Chapter 4 – 1990-2000 – Accomplishing the harder reforms

Despite immediate difficulties left over from inflation and turmoil in the 1980s, China's economy in the 1990s squarely addressed its most difficult challenges since the breakup of communes and return to family farming. During the 1990s decade, China accomplished the last key agricultural price reforms, dramatically restructured state enterprise management and employment, recapitalized its banks, revamped its tax system, instituted financial securities markets, began selling off state owned housing to residents, and met global standards for international trade and finance by implementing current account convertibility and successfully negotiating its entrance into the World Trade Organization (the WTO). The macroeconomic cycle of slowdown, boom and then slowdown again created conditions making these changes politically acceptable, especially to the subsidized urban workforce. The 1990s also confirmed that China's growth was not export-led but was instead domestically driven – a contrast with "miracle" growth in other East Asian economies like Japan's, South Korea's, Taiwan's and Singapore's. Through slump at the start, boom in the middle and slower growth again at the end of the decade, 1990s reforms made China's economic system qualitatively different from what it had been at the end of the 1980s.

A. Austerity, recovery and new reforms

China in 1990 was in economic difficulty. Industrial output was falling at the start of the year, while inflation remained serious. Anti-inflation budgetary, credit, and pricing policies severely affected enterprise sales, and unsold inventories accumulated as enterprise profitability dropped sharply, generating heavy financial losses for many firms. Nevertheless, reformers in 1990-91 both managed the economic situation and introduced path-breaking farm price reforms, financial reforms, statistical reforms and major steps for further coastal opening.

Managing the economic situation in 1990 required both bringing inflation down and cleaning up unnecessary damage from credit and demand cutoffs. The standout problem was the financial difficulty in urban enterprises, which in addition to weak sales and loss of profitability found themselves owing large payments to creditors while they themselves were unable to collect from other firms that in turn owed money to them. The Chinese word for the problem was "triangular debts" (三角债) – a network of business obligations in which everybody owed everybody accounts payable, but nobody could pay because unpaid accounts receivable were so large. China first piloted its solution in the northeast region by studying the pattern of interwoven indebtedness, designing a payment sequence, and then injecting funds at key junctures to create a cascade of payments that cleared payables and receivables alike. More assistance for enterprise finances came at the very end of 1990 when, with inflation worries clearly ended (Figure 2.2 in chapter 2), authorities relaxed credit, budget spending and investment authorizations. These moves, however, did not signal a reversal of reforms and restoration of state enterprise primacy. On the contrary, they helped set up state firms for the price reforms in wage goods the following year, reforms that spelled most state enterprises' ultimate doom by the end of the decade.

Other reform initiatives continued in the 1990-92 period as well. In particular, housing reform, which had set ambitious but unrealistically privatization goals in 1988, made additional headway on the legal front if not in implementation. The State Council in 1990 ruled on the legal distinction between state ownership of land and the right to use land as a rental or leased commodity. This facilitated policy announcements in 1991 and 1994 expanding and clarifying the 1988 reform plan, which first made the distinction between subsidized public housing and market-based private housing for wealthier residents (Hui 2009). As in the case of food price reforms, the long-term goal was to increase housing costs for urban residents, either rental or owner-occupied, to levels that could reasonably cover the cost of construction and maintenance. By 1994, however, with inflation a problem again, resistance to paying higher rents was strong and low worker cash incomes inhibited subsidized housing purchases. Even though private housing accounted for as much 60 percent of the total in more liberalized southern coastal provinces, it was less than 20 percent in major cities like Beijing and Tianjin (Hui 2009). Completion of these piecemeal reforms would have to wait until 1998's more dramatic housing reforms.

1. Price reforms – the next stage

Recovery of output in 1991, to over 9-percent GDP growth with low inflation, created ideal conditions for further price reform. In July 1990, the State Council had already formally stated its intentions for further grain and cooking oil price reforms. It noted that higher prices to encourage output coupled with low-priced state sales in the cities created too large a government budgetary subsidy burden, while at the same time low urban prices overly encouraged consumption. It instructed provinces to experiment and look for practical solutions.

Less than a year later, in April 1991, China carried out the first phase of its grain and food-oil price reforms, reforms which Zhao Ziyang in 1988 had tried to ram through despite already high inflation. Along with the 1991 price reforms, to compensate for the impact on urban living standards, reforms also required increased salaries for enterprise and government employees. For food oils, it was the first change in food oil prices for 25 years and completely eliminated oil price subsidies. Price subsidies and ration coupons continued for grain, but not for long. In April 1992, the State Council's second phase raised grain prices dramatically a second time, reaching levels high enough to eliminate price subsidies, so that retail prices were no longer lower than wholesale procurement prices. Analysis of quarter-on-quarter prices, seasonally adjusted, shows two dramatic price spikes in the second quarters of 1991 and 1992 (Keidel 2008, p. 58). Once again, as in 1991, the government mandated urban employee wage increases to match the new prices. This two-step grain price reform, less than three years after earlier urban unrest against price reform, abolished a system of urban grain subsidies that had existed since the early 1950s. By completing the shift of subsidy burdens from government budgets to enterprise labor costs, these reforms also put severe pressure on most state enterprise wage costs, prepared the way for urban enterprise management, labor and financial reform after the next economic growth slump in China's macroeconomic cycle five years later.

Grain and food oil prices in 1991-92 are most important because of their urban-rural terms of trade significance, but other price reforms also took advantage of the macroeconomic cycle's ideal low-inflation conditions in 1990-91. In 1990, rail freight charges corrected illogical prices which had made rates higher for long-haul cargos compered to short-hauls. In 1991-92, prices were raised for 19 industrial products, ranging from steel, to chemicals, to textiles. The

Communist Party Congress in late 1992 confirmed this direction for price reforms, intended to allow market forces to generate basic price formation mechanisms.

From this period in the early 1990s on, China could say that the large majority of retail prices were set according to market forces. This didn't mean elimination of indirect government steps to influence retail prices, especially for farm products, as later policies would show. It also didn't mean that government didn't resort to direct price-formation pressures for products like pork, poultry and dairy in subsequent decades. Nevertheless, coming directly on the heels of inflation-related social unrest in the 1980s, the price reforms of 1990-92 were a major turning point.

2. Measuring China's economic performance

At the same time that China was planning and carrying out these most difficult price reforms, it was also retooling its statistical system. China had received its statistical system from the Soviet Union, and it reflected a soviet definition of output, called net material product, that excluded most services. In 1990 China began serious study of the United Nations system of national accounts, with which it could report the international standard output statistic, Gross Domestic Product (GDP). The job turned out to be harder than expected. The greatest challenge wasn't renaming flows and activities or adding them up differently to meet UN system requirements. China solved those problems well.

The real difficulty was the ways data were collected at the grassroots level and what that meant for the quality and scope of statistics reported. Originally intended for an economy of communes and state enterprises, China's system relied heavily on direct administrative reporting from individual production units. After reforms in the 1980s, with family farming, TVEs, and the spread of urban activity beyond state-owned firms, direct reporting missed increasingly large portions of overall economic activity. This early 1990s statistical reform began a long process of introducing more accurate sample survey techniques. Later, occasional but more comprehensive economic censuses helped revise earlier output estimates upward.

