unlisted securities is prohibited, but widely practiced nonetheless. The market structure of China's secondary stock market comprises the following:

- the Shanghai Securities Exchange (SHSE) and the Shenzhen Securities Exchange (SZSE);
- the regional securities trading centers;
- the cross-regional securities trading arrangements; and
- the Securities Trading and Automated Quotations (STAQ) System and the National Electronic Trading (NET) System.

#### The Shanghai and Shenzhen securities exchanges

18. Under the relevant regulations, a securities exchange in China is defined as a legal person (i.e., institution), not-for-profit, self-regulatory membership organization, established for the purpose of providing a centralized and organized place for the trading of securities, with the approval of the State Council. The regulations do not specify any particular "trading rules" to be adopted by the securities exchanges, but rather devolve such powers to the governing councils of the exchanges themselves. Since 1990, two securities exchanges, one each in Shanghai and Shenzhen, have been authorized.

19. **Shanghai Securities Exchange.** The SHSE was established on November 26, 1990, and began trading on December 19 of the same year. It trades A-shares, B-shares, investment fund shares, and treasury bonds. Trading can only be conducted by member organizations, who are prohibited from becoming members of any other securities exchange, and off-board trading must be specifically authorized. The trading unit of stock is measured at its face value.

20. The SHSE operates in an auction market environment, without a specialist or market-makers system. Both retail and block trading are permitted. For retail trading, open outcry, computerized automatic matching, and intermediary broker matching systems are used. Price transparency is achieved through an electronic demonstration board showing the highest bid and the lowest offer at any point in time, the highest and lowest execution prices of the day, and the cumulative daily trading volume, among other information. For block trading, in the case of a sale, the seller's agent delivers the offered sale price to an intermediary broker in a

sealed envelope; the highest bidder above the offered sale price gets the trade. Block purchases are handled in a similar manner, with the lowest offer price getting the trade. A noteworthy feature of this system is that the intermediary broker is not under any obligation to be market-maker, contrary to common worldwide practice.

21. **The Shenzhen securities exchange.** The SZSE was founded on December 1, 1990, and began trading in July of the following year. As is the case in Shanghai, the exchange in Shenzhen trades A-shares, B-shares, investment fund shares, and listed treasury bonds. Membership, access, and trading rules and practices, including the lack of a specialist or market-makers system, are virtually identical to those on the SHSE. However, there are some subtle differences between how the two markets operate in that the Shenzhen exchange does not mandate members' cooperation in engaging in proprietary trading to ensure the continuity and stability of the market. Further, one trading unit of A-shares on the SZSE is expressed by the number of shares, which varies from issuer to issuer, rather than at face value as on the SHSE.

#### **Regional trading centers and informal markets**

22. As of late 1998, there were 30 regional securities trading centers located in major Chinese cities where investment fund shares and government debt securities are listed and traded. The former are generally a mix of investments, including shares listed on the two formal exchanges as well as government bonds. These trading centers have been established as financial institutions under the jurisdiction of the provincial branches of the People's Bank of China (PBC). The three largest regional trading centers are found in Shenyang, Tianjin, and Wuhan. The trading environment in these regional trading centers, governed by the PBC's Provisional Measures on Cross-Regional Trading of Securities, is fundamentally the same as that of the two main securities exchanges.

23. Informal share trading has also sprung up on these exchanges beginning in the early 1990s after thousands of enterprises, when given the go ahead to experiment with shareholding systems, issued internally-traded shares to their employees, or legal-person shares to other companies. Although such shares were not allowed to be sold to outsiders, most were in fact traded freely, and began infiltrating the regional trading centers. In addition, more informal over-the-counter (OTC) markets also emerged in various parts of the country. In 1998, the regulatory authorities began restricting the activities of the trading centers and shutting down the informal OTC markets with a view to phasing them out altogether. To this end, the CSRC shut down 42 OTC markets in 1998, resulting in the effective delisting of more than 500 enterprises with a total of about three million investors. In addition, new investment fund shares became subject to a Y 2 billion minimum capital requirement, and new listings are now limited to the two main stock exchanges in Shanghai and Shenzhen.

### **Cross regional securities trading arrangements**

24. Under the Provisional Rules set out by the PBC, cross regional trading of securities comprises the trading of stocks, government bonds, and enterprise debt securities by trading institutions across provincial and municipal boundaries. Over time, the 30 regional trading centers have set up linkages with the Shanghai and Shenzhen exchanges. Through a computerized trading system, the securities exchanges and the regional trading centers are interlinked, facilitating trading in a kind of hub-and-spoke system, thus allowing investors from around the country access to the securities exchanges. In participating in such cross-regional trading, securities trading institutions may not trade with any nonsecurities trading institutions, or with any individuals. In August 1996, the State Council Securities Commission (SCSC), exercising its comprehensive regulatory jurisdiction over the securities exchanges, mandated that all linkages with a securities exchange to provide trading facilities not listed on the exchange would henceforth be subject to the approval of the CSRC. From that point forward, such regional securities arrangements became subject to joint regulation from the PBC and the CSRC.

### **The STAQ and NET systems**

25. The STAQ and NET systems—Nasdaq-type computerized trading systems—round out the securities trading structure in China (see Appendix II for more details). Technically, both the STAQ and NET systems perform the same function of providing a secondary market for the trading of legal person shares and treasury bonds. However, each system is operated and regulated by different government agencies. The STAQ system is subject to the jurisdiction of the State Economic Restructuring Commission, and regulated as a nonenterprise government institution, while the NET system is subject to jurisdiction of the PBC, and regulated as a nonbank financial institution. Historically, the STAQ system has been far and away the more liquid of the two markets. With the passage of the new Securities Law, the future of these two trading systems is unclear, but their trading activity in any event has declined sharply as the restrictions on the transfer of legal person shares have been liberalized.

### **Limitations of the current trading structure**

26. China's securities markets, in the law and in practice, lack the concept of a national market system as found and practiced in most countries. The lack of such a consolidated and unified market system affects the liquidity, transparency, and efficiency of secondary securities trading in China. Market liquidity is further impeded by the different types of shares, and the lack of either a specialist or market-makers system. A comparison of the relatively liquid STAQ system (which has market makers) and the far less liquid NET system (which has neither specialists nor market makers) illustrates the benefit of these systems in terms of increased liquidity. In addition, the general absence of "best execution" and "proprietary trading not to be permitted ahead of agency trading at the same price" practices

discourages the development of basic professional ethics and compromises investor interests. Finally, the rule of the SHSE barring members from joining other exchanges impedes competition and is a further constraint on the development of a national market system.

#### **D. Market Ownership and Regulatory Structure**

27. China's securities industry is entirely state owned. Ownership of securities institutions has traditionally been restricted to: the various Party and state organs, the military, and other central government agencies; local government treasury and finance departments; the state commercial banks; various local financial institutions (the regional commercial banks, trust and investment corporations, enterprise group financial corporations, and the finance companies); the state insurance companies; the various securities institutions; and state-owned enterprises. Ownership in the securities industry is specifically prohibited to: the state policy banks; the urban and rural credit cooperatives; any wholly foreign-funded or any Sino-foreign joint venture financial or nonfinancial institution; and any private individual. Securities institutions are allowed to invest in other securities institutions and in other nonsecurities financial institutions, and a nonsecurities financial institution is allowed to invest in a securities institution, but no mutual holdings are allowed between institutions. Similarly, while a nonfinancial enterprise can invest in a securities institution, no mutual holdings are allowed.

28. This state-dominated ownership structure was consolidated in September 1992 when, with the PBC's approval, seven large financial institutions—the Industrial and Commercial Bank of China, the China Construction Bank, the Agricultural Construction Bank, the Bank of China, the Communications Bank, the China Investment Bank, and the People's Insurance Company of China—established three national securities companies, popularly referred to as the "big three". They are: China Securities Co. Ltd. (also called Huaxia Securities); Guotai Securities Co. Ltd.; and China Southern Securities Co. Ltd. (also called Nanfang Securities). These three securities firms have grown rapidly, and their capital bases are now several multiples of their initial registered capital of RMB 1 billion. However, with such high profits to be made from stock underwriting and trading, most local governments were eager to set up their own securities firms, and the number of such institutions has proliferated, reaching 90 brokerages by end-1998. In addition, each of the 240 trust and investment companies also has a stock trading unit.<sup>14</sup>

29. The securities companies have been associated with the worst abuses in China's

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<sup>14</sup>At the time the Commercial Bank Law was promulgated in 1995, which prohibited "state commercial banks from engaging in trust and investment and stock business, and from investing in nonbank financial institutions", China's securities industry was already 90 percent owned by the state commercial banks. Hence, the Law included a grandfather clause providing separate provisions for banks already engaging in such business.

securities markets. Close links with their largest shareholders—the state commercial banks—provided the large brokerages with abundant capital resources that could be used to manipulate the market. As the state banks have become less willing to engage in such practices in recent years, the securities companies turned to client accounts to finance their trading activities. Such practices by large securities firms have pushed A-share prices far beyond fundamental values according to most market analysts. China's A-shares rose more than 100 percent in 1997 and the first half of 1998, before a correction in late 1998 and early this year eliminated some of those gains; the A-share market has subsequently surged to record highs in recent weeks in the wake of the introduction of market stimulus measures and pronouncements of official support for higher share prices (Chart VII.3).

### **Evolution of the regulatory system**

30. The regulatory structure of the securities industry evolved against the background of monopoly ownership by the state commercial banks. Instead of facilitating a “unified and stable national securities market”, this ownership structure resulted in fragmented local regulation and engendered market instability. Until October 1992, the PBC exercised “comprehensive” regulatory and administrative jurisdiction over the financial industry, the insurance industry, and the securities industry. The PBC further delegated certain regulatory and legislative powers to its provincial and municipal branches for securities market regulation, which worked closely with and were heavily influenced by local governments. By end-1992, every provincial government and some municipal governments, generally in conjunction with the PBC's local branches, had legislated their own rules for the regulation of securities markets and institutions in their localities, which were not always consistent with the prudential concerns of PBC headquarters in Beijing. This excessive fragmentation of regulatory power resulted in numerous disputes among various localities, and led to lax overall supervision of market activities.

31. In response to this, the SCSC and the CSRC were established in October 1992. The former was headed by then-Vice Premier Zhu Rongji, and included high level representation by 13 government agencies, including the PBC and the Ministry of Finance (MOF). The specific powers of the two entities were formally designated by the State Council in a Circular on Further Strengthening Macro-Regulation of the Securities Market, in which it was resolved to address the “confusing” and “multi-sourced legislative and regulatory authority” that had evolved. Specifically, the SCSC was designated as:

“... the state organ in charge of macro-regulation of China's securities market, empowered with specific responsibility to: draft laws and statutes on the regulation of the securities market; formulate policies and guidelines related to the securities market; develop proposals and plans for the long-term development of the securities market; and provide guidance, supervision, and overall co-ordination on the securities-related regulatory work of the central government departments and various local level governments”.

while the CSRC was designated as:

“... the executive arm of the SCSC with specific responsibility to: formulate detailed regulatory rules governing the securities market when authorized to do so by the SCSC; exercise regulatory powers over securities activities, especially stock proprietary trading activities; exercise regulatory powers over the issuance of stocks by Chinese domestic enterprises in the overseas market; and, in cooperation with other government departments concerned, perform statistical and other analyses of the securities market, and submit reports and recommendations to the SCSC”.

Other government agencies also continued to play a role, especially the PBC, which maintained its jurisdiction over the licensing of securities institutions as well as the regional securities trading centers and cross-regional trading arrangements, while the SHSE and SZSE remained under the administrative jurisdiction of local governments, but became subject to CSRC regulations. In addition, MOF was given jurisdiction over the registration of accountants and accounting firms, but the qualifications of such persons and firms working in the securities industry were to be examined and approved by the CSRC.

32. In early 1996, the SCSC further expanded its regulatory jurisdiction over the securities exchanges by promulgating its Regulations on Securities Exchanges. These regulations empowered the CSRC to exercise both “administrative and regulatory” jurisdiction over the securities exchanges, securities registration, and clearing corporations established by the exchanges. This move effectively ended local governments’ administrative control over the securities exchanges, and challenged the PBC’s control over securities institutions. In addition, the PBC’s control over the regional trading centers and cross-regional trading was also diminished by requiring that any linkage with the securities exchanges for purposes of trading listed stocks would be subject to approval by the CSRC. The Regulations also gave the CSRC broad powers to appoint officials in the securities industry, investigate violations of rules and regulations, and enforce compliance with stock issuance and trading rules.

33. Subsequently in 1996, the CSRC promulgated a Decision on the Delegation of Certain Regulatory and Supervisory Powers to the Local Securities and Futures Regulatory Agencies. In this Decision, the CSRC first asserted its regulatory jurisdiction over “all securities institutions, securities registration corporations, futures brokerage corporations, securities advisory firms, and futures advisory firms; all branches and all professionals of the aforementioned entities; and investors in the securities and futures markets”. It then delegated the day-to-day, local supervision of the industry to the securities and futures regulatory agencies established under the jurisdiction of local governments. The CSRC further delegated the investigatory and enforcement powers to local agencies established for such purposes, subject to the proviso that it would handle cases with national impact. It also established appeals procedures for any person or entity aggrieved by the local regulatory agencies, and required them to submit reports on enforcement activities in their areas of jurisdiction.