Using China's new statistical reporting results to compare China's performance with that of other countries faced additional hurdles, not all of which had been satisfactorily cleared even after the global financial crisis. First, China's price system in the 1990s was still too distorted to make its reported overall output comparable. Until privatization of housing at the end of the 1990s, for example, urban housing rents, as paid and reported, were extremely low (World Bank 1994). Second, setting aside whether China's commercial exchange rate reflected market-based traded goods prices, China didn't participate in the United Nations sponsored purchasing-power-parity (PPP) surveys until 2005, and even then there were questions about how representative data collection locations had been. Despite these challenges, China's statistical reporting beginning in the 1990s, and especially for some variables like household survey statistics, was more comprehensive and useful than typical economic statistics from other countries at China's early level of development.

3. Major new international commercial opening – Shanghai's Pudong

As if in response to the international cutoff of foreign lending after 1989's Tiananmen violence, China in 1990 launched its most ambitious special economic zone up to that time – the special zone of Shanghai's Pudong district and other parts of Shanghai granted special status. In the 1980s, Shanghai had received little attention compared to other special zones like Shenzhen on Hong Kong's border. This was in part because Shanghai at the start of reforms was already China's most advanced industrial center; it was safer to experiment with new systems in less risky locations. The developed part of Shanghai in 1990 was all to the west of the Pu River (Puxi). The large district east of the Pu (Pu-east or Pudong) was almost entirely agricultural. Over the next twenty years it would become a highly developed new zone, with a new international airport and a full complement of domestic- and foreign-invested firms.

China's premier, Li Peng, went to Shanghai in April 1990 to announce the State Council's decision to allow development of the whole Pudong district as a special economic zone. Two months later the State Council legally opened the district for foreign investment. At the same time, it opened a string of other cities further up the Yangtze River as complements to Pudong in what was called the Yangtze dragon, with Pudong as its head. The Shanghai government made development of Pudong a "major task" for the next ten years, and in 1991 Shanghai's special privileges spread beyond Pudong to old sections of Shanghai, with launch of a new technology zone in the old city's southern region.

The rapid launch of the Pudong SEZ so soon after urban unrest in 1989, especially when considered alongside the dramatic price reforms of 1991-92, made it clear that containing civil disorder would in no way imply that China was rethinking its basic strategy of moving the domestic economy in the direction of stronger market forces while opening further to international commerce and competition.

4. Stock markets open

If anything symbolizes markets and capitalist methods, it is stock markets. Transactions in company stocks had already begun inside trust companies in the 1980s, but in November 1990, Shanghai officially opened China's first stock exchange on the mainland since 1949. The next month, Shenzhen SEZ, next to Hong Kong, opened its stock market as well. The stock markets themselves, owned by city governments and heavily influenced by Communist Party committee leadership within the stock exchange companies themselves, screened and selected the firms to be listed on the exchanges. The listed shares were known as "A shares," which were denominated in the Chinese currency (RMB yuan) and could only be bought and traded by Chinese citizens. Some in government and in enterprise leadership saw listing on a stock exchange as a way to raise needed capital and as preferable to bank loans or other debt instruments, even though for a large or fast growing company, equity sales in the long run can be a significantly more expensive way to raise funds.

It also turned out that most companies that listed couldn't and didn't have all their shares for sale – major portions of listed company shares remained in the hands of government agencies or other state enterprises and were legally non-tradable shares. Hence, listed shares usually represented only a smaller portion of ownership. The idea that these stock markets transferred control of firm leadership to shareholders was misleading. To be sure, many Chinese stock-share companies were controlled by their shareholders, especially TVEs and after enterprise reforms late in the 1990s, many of the sold-off smaller and medium-sized state enterprises. But those firms didn't receive permission to list on the Shanghai and Shenzhen exchanges, at least not for quite some time.

Despite their limitations, however, creation of stock exchanges in 1990 followed a pattern already identified in the 1980s. By setting up the form of modern stock market institutions but only gradually granting them economy-wide operational significance, China established the foundations of later market effectiveness while at the same time maintaining underlying conditions for rapid growth and financial stability. Many Chinese reforms first create the skeleton of modern market institutions and later gradually flesh them out with real-world functionality. China's stock markets are a good example of this approach. Even after the financial crisis and in the years immediately following, they were still a long way from optimal functionality.

China's securities market activities continued to expand. August 1990 saw the first sale of negotiable enterprise bonds. In late 1991 China allowed firms to issue the first of what were called "B shares." Denominated in U.S. dollars, B shares could be purchased by foreigners, but once issued could only be sold for dollars to other B-share investors. After the initial purchase, they were cut off from China's RMB yuan-based economy. This separation allowed foreigners to invest in Chinese stocks without a double risk to China. In an atmosphere of uncertainty, large-scale sale of yuan-denominated stocks followed by conversion of those yuan into foreign currency would have created sudden crisis-level downward pressure on both stock and currency markets. Hong Kong, Thailand, South Korea and other economies suffered from just this double risk in both the East Asian financial crisis of 1997-98 and in the global financial crisis. China did not.

China's stock market over subsequent decades contributed significantly to the effectiveness of China's financial system in many obvious was, but also in one counterintuitive way. China's stock market prices were volatile. Since the founding of these exchanges, Chinese investors showed a strong interest in short-term capital gains. Brokerage parlors opened all over the country, where citizens could go, sit in an armchair, sip tea, follow market activity on large electronic displays, and buy and sell shares. Firms, and even government agencies, also engaged in what is best called speculative market activity. The volatility of stock prices over future decades made it more of a gambling casino than a mechanism for sharing ownership responsibilities or gaining long-term returns. This volatility, however, maintained the attractiveness of bank deposit security for most Chinese household investors not directly investing in a business. This, in turn, helped maintain a lower price of capital for infrastructure and other government public investment projects funded with policy-directed loans. Chapter VII on China's financial system elaborates this point.

Given the cyclical pattern of reforms in the 1980s, it is not as surprising as it might seem that China introduced an iconic symbol of capitalism, stock markets, immediately following the Communist Party's clear reassertion of social stability and socialist orthodoxy in 1989. Just as 1990, a year of near-zero inflation, was ideal background for launching new price reforms, so it was that a year of clearly restored Party and government orthodoxy had weakened conservative resistance to new market economy initiatives like the opening of the Pudong SEZ and the establishment of stock markets. The cyclical nature of China's reforms and economic policies in general is important to recall when analyzing apparent shifts in China's economic development.

B. Before and after Deng's early 1992 'Tour in the South'

With the continuation of market reforms in 1990-91, GDP growth also recovered to a healthy level – above 9 percent for all of 1991 (Figure 4.1). The years after 1990 are best understood as paving the way for 1994's remarkable surge in complex and sophisticated reform initiatives. These years also solidified future leadership's commitment to ongoing market reforms a result of Deng Xiaoping's last major reform intervention, his 'Tour in the South.'