34. Thus, until very recently China's securities industry was regulated by contentious legislative voices at the central government level, and by rival provincial and municipal authorities, at the local level. Under the system that had evolved, the PBC was in charge of licensing securities institutions in its capacity as regulator of financial institutions, while the SCSC and CSRC were in charge of regulating the securities activities of securities companies and trust and investment companies, though also overseeing the qualifications of securities professionals working for these institutions. The PBC further exercised administrative and regulatory jurisdiction over the regional securities trading centers, while the SCSC exercised similar jurisdiction over the securities exchanges. In addition, the PBC asserted regulatory control over cross-regional trading based on its authority over the regional trading centers, while the CSRC also asserted some jurisdiction to the extent there were linkages with the two securities exchanges. This dual regulatory structure resulted in wasteful bureaucratic competition and market fragmentation, and imposed unnecessary administrative burdens on the securities industry, without achieving widespread compliance with the rules and regulations.

35. In mid-1998, the CSRC was strengthened further when it was merged with the SCSC and elevated to ministerial rank, as a precursor to assuming sole responsibility for regulating China's securities markets. Subsequently in September of last year, rules were passed to allow the CSRC to set up an organizational structure along regional lines to help remove any remnant of local government influence on securities industry regulation. Under this set up, the CSRC would establish nine regional branches to form a network cutting across geographical boundaries, as the PBC itself was doing to strengthen its capacity for supervising the banking system. The new structure replaced the existing system under which local securities regulatory offices throughout the country—which numbered more than 30—were widely influenced by local governments. Finally, in November of last year, the CSRC formally became the sole regulatory authority of China's securities markets, and the last vestiges of the PBC's role in stock market regulation were removed.

## **E. The New Securities Law**

### **Background**

36. China's first national Securities Law was adopted by the Standing Committee of the National People's Congress on December 29, 1998. The new Law, which had been on the drawing board for six years, took effect on July 1 of this year.<sup>15</sup> It is applicable to the

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<sup>15</sup>The NPC started drafting a national securities law in July 1992, as a precursor to its ambitious plan announced the following year at the 8th NPC to construct a legal framework for China's "socialist market economy". Since then, more than a dozen drafts of the Law were produced, and the 14-member Drafting Committee visited a number of

(continued...)

issuance and trading of domestic shares, corporate bonds, and other securities (except government bonds) recognized by the State Council, and comprises 12 chapters—General Provisions, Securities Issuance, Securities Trading, Acquisition of Listed Companies, Securities Exchanges, Securities Firms, Securities Registration and Clearing Organizations, Securities Industry Associations, Securities Regulatory Organization, Legal Liability, and Supplementary Provisions—and 214 articles.

37. Compared with the previous set of regulations, the Law confirms, among other points, that the State Council, in effect the CSRC, has sole responsibility for unified supervision of all securities market activities in the country, effectively ending the bureaucratic overlap and confrontation of the past. In an effort to counter the speculation and volatility in the stock market, the Law imposes greater discipline on and more clearly defines the obligations of market participants—including listed companies, their directors and officers, underwriters, brokers, dealers, and law and accounting firms. It also stipulates transparent procedures for examining and approving applications for stock issuance and listing, toughens penalties on false disclosure and improper (e.g., insider) trading activities, forbids brokerage firms from mixing their own and clients' money to trade shares, clearly defines the scope of activity of the various types of securities firms, and bans banks and SOEs from speculating on the secondary market. In addition, the Law also loosens several provisions related to the acquisition of listed firms, in particular restrictions on individual stock holdings, which could facilitate broader ownership of listed companies by nonstate entities and thus help to speed up the enterprise restructuring process.

38. At the same time, many of the market's fundamental structural problems are not addressed: the segregation of A- and B-shares; the illiquidity of state and legal person shares on the secondary market; and the government control of the IPO process, including pricing. As such, it does little in and of itself to challenge the state's dominant ownership of listed companies, and fails to address problems in the illiquid B-share market.<sup>16</sup> Indeed, from the very beginning the objective was to formulate a law that would preserve "Chinese

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<sup>15</sup>(...continued)

countries—including the United States, Japan, Korea, Hong Kong SAR, and Singapore—in search of a model and lessons that might be relevant for China. The drafting effort also received critical technical assistance from the Asian Development Bank in the latter stages.

<sup>16</sup>The B-share market and companies listed on overseas markets continue to be governed by measures separately formulated by the State Council. Accordingly, the authorities have indicated that the problems in the B-share market would be addressed separately. To this end, in June 1999 the stamp tax was reduced from 0.4 percent to 0.3 percent and the door appears to have been opened for collectives and private enterprises to tap the market on a wider scale. In this regard, the authorities have announced that such companies meeting the listing requirements would be allowed to issue B-shares.

characteristics”, including official control over the selection of enterprises for share issue and the classification of shares into different types based on investor identities. Professor Li Yining, the chief architect of the Law, noted early on in the drafting process that “as China’s economy grew and its currency became fully convertible, a revision of the securities law would be possible after enactment ... to make it compatible with internationally accepted practice and to adapt the Chinese securities market to global markets”.

### **Main features**

39. **Stock issuance and listing procedures.** In a bid to eradicate the scope for fraud in the stock issuance and listing process and increase transparency, the Law stipulates that applications for stock issuance must be resolved by vote, which must be made public. It also enjoins the CSRC to set up an Issuance Examination Committee, composed of professionals from the regulatory authority as well as outside experts (e.g., academics). The structural organization of the Committee is to be determined by the CSRC and reported to the State Council for approval. In addition, there is at least a gesture toward loosening the CSRC’s control over IPO pricing—issuers and underwriters are allowed to negotiate IPO prices among themselves, which nonetheless still remain subject to CSRC approval. While the Law falls short of specifying detailed and objective criteria for the selection of listed companies and the determination of listing prices, it still appears to be an important step forward toward a more market-driven listing process.

40. The new Law further provides that decisions regarding listing applications made by the CSRC that are not in accordance with the established procedures must be withdrawn and canceled. Where improper decisions have been made but stock has not yet been issued, issuance activities must cease. Where securities have already been issued on the basis of such improper decisions, the holders of these securities have the right to request a refund from the issuer with interest, calculated in accordance with bank savings rates over the relevant period. It also confirms that following the issue of new stock, the issuer—and not the government—will be responsible for its own operations and profits and losses. The investment risk in shares arising from changes in operations and fluctuations in the financial performance of the issuer will be borne by investors. This provision should effectively shield issuers from claims by investors who incur losses in stock trading; given that listed companies are state owned, investors—as well as the listed firms themselves—have generally taken for granted that poor performance would be bailed out by the government. The Law is nevertheless vague on how this will work in practice.

41. Finally, underwriters of new share issues may participate on an agency underwriting (best efforts) or a fully underwritten basis; a new issue exceeding Y 50 million must be underwritten by an underwriting group, comprising of a lead underwriter and participating securities firms. The Law prohibits the underwriter from selling the securities if there are false or misleading statements or serious omissions from the issuing prospectus. It also obliges the underwriter to cease selling such securities and to take corrective action if the

process is already underway. Responsibility for false or misleading statements, as well as omissions from prospectuses and financial reports resulting in losses to investors, must be borne jointly by the issuer and the underwriter(s). These provisions should also enhance the transparency of the listing process while simultaneously improving the quality of listed companies.

42. **Market trading and disclosure.** The Securities Law strengthens the disclosure obligations of listed companies by requiring the periodic submission to the CSRC of key information on financial performance from listed companies. It further obliges listed firms to report immediately to the CSRC “material transactions” that could have an impact on share prices, including potential breaches of debt repayment obligations, material losses (in particular, those exceeding 10 percent of net assets), and material changes in the interests of shareholders holding over 5 percent of the company’s shares. This feature prompted an unprecedented surge of transparency among listed companies even before the Law took effect, as a record number of companies issued profit warnings in the early months of 1999 ahead of the release of full financial statements this past spring.<sup>17</sup>

43. The Law lists categories of insiders who are considered to have inside information and who are thus prohibited from securities trading activities.<sup>18</sup> It also prohibits traders from improperly profiting or off-loading risks by concentrating capital or shareholding to manipulate or influence share prices and turnover by pre-arranged timing, pricing and trading methods, or by self-trading without actual transfer of share ownership. Other provisions prohibit securities professionals from abusing clients’ names or funds, or misleading clients in the conduct of securities transactions, as well as the use of public funds in the trading of securities.

44. Finally, SOEs and other entities holding legal person shares or shares purchased with state assets are prohibited from speculating in the market—which is not defined in the legislation—but can nevertheless continue to trade shares. The Law also expressly prohibits bank loans from “illegally” flowing into the stock market, suggesting that bank financing of share purchases may continue to be permitted under some circumstances. Covert bank loans and SOE funds have been the driving force behind much of the market speculation to date.

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<sup>17</sup>In June 1999 the Shanghai and Shenzhen securities exchange reported that they had censured 25 listed companies for problems with their 1998 annual reports. The problems for both domestic A-share and B-share companies ranged from a lack of disclosure to errors in their reports.

<sup>18</sup>Inside information is defined to include proposed distributions, capitalizations, material changes in shareholding, major acquisitions by the listed company, and the charging, sale or writing-down of more than 30 percent of assets.

45. **Acquisition of stock.** The Law eliminates the restriction clause found in previous legislation banning Chinese individuals from holding more than 0.5 percent of total publicly-issued shares. In addition, it seems to end the discrimination between individuals and legal persons by designating each as “investors”, but it is not clear what this means in practice. An investor acquiring over 30 percent of the shares of a listed company with the intent to continue acquiring shares must report to the CSRC and make an offer to acquire all listed shares of the company, unless exempted by the CSRC. The buyer must also announce an offer within 15 days of reporting; the offer must stay open for no less than 30 days or no greater than 60 days, and cannot be withdrawn. If the buyer’s stake in the target company is 75 percent or more at the end of the offer period, the target company must be delisted from the relevant securities exchange. If the stake reaches 90 percent, the remaining shareholders have the right to be bought out on the same terms as the general offer.<sup>19</sup> As such, the Law appears to set out a takeover regime of sorts and clear the way for much broader nonstate ownership of listed companies.

46. **Regulation of securities exchanges and firms.** The Law sets out regulatory frameworks for the securities exchanges and securities firms. The former are allowed to implement technical suspension of listing of individual stocks if there are events affecting normal trading of securities. However, if there are *force majeure* events affecting the normal working order of the securities exchange, it has the power to suspend market operations but must report this immediately to the CSRC.

47. In addition, the Law lays down rules for the qualification and establishment of securities firms in an attempt to rein them in. Securities firms are also required to observe guidelines on debt-asset ratios and to hold reserves to guard against and minimize operational risks. The Law further prohibits securities firms from financing customers’ trading activities and engaging in discretionary trading. In addition, they will no longer be allowed to take possession of and use clients’ transaction settlement funds to trade on their own behalf, but rather will be required to deposit these funds in a designated bank. Up until now, it has been common practice for securities companies to use such funds without paying interest to their clients; the income generated from the use of these “interest free” loans has constituted a significant portion of securities companies’ profits in recent years.

48. The new Law also sets out a two-tier ranking system of brokerage firms (top houses would need a minimum capitalization of Y 500 million, with an industry minimum set at Y 50 million) that significantly decreases the number of firms qualifying to underwrite new share issues, conduct own-book trading, and trade on their own account. The intention is to strictly limit the number of houses providing the full range of investment banking

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<sup>19</sup>While the acquirer must hold the shares so acquired for at least six months, the Law does not address deficiencies in the Company Law regarding minority shareholder protection in such circumstances.

services—no more than 20 of the 330 stock trading units in China will initially qualify as comprehensive securities houses, and as many as half of the remainder could be closed or merged according to some analysts—while the majority will engage only in brokerage activities or trading on behalf of clients. This two-tier ranking is one of several stringent provisions that give legal backing to the authorities' more recent efforts to rein in the securities industry. In addition, securities businesses are to be strictly separated from the banking, trust, and insurance businesses.

49. **Other.** The Law also encourages securities firms to form industry associations to promote regulatory compliance and to assist industry participants in making representations to the CSRC. The associations can also adopt disciplinary procedures in accordance with the Law and their own articles. Further, it contains provisions for the establishment of a centralized clearing system to facilitate the swift settlement of transactions and to avoid technical errors and mistakes. Finally, the Securities Law lays down civil and criminal sanctions for violations and noncompliance with market regulations, which are clearly intended to curb widespread fraud and manipulation through the imposition of harsh penalties.

#### **Overall assessment**

50. The A-market capitalization—which fluctuated in a range of \$220–240 billion in the early months of this year, before surging to the \$300 billion level during the past month—rests upon many factors the Securities Law aims to do away with. In particular, it depends on the presence of large sums of “hot” or “illegal” money, including SOEs' working capital, pension funds, insurance premiums, loans from state commercial banks, and securities firms using customers' money to trade on their own account. As noted above, only about one-third of the market capitalization is freely traded, and about half of this is estimated by market observers to be in the market illegally.

51. Some of this illegal money left the market during the final quarter of 1998 when it became apparent that the new Securities Law would be passed—market capitalization fell by about \$20 billion last December alone—and additional liquidity departed in the early months of this year. But many analysts believe that if all of the remaining illegal money were to depart abruptly, share prices and market capitalization could fall significantly; such a decline could be half or more of the current market valuation, based on analysts' evaluation of reasonable P/E ratios given market fundamentals—i.e., the view is that P/E ratios of 15–20 would be reasonable for A-shares, in comparison with actual ratios currently in the low 40s (from ratios in the low 30s early this year and in the 45–50 range at end-1997).

52. In light of these concerns, the authorities have indicated they will take a more gradual approach to implementing the provisions of the Securities Law. For example, enforcement of the new minimum capitalization requirements for securities firms and provisions requiring them to stop using their customer's money to trade on their own account will be phased in

over time. In addition, various stimulus measures have been announced in recent weeks—including allowing brokerages to borrow from banks using collateral and from the interbank treasury bond repurchase market, and allowing SOEs to trade legal person shares held more than six months, among other measures—and more are expected in the period ahead to boost the market and facilitate the entry of legal money as the illegal money departs. Indeed, the number of new accounts on the SHSE and SZSE has averaged nearly 12,000 per day over the past month, almost double the historical average, and A-shares have surged to all-time highs.