Early in 1992, in his 88th year, Deng Xiaoping took his family in a special railway car for a long vacation in the south of China. During this so-called vacation, however, he met with officials and urged faster reforms everywhere. Most significantly, he made it clear that he would only support new national leaders who also strongly backed market reforms. The next once-in-five-years Communist Party Congress, which would choose leaders for the next ten years, was scheduled for that autumn. As part of Deng's exhortations for faster growth, reforms and international opening, Deng was able to extract strong reform commitments and actions from front-running leadership candidates (Vogel 2011).

For the rest of 1992-93, growth, inflation and international commerce became the focus of attention. Price liberalization and investment funding surged even more in the second half of 1992, most likely reflecting encouragement from Deng's 'Tour in the South.' However, data on investment funding describe how the investment boom began well before Deng's intervention. Bank loan funding for fixed capital investment, after stagnating in 1989-90, grew 48 percent in 1991 and 68 percent in 1992, in nominal, cash, terms (loan growth was 36 and 46 percent, respectively, after correcting for price changes (see Table 4.1). Such lending increases are rapid rates of expansion by any standard.

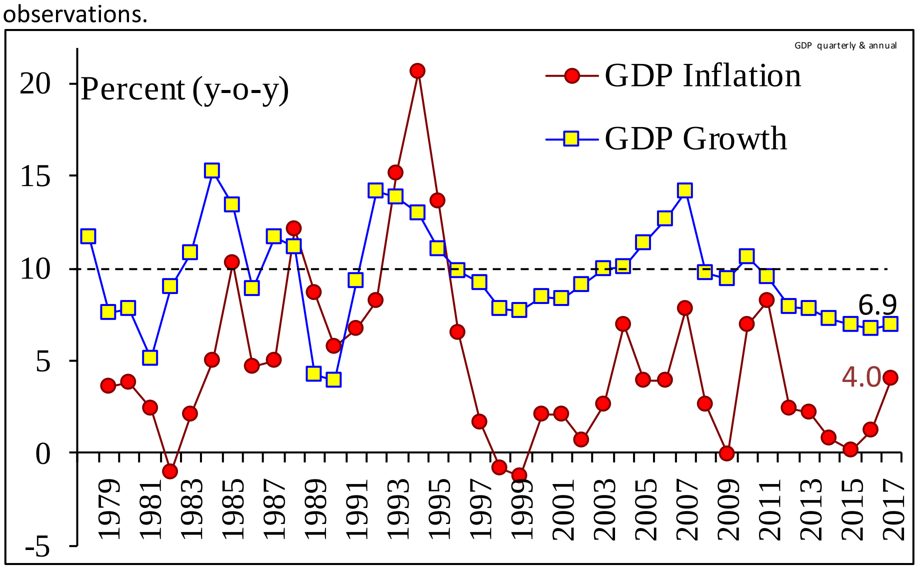
The 1991-92 investment loan surges provided enormous cash infusions into the economy, beginning in 1991, before Deng's 'Tour.' Of course, statistical reporting on 1991's economic rebound for the full year hadn't come out by the time Deng set off on his Tour in the South, but he would have been aware of the shift in 1991 from monthly reporting on output, trade, bank loans and price changes. How necessary was his further encouragement? Rather than re-starting reforms – they had already restarted in 1990 – Deng's greatest contribution was ensuring ongoing reform commitments at the highest levels of China's future leadership (Vogel 2011).

Both the 1991 growth recovery and the major wide-ranging reforms in 1990-91 support a description of China's reform and opening process as a continuous effort to reach long-term goals, albeit an effort forced to respond to a range of cyclical macroeconomic difficulties as well as unexpected events. This conclusion on reform continuity subject to circumstances remains valid through the rest of the 1990s and past the global financial crisis that started in 2008. It implies that China's growth and reform process, when undisturbed by excessively rapid liberalization and related social unrest (Chapter 10), was driven less by personal leadership differences and more by China's practical, consensus-seeking, system of government decision making.

The late-1992 Party Congress officially pronounced that China now had a “socialist market economy,” rather than merely a “socialist commodity economy.” Such semantics were significant because more orthodox Communist cadre saw any market economy as necessarily capitalist – in the 19th-century sense of the word: a system designed for the benefit of capitalists, the owners of capital. This new “socialist market economy” phrasing made it possible to promote market forces as determinants of prices, rather than understanding markets only as places where commodities were exchanged for money. By the end of 1992 both newly confirmed leadership and a stronger market-friendly ideology made possible further liberalization of prices, such that market forces could play a stronger role in allowing prices to find their appropriate values.

Figure 4.1 – GDP Growth Cycles, 1978-2017

China’s economy is clearly cyclical. GDP fast and slow periods are not as pronounced as inflation cycles and tend to peak about one year before inflation peaks through the 1990s. In the 2000s, inflation is the better guide to domestic cycles because of the strong influence of foreign trade demand. A key lesson: the lengths of China’s cycles recommend caution when interpreting long-term future trends from only a few recent years’ observations.



Note: China’s authorities do not publish a GDP deflator, which is the broadest measure of inflation, weighted by GDP components. Instead, the interested researcher must divide the nominal GDP year-over-year ratio by the real GDP year-over-year index ratio to generate the year-over-year GDP price change ratio.

Sources: NBS (2017), NBS (2018b) and author calculations Figure 4.1 GDP Quarterly & Annual

Suddenly, inflation went from near zero in 1990-91 to a serious problem in 1992-94. Pushed up by the earlier feed-grain price liberalization and pulled up by the rapid 1991-92 credit expansion, prices of meat, eggs and vegetables in large cities like Beijing rose by as much as 40 percent in 1992. GDP growth peaked at 14 percent in 1993, as China’s broadest measure of inflation, the GDP deflator[1], jumped to 15 percent in 1993 before peaking at over 20 percent in 1994 (Figure 4.1). The combination of crop price reforms in 1991 and early 1992 and the large

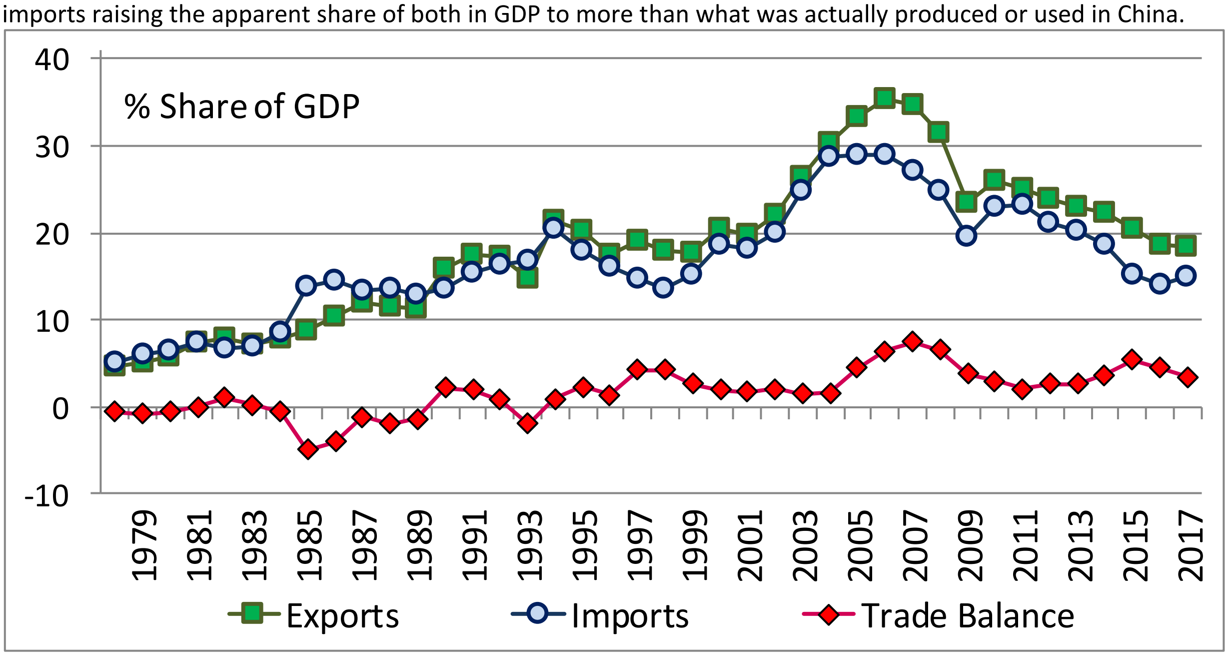
[1] China’s authorities do not publish the GDP deflator, the broadest measure of inflation weighted by its GDP components. Instead, the researcher must divide the nominal GDP year-over-year ratio by the real GDP year-over-year index ratio to generate the year-over-year GDP price change ratio.

investment surge in 1991-92, coupled with Deng's 'Tour in the South,' resulted in an overheated economic boom that lasted until 1996, despite major efforts beginning in 1993 to cool it down.

China's domestic slow and fast GDP growth surges before 1994 were matched on the international front as well. Foreign direct investment, after stagnating in in the 1988-90 years, accelerated sharply in 1991-93. It appears that the FDI influx was attracted by the domestic boom rather than causing it. It is possible that the more general increase in foreign investment beginning in 1992 reflected recovery in the U.S. economy and U.S. import demand at the start of the U.S. 1990s dot-com boom. But as we will see, the 1998-2000 slumps in China's GDP and FDI growth, just as the U.S. dot-com bubble peaked, undermines this causal link. Part of the early FDI influx came heavily from an unexpected source, the island of Taiwan. In 1992, Taiwan authorities relaxed restrictions on Taiwan businesses investing in certain manufacturing subsectors on the mainland. The result was a 1992 jump in Taiwan FDI contracts and funding that became even more pronounced in 1993-94. Taiwan businesses in those years operated through Hong Kong rather than directly across to the mainland, and they were clearly aware of the sudden flood of domestic funding available to match their own contributions.

Figure 4.2 – Foreign Trade in Goods, 1978-2017

Chinese foreign trade experienced frequent deficits in the 1980s and surpluses for all but one year after 1989. Surpluses appear to correlate with weakened import growth as much as accelerated export expansion. After China's 2001 WTO accession, an increasingly significant share of exports came from processed and assembled imports raising the apparent share of both in GDP to more than what was actually produced or used in China.



Source: China Customs Statistics reported in NBS (2017), NBS (2018b) and Customs (2018) with author calculations. Figure 4.2

Export and import growth also accelerated together in 1990-92, until inflation in 1993 boosted import demand but made exports less competitive (Figure 4.2). China's 1993 trade deficit came in the last year of China's dual exchange rate system, with both a 'swap' rate and an official rate, under which roughly 20 percent of importers had access to the official rate's low price for dollars. The swap rate, meantime, under the influence of market forces depreciated significantly in 1993, to 10 yuan per U.S. dollar, compared to the official rates 5.8 yuan per dollar. Beginning in the latter 1980s, the U.S. Treasury Department had repeatedly cited China as a currency manipulator, on principle, because of its two exchange rates, even though China's rifle-and-shotgun trade system meant that exchange rates played a secondary role in determining China's trade balances. Still, U.S. pressure and China's trade and current account deficits in 1993 further encouraged the exchange-rate dimension of the major reform initiatives launched in 1994.

C. The 1994-95 Reform Extravaganza

On January first 1994 China began a wide-ranging series of reforms in almost every dimension of the economy. With inflation raging, these were the kinds of reforms appropriate for this phase of the macroeconomic cycle: tax reform, corporate governance reform, financial reform, exchange rate reform, reform in urban working conditions, and a ratcheting back of the inflationary impact of earlier grain price and grain planting liberalization reforms.

1. Government revenue reform

Hardly anything is more critical for a well-functioning government than the ability to raise funds for necessary public expenditures. China's mid-1990s reform extravaganza addressed this issue directly. China's government revenue system at various levels had for over a decade been a mix of taxes and fees, but central government authorities were dissatisfied with two aspects of the fiscal situation – revenues were too low, and they were heavily skewed in the direction of local government income. The fiscal reforms of 1994 addressed these two issues with new taxes accruing heavily to the central government, such that local governments became dependent on the central government transferring back to them enough funding to meet their expenditure needs. Between 1993 and 1994, the central government share of tax revenues went from 22 percent to 56 percent, while its share of total national government spending only rose from 28 to 30 percent (fiscal yearbook 2011, pp 459 ff). From then on, the central government enjoyed both a mechanism for redistributing funds between different local governments and a degree of discipline over the scale of local budget spending.

The major new tax was a value added tax (VAT), which required more sophisticated reporting than earlier simpler taxes. In addition, VAT revenues were shared between the central government and local government, which local governments saw as a kind of penalty. The central government took 75 percent of all revenues, but then returned significant sums to each local government according to various formulae and depending on the locality's needs (Ahmad 2004). Without the returned revenues from the central government, local governments would not have had enough income, resulting in what appear to be curious deficits in statistics for local budgets.

The VAT also required special treatment for exports and imports. Importers had to pay the VAT on imported goods, and exporters were permitted a refund of the accumulated VAT paid at various stages of production and handling. By filling out a form documenting the VAT already paid on an export's value, a business could receive a cash payment from the government as a VAT refund. Over the years, the scale of the allowed export VAT rebate varied; a higher rebate rate encouraged exports. The export VAT rebate also offered opportunities for fraudulent submission of VAT rebate claims, one of many forms of corruption related to foreign trade that needed attention in later years.