53. While the new Securities Law is not a major breakthrough, its impact on the longer-term development of China's securities markets should not be underestimated. The new restrictions on securities firms will force the industry to consolidate, while the relaxation of restrictions on tender offers should eventually make it easier to broaden corporate ownership and control of listed companies. The strengthened regulations for securities firms and the new powers given to the CSRC should also help to facilitate a more orderly marketplace. It is noteworthy that, as the new Securities Law went into effect on July 1, China's largest and most powerful securities companies pledged to refrain from illicit trading activity; to stop allowing clients to trade on margin—another illegal but common practice; and to close all stock-trading accounts opened under false names and used to manipulate share prices.

54. The passage of the Law, and the more detailed implementing regulations to follow, also marks an end to the inconsistent and confusing patchwork of existing rules and regulations, and as such is a clear step forward in cleaning up the freewheeling nature of China's securities markets. The most important test for the new Law, however, will lie in its implementation. To move market reform forward, a culture of voluntary compliance with legislated market norms must simultaneously be established, and this will be no easy task. An equally important issue for the future will be the role the stock market is ultimately allowed to play in China's economic development. If the tradition of directed bank lending to poorly performing SOEs is merely replaced by a modern, government-determined capital market, and if policy lending is simply replaced by policy stock issuance, then there will be no fundamental improvement in capital allocation in China.<sup>20</sup>

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<sup>20</sup>Analysts have noted that too much of the money from stock-market listings has gone to poorly managed companies, which has added to the market's problems. The ongoing effort to use the markets to aid reform of the country's state-owned enterprises also calls for high quality financial information to be disclosed to the public, in line with internationally-agreed codes and standards.

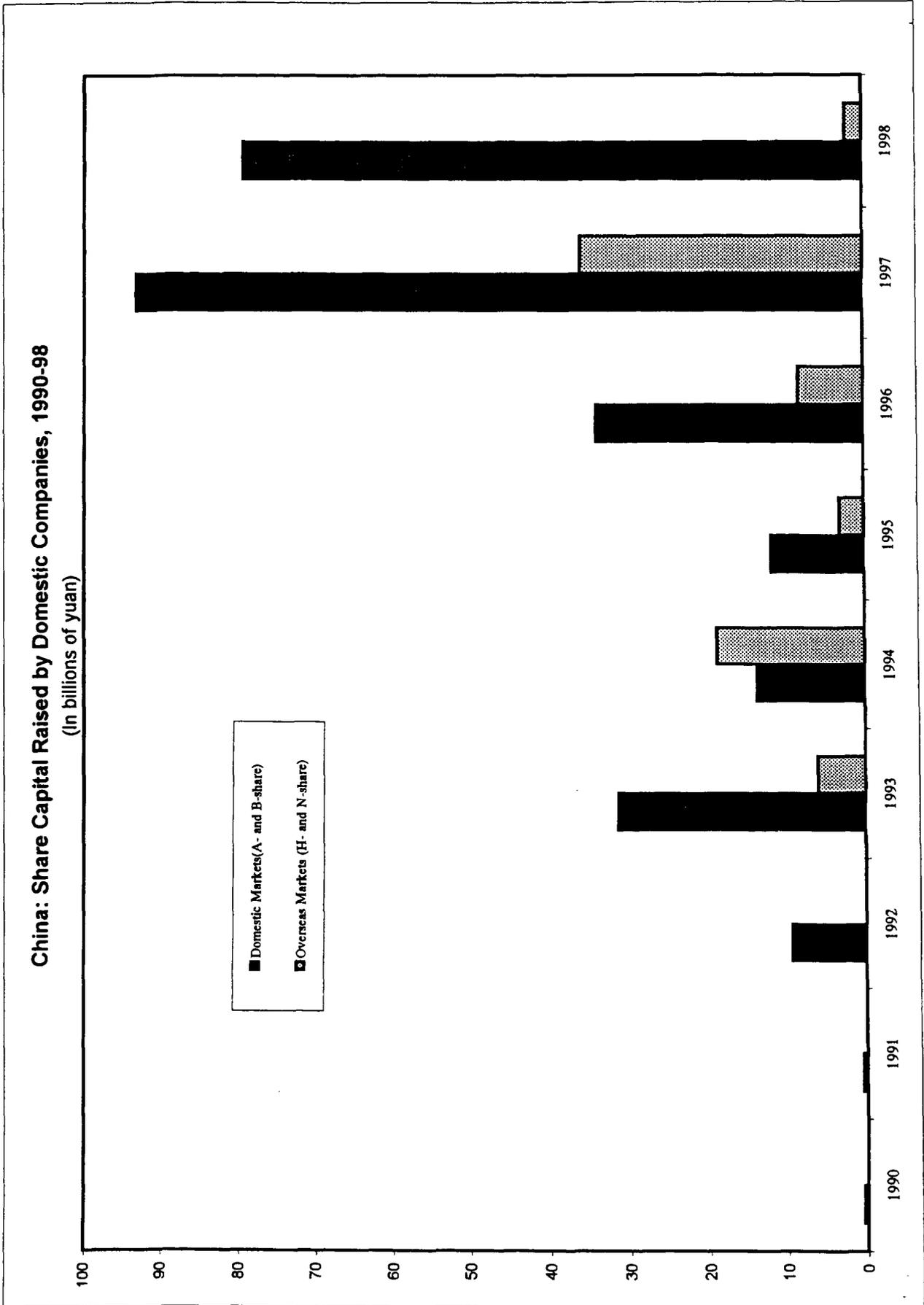
Table VII.1. China: Stock Market Summary

	Domestic Listings		Hong Kong
	Shanghai	Shenzhen	
Date first Chinese individual shares listed	December 1990	July 1991	...
Date first foreign person shares listed	February 1992	December 1991	July 1993
	End-December 1998		
Number of listed companies			
A-shares	425	400	...
B-shares	52	54	...
H-shares	...	...	43
Price-earnings ratio			
A-shares	34.4	32.3	...
B-shares	6	5.7	...
H-shares	...	...	17.8 1/
Market capitalization (in US\$ billions)			
A-shares	127.1	106.0	...
B-shares	1.2	1.3	...
H-shares	...	...	4.9 1/