A second form of government revenue came from fees collected outside the budgetary process. They were unpopular, because they could be collected by local government with limited oversight by other authorities. By 1992, these extra-budgetary revenues had reached a level where they were 111 percent of budgetary revenues. 1993 reforms preparing for the 1994 tax reforms had converted much of this fee income into on-budget revenues, such that by 1993-94, extra-budgetary revenues had dropped to 32 percent of their on-budget counterparts (MOF 2011 p. 471 ff & calculations). Because off-budget fees could be applied capriciously and abused by local officials, these adjustments in 1993 were only the first step in what would be an on-going effort over coming decades to control and limit fees or convert them into legitimate budgetary income (Chapters 5, 6 and 10).

The fiscal reforms of 1994 transformed and modernized China's government budgetary system. It introduced new problems, however, such as how to regulate export VAT rebates, and it left important shortcomings of the budgetary process for later reform efforts. The most important were China's wasteful expenditure systems, the heavy burden that taxes and fees placed on China's rural population, and China's opaque process of transferring funds from rich to poor regions.

2. Enterprise management reform

Efficient management of for-profit enterprises is arguably as important as an economy's tax system. In January 1994, China's legislature, the National People's Congress (NPC), passed the Company Law. It described the nature and regulation of a corporate structure for China's state enterprises, calling for ownership to appoint a board of directors responsible for hiring and supervising management, as well as a board of supervisors to serve as an external watchdog. Such corporate structures had existed since the 1980s, but the Company Law set them as a preferred standard for managing state firms.

To complement the Company Law, the NPC in 1994 passed its first national labor law, delineating worker rights and regulations, with major modifications to the traditional urban-hukou work and lifestyle guarantees, known as the labor assignment system, inherited from the Maoist era. The new law focused on establishing labor contracts between worker and employer, which included processes for terminating employment and acceptable conditions for cutting a firm's total labor force. Conditions necessary for large-scale layoffs included a firm's deep business difficulties or determination that a firm was on the "brink of bankruptcy" (MOFTEC 1994). This reform made possible, later in the decade, widespread layoff of state enterprise workers.

Company Law implementation stretched out over many years. Late in 1994, government selected 100 large state-owned firms to carry out pilot introduction of corporate management systems. It was a complex problem, in large part because of issues of ownership. Ultimately, the State Council in 1996 promulgated guiding principles on state firm property rights, to regulate property rights transfers, acquisition, and to limit if not stop the breakup of state firms in an 'asset-stripping' form of privatization.

The process was hardly straightforward. This author participated (speaking Chinese) as the only foreigner in a 1997 three-day retreat in Shenzhen, sponsored by China's planning commission, to explore difficulties facing the largest of China's state firms as they tried to adjust to corporate structures. The retreat included heated discussions, breakout-sessions for specialized topics and brainstorming to come up with solutions. A major roadblock was the many parts of a large state firm, located in different provinces, with partial ownership claims not only by those other provinces but by their local governments as well. The 100 pilot programs had, by 1997, made progress for China's largest state firms. The vast majority of state firms, however, were small and medium-sized, and their reform moved ahead more quickly.

China's basic rule at the time was that the local or national government entity that had provided the funding for an installation exercised state ownership's control over it. So instead of there being only one owner, the state, there were multiple entities sharing control over the various parts of large state firms. Each entity resisted giving up access to related revenue streams. The Shenzhen retreat indicated a need for numerous complex compensation and divestiture schemes to settle into the corporate structures called for in the law.

These state firm adjustments to corporate structures were only the prelude to much more difficult reforms, bankruptcies, sell offs, layoffs and bank loan refinancing programs, begun in 1996-97. They also pointed to additional reforms in the 2000s consolidating state firm ownership functions. The process of shifting state control over productive operations originally overseen by ministries continued after the global financial crisis and even into initiatives by the new Xi-Li government installed in early 2013.

3. Financial sector reform

China's 1994-95 financial sector reforms were also institutional. China established three 'policy banks'0 intended to provide credit to businesses and projects with a public service dimension. The Agricultural Development Bank would service rural needs, like irrigation and instances of renewed crop subsidies. The Export-Import Bank would facilitate trade finance, and the largest of all, the State Development Bank, would support a range of infrastructure and other key projects in the national development plan. These banks were an effort to separate policy-directed loans from what should have been market-based commercial banking business.

Up to 1994, China's banks, large and small, were part of the government's investment and business funding plans, with loans directed toward public projects under instruction from governments at various levels, according to China's various plans, five-year, one-year and quarterly. While laudable in principle, the division between policy lending and commercial lending was, again, initially more form than function. In coming years, and especially in the 2000s, China's commercial banks' competitive capabilities would improve significantly, especially after the bank recapitalizations of the late 1990s. But the division between policy and commercial lending was never cleanly accomplished – which became especially clear in China's investment response to fears of a domestic economic downturn during the global financial crisis.

China made additional minor banking reforms in 1994. For example, China's central bank, the PBOC, began reporting money supply statistics that year according to the international standard M0, M1 and M2. It later retroactively published historical monetary statistics by the same definitions. In a related financial dimension, on January 1st 1994 the central bank abolished the 'swap' exchange rate and devalued the official rate to a value in between its and the swap rate's values in 1993. In 1995, China abolished the parallel SEC domestic money bills, and that year China also adjusted regulations for approving FDI projects to make them consistent with guidelines for domestically funded projects. All these were practical steps based on lessons learned up to that time.

China's major banking reforms, however, came in 1995, with the Central Bank Law and the Commercial Bank Law. These established the legal foundations for a modern banking system. For one thing, the law forbade the central bank from simply making a loan to the budget to cover its deficit. Instead it had to operate through the government bond market. In 1995 China also began converting its urban credit cooperatives into banks according to the commercial banking law. The commercial banking law set standards for operations, but it didn't change the ownership of China's major commercial banks, which remained vested in the Ministry of Finance. Nevertheless, these were important steps that made possible later incremental but meaningful and ongoing reforms in the direction of commercially oriented bank operations.

4. Stabilizing food price inflation

China's strenuous efforts to throttle food price increases might not register as a reform initiative, but they represented necessary regulation of market forces which were threatening urban social stability. Dramatic food price increases had naturally resulted from the 1991-92 price liberalization for grain, oilseeds and, later in 1992, vegetables, meats and fruits. The impact was in fact more dramatic than just a stimulus for food prices. The surge in rural cash income from higher crop prices generated a self-sustaining boom in rural areas, with TVEs showing especially rapid expansion (Keidel 2008). The effort to contain this market-based exuberance would, by 1997-98, result in stagnant rural consumption. The price control effort, however, succeeded in bringing urban consumer price inflation down to zero, which was essential for the difficult state firm closings and employee layoffs concentrated in the 1996-2000 period.

Efforts to contain inflation began in 1992 and intensified in 1993, but with little success at first. In June 1993, China's premier, Zhu Rongji, frustrated by the increase in money supply enabling inflation to continue, fired the governor of the central bank and personally took over the position. Some of the money increase had been necessary, however, since it had gone to fund subsidies for urban households facing higher food prices. By 1994 the urban CPI had climbed to 25 percent. The State Council authorized price ceilings on sensitive commodities. To further improve the lot of urban workers, the State Council also eliminated half-day work on Saturdays, giving urban-registered families a full two-day weekend.

By the end of 1994, however, a weak grain harvest made it clear something more dramatic was needed. The problem was complicated by the general level of inflation, which had pushed up farm costs – fuel, fertilizer, pesticides, equipment – and badly squeezed farm incomes.

Government took several key steps in 1995. First, government procurement resumed a major role in the purchase of grain from farmers; it also raised the grain purchase price by almost 50 percent to keep grain profitable. It then reinvigorated the “responsibility system” approach from the 1980s.

Grain production was inherently low-profit compared to other crops, and farmers chose to plant less grain if given the choice. In 1995 that choice was taken away by a new program called the “governor’s grain-bag responsibility system.” Each provincial governor was made personally responsible for guaranteeing an adequate supply of grain within his own province. The result was an inefficient but large-scale rebound in the area planted to grain. Grain rich provinces, like Hunan, restricted export of grain to grain-deficit provinces like Guangdong, and grain-poor provinces went to extremes to expand grain area – draining fish ponds and plowing under orchards to meet local planting targets. Local governments also expanded the “vegetable basket responsibility systems” they had originated in the 1980s.

By 1996, food price increases had moderated to single digits and beginning in 1996 farm purchase prices entered a five-year period of decline. By 1997 the urban CPI had dropped to 2 percent, representing success in achieving a “soft landing” for the economy. The landing wasn’t very soft in rural areas, however, and economy-wide China entered a period of deflation as retail and consumer prices declined modestly in 1998-99. Household survey data reported that rural household consumption growth was zero for these two years, and although the officially published GDP growth rate was 7.8 percent, many analysts doubted that it could have been that high.

The 1997-99 slowing in GDP growth, however, along with close to zero inflation, represented a new slow phase in the macroeconomic cycle propitious for perhaps the most difficult reforms of all – layoffs of urban workers and sale of most state enterprises into for-profit if not private hands.

D. The capstone reform – state enterprise and urban labor restructuring

The urban reforms of the late 1990s radically transformed the Chinese economy. They included state enterprise sales, large-scale layoffs, bank recapitalization, and the effective privatization of urban housing, arguably one of the most important parts of worker remuneration. These were the reforms that had been impossible in the late 1980s. Almost a decade later, however, shifts in subsidy forms and their funding had created conditions for pushing labor force restructuring and layoffs in a more politically acceptable way.

1. State enterprise and labor restructuring

A major difference between state enterprises in 1996-97 compared to the late 1980s was their deplorable profitability and high bank indebtedness. These were the direct result of the shift in the late 1980s to ‘visible’ price subsidies, by which firms raised worker salaries to match price-reform food increases instead of having government budgets subsidize lower prices in the marketplace. By 1996, and especially after the major food price reforms of 1991-92, state firms had had to borrow large sums from banks to cover their labor costs, inflated not just with wage subsidies but also with serious overstaffing. Many also carried large debts from the bogaidai reforms of the early 1980s. Together with labor costs, interest payments on these accumulated debts had left state enterprises in serious loss-making territory.

To make the upcoming reforms more palatable, government news outlets in 1996-97 began publicizing state loss-making problems. They even exaggerated the problem in early 1997 by giving special attention to enterprise losses in January and February, when the Chinese New Year holiday typically resulted in large enterprise expenditures but lower output and revenues. More fundamentally, workers were aware of unsold inventories accumulating in factory warehouses. China was at the bottom of its output and revenue cycle, and publicized losses and inventories made it easier for some workers, but by no means all, to acknowledge the need for reforms.

The reform's basic approach was to examine each enterprise's overall potential for profitability and the reasons for current losses. If a firm had good product lines with good sales, even though costs were too high, it was slated for continued operation after cost reductions. If not, it was closed. For firms with profit potential but high cost burdens, treatment was different depending on the split between high labor costs and high bank interest payment costs. To reduce labor costs, enterprises resorted to what were called "leave your post," or xiagang (下岗), reforms. To reduce interest payment costs, debts were turned over to asset management companies, essentially bad debt warehouses, using government-backed funding to restore bank balance sheet health.

The process of laying off state workers was first piloted in Shanghai. The key mechanism was the "leave your post," or xiagang method by which a firm told certain workers that they no longer could go to their place of work, but that they were still employees of the firm. This allowed firms to avoid firing workers and turning them out on the streets. Enterprises provided xiagang workers with a stipend that was lower than what their wage had been. Firms also, either individually or in groups, opened "reemployment centers" where xiagang workers supposedly learned about new work opportunities outside the state enterprise system – in the private services sector, for example. Initially there were few such employment opportunities. Workers with particular skills also sought employment in potentially profitable firms if they were hiring, but these opportunities were also limited.

As it gradually evolved in the late 1990s, China put in place a three-tiered program of unemployment compensation. The first tier was the xiagang tier, with relatively generous compensation. If a xiagang worker took another job and then lost it, he or she couldn't go back to xiagang status but had to apply for recently created unemployment insurance support, which was significantly lower. After a certain time, the worker had to go off unemployment support and, depending on how poor the family was, begin receiving China's also recently begun minimum living assistance support (低保).

The scale of urban layoffs in these years was large, though data are not consistent, especially for numbers of xiagang workers. Official labor statistics indicate that the number of state firm and urban collective employees dropped from 144 million in 1995 to 96 million in 2005, a decline of one third. Not all the decline was xiagang workers, however. Some state firms converted to limited liability stock share companies and took workers with them. This kind of employment increased 17 million between 2005 and 2000. But new employment in private firms, including sole proprietorships, increased 43 million. Clearly, China's urban employment restructuring in these years was striking.

The scale of the xiagang system is uncertain, because data tend to report workers still in xiagang status at the end of any particular year, rather than detailing how many newly laid-off xiagang workers had been created. Official data for the end of 2000 put the number of xiagang at only 3.6 million, a small fraction of the reported 20 million urban residents looking for work. Other official estimates reported elsewhere describe the number of xiagang workers as increasing from 4 million in 1995 to over 20 million in 1999 (Lin 2001). With the total urban workforce at roughly 230 million in 2000, 20 million looking for work represent an unemployment rate of roughly 9 percent.

The conversion of state firms to limited liability stock share companies was part of a larger urban enterprise ownership reform called, "seize the large; let go the small (抓大放小)." Its basic function was to sell off or convert to new ownership systems all small and medium-sized state firms while keeping the large state firms in government hands. This program largely accounts for the rapid increase in non-state employment during the late 1990s. The effort to sell off state firms gained ideological support from the decision at the 1997 Communist Party Congress to welcome private business owners and managers into the Party and to encourage employment growth in the private sector.

The processes of enterprise ownership change, worker layoffs, and private sector job creation begun in the latter 1990s continued throughout the following decade. They created the foundations for a more competitive and efficient urban economy. Urban worker subsidies remained in the form of benefits for officially urban registered households, but the grip of guaranteed employment had been broken, and urban firms of all types were placed on a stronger for-profit operational basis.