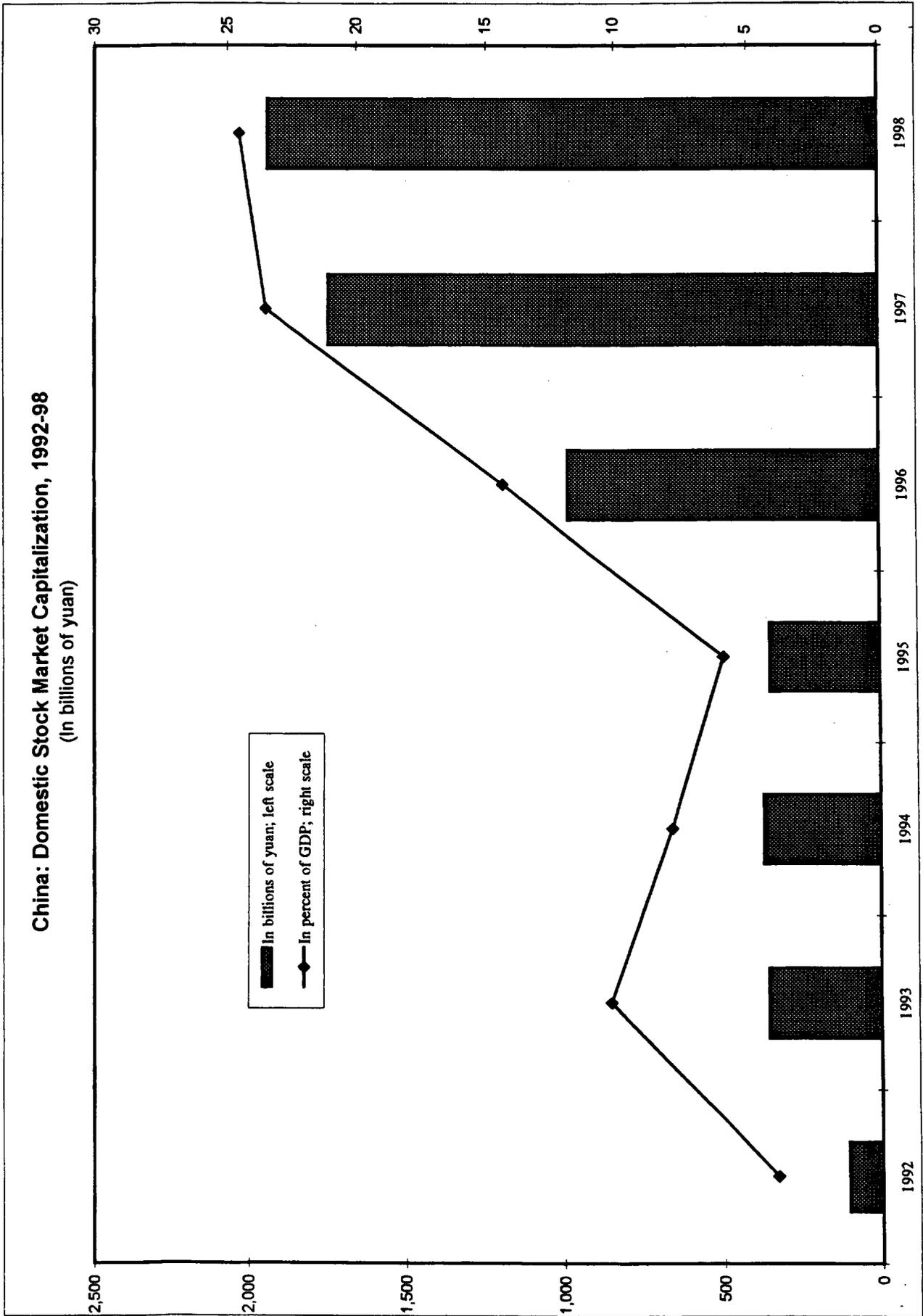
Source: China Securities Regulatory Commission and Bloomberg.

1/ Mid-June 1999.

Chart VII.1

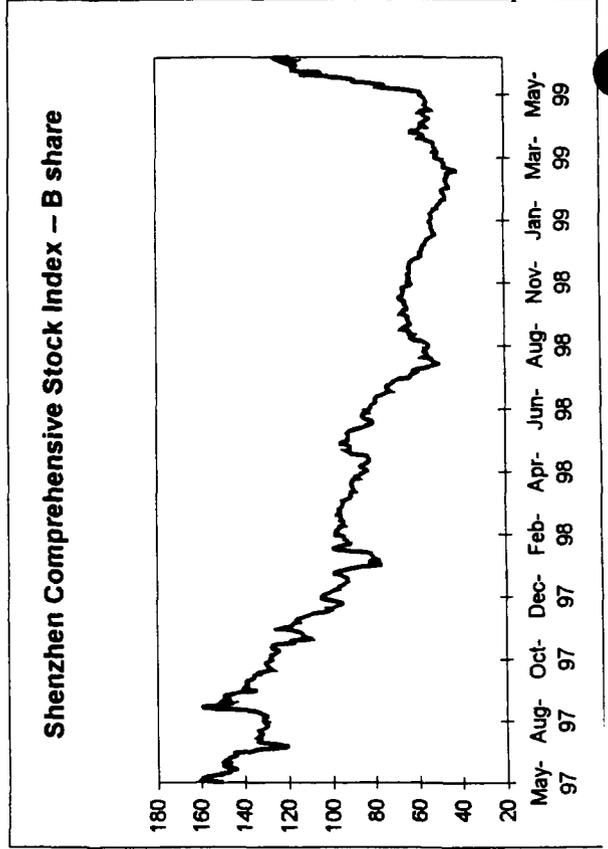
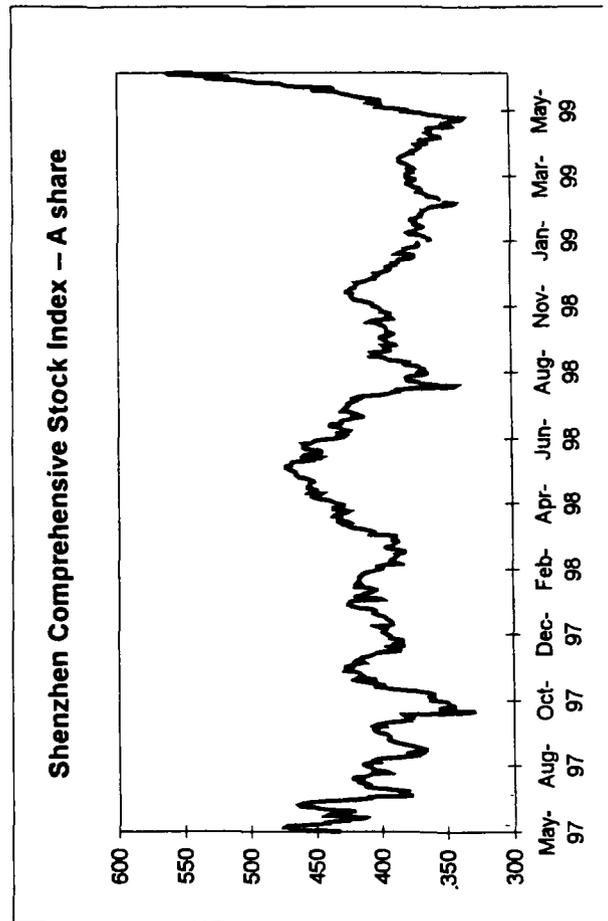
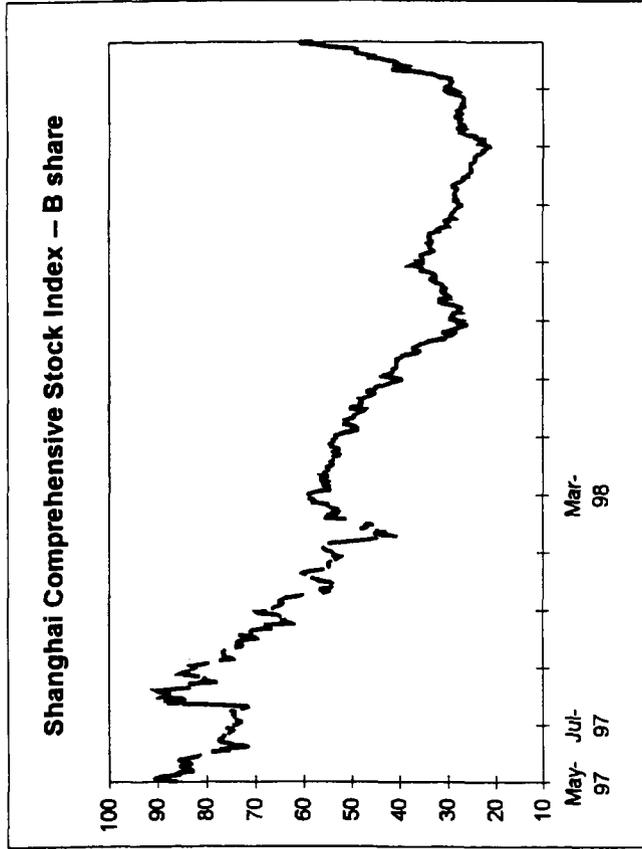
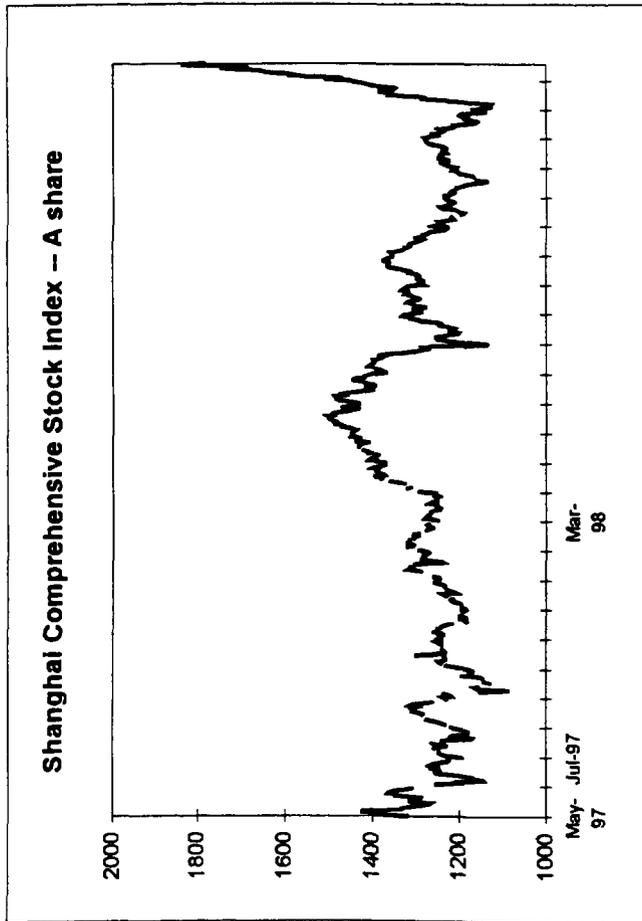


China: Domestic Stock Market Capitalization, 1992-98  
(In billions of yuan)

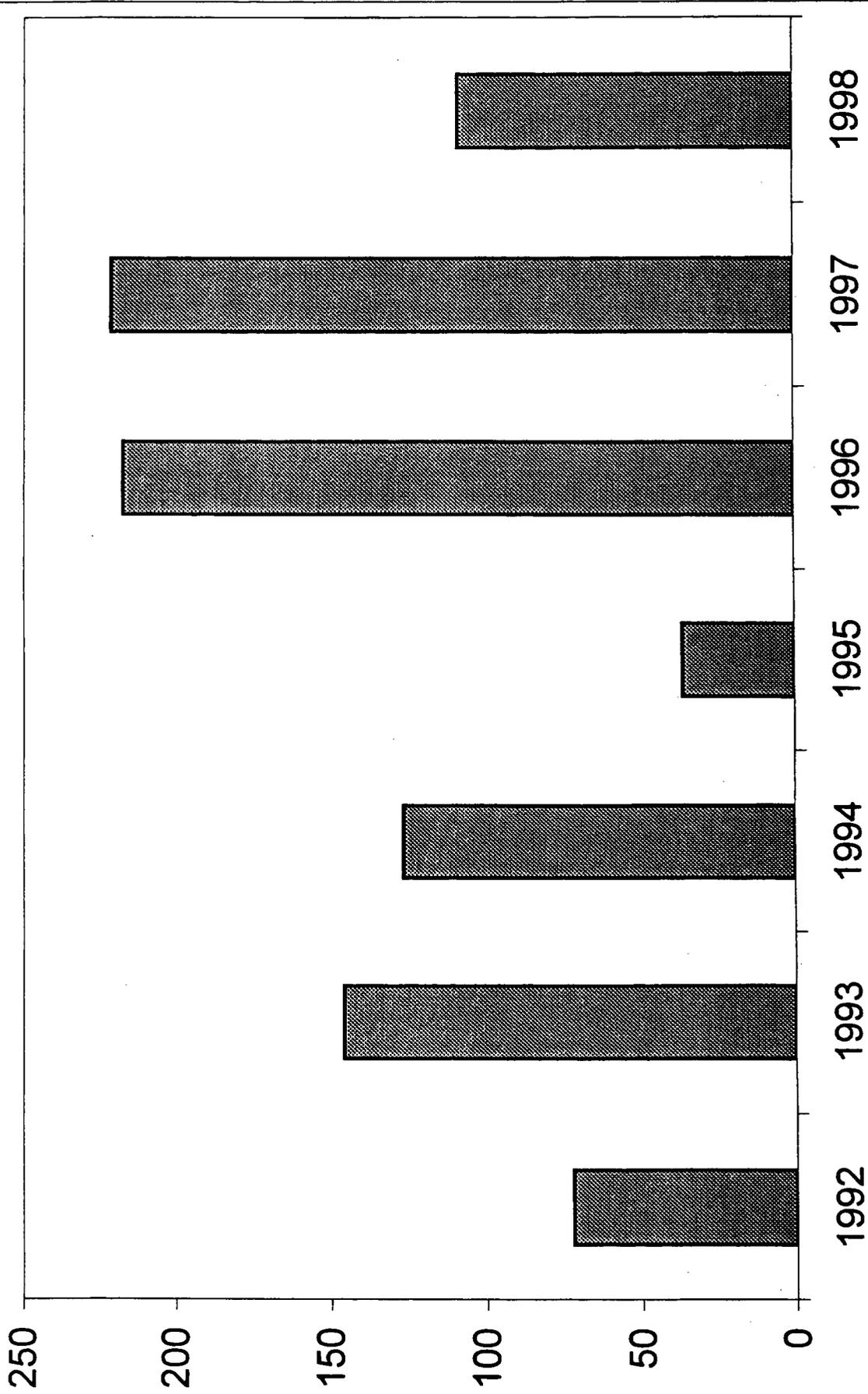


Source: China Securities Regulatory Commission.