2. Bank recapitalization

In order to relieve state enterprises of their accumulated debt burdens, China had to relieve state banks of what were now acknowledged to be bad enterprise loans on their books. The most important mechanism for accomplishing this was the creation of four asset management companies (AMC), backed by the Ministry of Finance and eventually by the central bank, one AMC for each major state-owned bank. Each AMC used its government financial backing to issue ten-year bonds, which it used to pay for a subset of its counterpart bank's bad loans, at full value. AMCs then acquired those bad loans. With the AMC's government guaranteed IOUs on its balance sheet, the banks were healthy again – or at least healthier. A major portion of their bad loans were gone, and a large share of state enterprise loan repayment obligations were in essence forgiven or transferred to AMCs and their contracted agencies for collection. Where collection was pursued, returns were low.

The transfer of bad loans to AMCs in the late 1990s was only the beginning of a process of bank reform and bank asset quality improvement that continued in the subsequent decade and well past the years of the global financial crisis. But it was a significant beginning, and it succeeded in overcoming the inertia of banks' inherited ways of doing business with state-owned firms.

Indeed, the restructuring of state-owned firm and urban labor markets in 1996-2000 was the mirrored counterpart of the restructuring of bank assets in those same years. One could not have happened without the other.

The creation of AMCs and the initial tranche of restructuring finance through them in the latter 1990s bequeathed a range of related cleanup and further refinance in the 2000s. A major issue would be what to do with the balance sheets of AMCs themselves when the ten-year bonds became due, because the bad loan assets they held could hardly provide the capital necessary to make the bonds good. In addition, banks still had more bad loans on their books and were still lending to state enterprises. But confronting these problems in later years became almost technical tasks. Continued restructuring and clean up became part of a long-term process that included other technical adjustments to bank management and supervision that China had begun in the 1990s and even before (García-Herrero 2006). Step-by-step improvements included adjustments to regulations on deposit and lending interest rates, reserve requirements and capital adequacy targets, loan loss provisions, creation and expansion of interbank money markets, new or improved regulatory agencies, and efforts to adhere to international standards. China's central bank had in 1996 joined the Bank of International Settlements (BIS).

With banking reform an ongoing process, the best way to think about the AMC-centered bank recapitalization of the late 1990s is as a necessary component of the real priority at the time, which was state enterprise management and urban labor force restructuring. Those changes had to take advantage of the political opportunity offered by the 1995-96 anti-inflation downturn in the economy and its implications for enterprise losses and inventory build-up. Without that undeniable economic and political backdrop of enterprise financial crisis, enterprise restructuring layoffs, and hence the big push for bank recapitalization, would have been socially more explosive than they nevertheless still turned out to be. Chapter III elaborates on the significant social unrest in this period.

3. Housing, healthcare and pension reform

State enterprise and urban labor reforms not only prompted bank recapitalization but also required reforms in important social economic dimensions. By the late 1990s, urban resident housing in China was still heavily provided by one's place of work in return for a low nominal rent as part of urban workers' in-kind payment package. Urban rents were so low that they were recognized in the early 1990s as contributing to underreporting of China's total GDP (World Bank 1994). In-kind urban worker pay traditionally also included low cost healthcare treatment and universal pension coverage, both managed by one's place of employment. As part of enterprise costs and government urban subsidies, these programs were expensive. As enterprise and labor force reforms in the late 1990s separated workers from traditional employers, employer provision was no longer viable. As in banking, state enterprise management and labor reforms in the latter 1990s sped up change in these social dimensions as well, with successes, failures and much left undone for the future.

a) Housing Reform

China's housing reform acceleration came with a State Council decision in 1998. The reform was a complex combination of giveaways, sweetheart deals, administrative adjustments and significantly higher housing costs for nearly all urban residents. Most simply, employer provision of new housing was ended except for certain civil servants. Urban residents were allowed to buy the homes they lived in for a low price and often with financial assistance from an employer or former employer. With the market value of most of this housing much higher than the cost to the new owner, the program had provisions requiring owners to share back to the employer a large portion of any capital gains the family enjoyed on resale of the housing within a time frame of several years, usually three or five.

The most dramatic result was an urban burst of private family investment to improve their newly acquired homes. Do-it-yourself stores, furniture stores and home improvement companies suddenly proliferated. The livability of the existing housing stock improved substantially. The longer-term results were more problematic, however, because the programs underemphasized housing for the urban poor, what had been a public housing dimension of early reform plans. In addition, by championing market forces so strongly in the 1998 solution to enterprise and government housing cost difficulties, private real estate speculation became a serious problem for subsequent decades (Hui 2009).

b) Healthcare Reform

Market reforms and price liberalization programs in the 1980s and 1990s were especially hard on China's Maoist-era fully government-supported health system, and reforms in the latter 1990s only began the process of establishing viable alternatives. Early in the 1980s, with the breakup of communes, the minimal public-health oriented commune clinics closed and rural healthcare became basically privatized and hence expensive. Rural health insurance would have to wait twenty years and more. In urban areas, the ability of enterprises and other employers to maintain self-financed health benefits for employee families eroded until by 1998 more than 40 percent of urban residents were without health insurance (Liu 2002).

In 1998, after four years of pilot program experiments in two smaller cities, the State Council introduced a Basic Medical Insurance System. It pooled payments and treatment risks from both private and state employees, but because of medical cost increases, funding inadequacies, and conflicts between different government agencies over responsibilities and resources, implementation was limited (Barber 2010). A more serious effort at healthcare reform would have to wait until the following decade.

It is also important to note that while healthcare insurance systems weren't working well, healthcare services in China improved significantly in the 1980s and 1990s because of the much greater availability of modern medicines, modern equipment and better trained personnel. In a way, because much better life-saving interventions were available by the late 1990s, the perception that those with money had preferred access gave rise to widespread dissatisfaction. But while the quality of services had improved over that in the Maoist period, the basic situation was a significant shortage of capacity for delivering modern healthcare, as one might expect in a still relatively low-income country like China in the 1990s. Universal health insurance reform would help, but it would need to make difficult decisions about who would receive the limited supply of good care. The challenge of creating such a system would persist well past the following decade.

c) Pension Reform

Urban pension reform in the 1990s was even more intractable than healthcare reform, but the State Council nevertheless made a formal effort at progress in 1997. The pension system inherited from the Maoist period carried with it a wide range of fundamental and operational shortcomings. To start, there was no pension system for rural residents. In urban areas, one difficulty was the early age of permitted retirement – 60 years for men and 50 or, in some cases, 55 for women. A second was that level of pension benefit as a share of worker salary was high by international standards, as much as 80 percent (Béland 2004). These were legacies of the Maoist era effort to create a socialist workers paradise society for China's formally urban citizens. Hence, most important of all, urban workers had come to expect a full pension on retirement as part of their guaranteed lifestyle, and popular resistance to adjustments was strong.