Chart VII.3  
China: Recent Stock Market Developments, 1997-99



**China: Number of IPOs on the Domestic Stock Market, 1992-98**



### **The Legal Basis of Domestic Share Issuance**

1. Public shares are governed by the Company Law and the Provisional Regulations on Stock Issuance and Exchange. The Company Law defines two types of companies: those "limited by shares" and "limited liability companies". The fundamental difference between the two is that the Law imposes higher capital requirements on companies limited by shares and in addition allows them to trade shares publicly. Not all such companies are automatically qualified to issue public shares, and must meet other eligibility criteria prescribed in the Company Law.

2. Under the Company Law, a company limited by shares can issue shares using one of two methods: the promoter's subscription method, in which the promoters purchase all the shares the company is to issue; and the public flotation method, in which only a portion of the total share issue is purchased by the promoters, and the remainder is made available to the public for subscription. Public shares can therefore only be made available by this latter method, and by companies meeting all the conditions (e.g., in regard to profitability, minimum capital, etc.) set out in the relevant legislation. They can only be traded among members of the public, and the trading market of public shares is segregated from the trading market for other types of shares. Moreover, individual members of the public can be penalized for holding more than 0.5 percent of the total number of shares outstanding of the common stock of a company limited by shares, as the law provides the issuer the legal right—subject to the CSRC's approval on a case-by-case basis—to purchase the excess shares from individuals at either the initial purchase price or the current secondary market price, whichever is lower.

3. Employee shares were initially governed by the Regulations on Employee Shares Issued by a Company Limited by Shares Adopting a Targeted Flotation Method. Employee (as well as legal person) shares are issued through what is called the targeted flotation method, aimed at distributing shares to the issuer's employees only, and not to members of the public at large. The employee pool is defined to include both current and retired employees. Such employee-shareholders were not issued share certificates, but rather their share ownership was recorded in their company's share rights book, which they had no legal right of access to.<sup>1</sup> Employee shares were also not publicly traded, but could be assigned to other employees within the same company after three years. Even upon death or departure from the company, the employee-shareholder (or his estate) had to assign his shares to fellow employees or back to the company, at a uniform price fixed as a fraction of the company's net capital. Following the promulgation of the Urgent Circular on Putting an End to the Non-Standard Distribution of Employee Shares in March 1993, employee shares could be traded

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<sup>1</sup>Under these Regulations, employees in fact had no legal right to know the number of shares they held or the value of their portfolio. Such information could only be obtained from the securities institution designated as the mandatory depository for their employer's shares upon death or departure from the company.

freely like public shares after they had been held for six months. Employee shares issued before this date continued to be subject to the original trading and other restrictions noted above.

4. Domestically-issued foreign person shares are governed by the State Council's Regulations on Foreign Person Shares Issued by Companies Limited by Shares and Listed Domestically and subsequent Implementation Rules. According to these regulations, such shares are issued by a company limited by shares, using public flotation to "foreign persons", who comprise:

- foreign natural and legal persons and other foreign entities;
- Chinese natural and legal persons and other Chinese entities who reside in Hong Kong SAR, Macau, or Taiwan Province of China;
- Chinese citizens who are lawful residents of foreign countries; and
- any other investor designated by the State Council Securities Office (SCSC).

5. Any company limited by shares may issue both Chinese public shares and domestically-listed foreign person shares. While the Company Law provides for the "same rights and same obligations for domestically-listed foreign person shares as for Chinese domestic shares belonging to the same stock", other regulations and statutes allow for differential treatment. For example, under the Company Law, at least 12 months must elapse between issues of Chinese public shares by the same issuer, whereas under the Regulations on Domestically-Listed Foreign Person Shares, there is no such waiting period between share issues. In addition, domestic shares issued to promoters may not be transferred for three years from the time of corporatization, whereas the relevant regulations for foreign person shares contain no such restrictions. In addition, whereas a Chinese individual holding more than 0.5 percent of a total public share issue is subject to penalty, there are no such sanctions on foreign persons.

6. That said, the minimum capital requirements for a company to float foreign person shares, at Y 150 million, is considerably higher than that for domestic public shares (Y 10 million). In addition, there are no specific rules governing disputes among holders of foreign person shares, whereas disputes among all other categories of market participants are covered by specific legislation. Finally, to ensure, as the Chinese saying goes, that "the well water does not invade the river", trading of Chinese public shares is strictly confined to Chinese citizens residing on the mainland, while trading of domestically-listed foreign person shares is strictly limited to "foreign persons" as defined above.<sup>2</sup>

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<sup>2</sup>Domestic resident are nevertheless reported to own a substantial amount of B-shares. Market analysts estimate this could be as high as 40 percent of shares issued, and that domestic residents could account for as much as 60-80 of current daily market turnover. The intensification of foreign exchange controls in mid-1998 is often cited as a contributing factor to the decline in the B-share market. In addition, there are reports of illegal foreign investment, albeit in much smaller proportions, in the A-share market.

### **The Main Features of the STAQ and Net Systems**

1. **STAQ system.** The STAQ system was launched in July 1992 to provide the legal person enterprises that had been converted into stock corporations with a market to trade state-owned legal person shares on a trial basis, as well as treasury bonds. The STAQ system is operated as a membership organization, with class A and class B members; the former have direct trading access rights, while the latter can access the system only through the former. In contrast to the Shanghai and Shenzhen exchanges, the STAQ system operates in a dealer market environment with compulsory participation of a market maker in every trade. However, there is no concept of "market orders" on the STAQ system: all orders must either be "priced orders" or "limit orders".
  
2. **NET system.** The NET system was developed, and is operated and managed by the China Securities Trading System (CSTS) Co. Ltd. The CSTS, in turn, is jointly owned by the PBC, the Industrial and Commercial Bank of China, the China Construction Bank, the Bank of Communications, the People's Insurance Company of China, and three large national securities companies owned by the various state commercial banks. The PBC, while being a stockholder, also controls the board of directors and senior management of the CSTS, and is the market regulator.
  
3. The NET system went into operation in 1993 to trade state-owned legal person shares and treasury bonds using the PBC's existing VSAT satellite network. Unlike the STAQ system, the NET system operates in an auction market environment without a specialist or market-maker system. Further, in contrast with the Shanghai and Shenzhen exchanges, which provide a continuous auction market using three trading mechanisms for retail trades and one mechanism for block trade, the NET system provides a call auction market through an automated execution system. As on the STAQ system, transfers of legal person shares are only allowed between legal person entities, and all orders must either be priced or limit orders.

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