In operational terms, the pension system had become highly decentralized during the Cultural Revolution, and local enterprises, agencies and governments were loath to give up control of such large sums of money to municipal or provincial pools managed by higher levels of government. Such pools were needed for more equitable and efficient coverage. As enterprise profitability sank into losses in the 1990s, enterprises ran into difficulty paying their already retired staff. As a result, pension funding by the 1990s had shifted from enterprise outlays to funds taken from salary deductions, supplemented by government support. To meet pension payment needs, enterprises and agencies began deducting high shares of worker salaries just to finance what was in essence a pay-as-you-go system, even though workers were told they were contributing to their own pension funds. These pension difficulties were one more example of what market reforms had done to the urban economy's ability to pay for the security of its accustomed – and subsidized – standard of living.

In 1997 the State Council set out a framework for eventual progress, but the system's local fragmentation and its basic funding deficits at a time of financial difficulty meant that it couldn't deliver a nationwide urban solution.

E. International shocks and breakthroughs

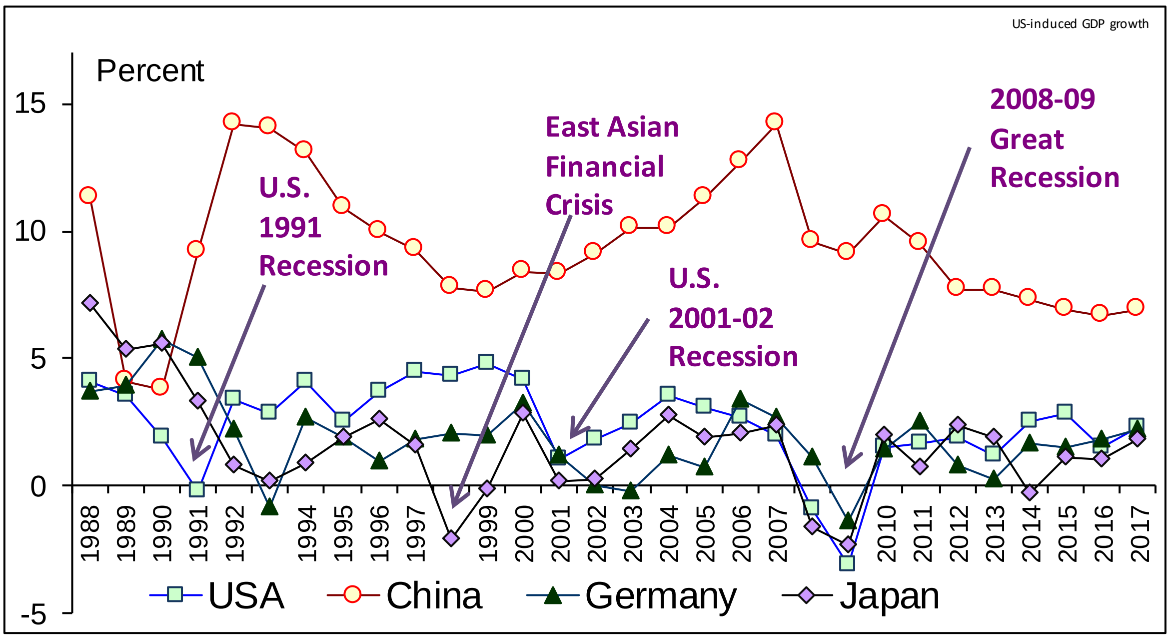
While overseeing historic domestic reforms in the latter 1990s, China also faced significant international commercial challenges, especially the Asian financial crisis of 1997-98 and the difficult process of negotiating Chinese entry into the World Trade Organization. Success in both these dimensions was important for establishing a strong basis for international commercial expansion in the subsequent decade.

1. Asian financial crisis

China's urban reforms in 1996-2000 coincided with an international challenge, the Asian financial crisis (AFC) of 1997-98, which severely affected most Asian economies, including Japan – but not China. China's economy during the AFC reacted more to domestic developments, especially the downturn in growth and credit availability that had started several years earlier. China's growth slowing in 1977-78 correlated with the AFC, but closer examination of actual developments shows that the AFC impact was secondary, if it had much impact at all.

The Asian financial crisis began with the sudden devaluation of the Thai baht in early July 1977, under pressure from short-term capital outflows. South Korea also experienced a sharp devaluation as foreign exchange fled the country. Devaluation in turn revealed the inability of many Thai and South Korean firms to service their international borrowings because they were denominated in foreign currencies, mostly in U.S. dollars. With steep devaluation, the foreign currency obligations became prohibitively expensive in local currency terms.

Figure 4.3 – GDP Growth Rates Compared, 1988-2017



Sources: World Bank, IMF, China National Bureau of Statistics and author calculations. Figure 4.3

The real cause of the Asian financial crisis had its roots at the turn of the 1990s decade, when countries like Thailand and South Korea opened their markets to unhindered short-term international financial flows. In financial jargon, they instituted an open capital account, also known as capital account convertibility. They did this even though their domestic financial regulatory and enterprise oversight capabilities were far from adequate. This internal weakness was the cause of the Asian financial crisis. Things proceeded well while exports and trade surpluses grew in the middle 1990s. Investment inflows were welcomed in good times. But when trade balances edged in a negative direction and foreign-funded projects began to show difficulties, the financial flow reversal was swift and destructive. The AFC demonstrated the folly of prematurely implementing capital account convertibility – and as some would argue, the folly of ever implementing it at all.

Other Asian economies besides South Korea and Thailand also suffered. Singapore lost 30 percent of its money supply in foreign currency outflows. Other economics didn't have large enough foreign exchange reserves to defend their currencies and suffered strong devaluations and numerous enterprise financial failures. Hong Kong's stock market dropped 33 percent in October 1997, as large international financial firms executed a double play – selling off the stock market and then selling the Hong Kong dollar proceeds for foreign exchange, nearly collapsing Hong Kong's pegged currency board exchange rate system. Foreign firms' plan was to buy back into both the foreign exchange market and the stock market when they hit bottom. Hong Kong thwarted their efforts by intervening directly in the stock market to reverse the drop in stock prices and restore confidence in the market's future.

China wasn't seriously affected by the crisis because it had not allowed free foreign financial flows. It had not allowed its banks and non-financial firms to become indebted to international creditors based on foreign currency borrowings. Just as importantly, China's GDP growth was not dependent on exports – it was not export-led. It is common to compare China with Japan, South Korea, Taiwan, Thailand, and even Germany and assume it has also been growth-dependent on U.S. demand for its exports. But China is an exception to the Asian export-led growth experience. China's growth cycles have all been domestically generated from policies intended either to quell price inflation or restore growth with a loan and public investment surge once inflation was under control. China's growth cycles in most cases are negatively correlated with U.S. growth cycles. Other major U.S. trading partners' cycles are highly correlated (see Figure 4.3). Throughout the crisis, unlike other countries China held its exchange rate steady with the U.S. dollar and never devalued the RMB, providing a degree of currency stability for the region.

To be sure, China did experience several 1997-98 events related to the Asian Financial Crisis. The best known was the default on foreign borrowings by the Guangdong Development Bank in southern China. It had received foreign currency loans and used the funds for domestic projects, in violation of China's managed capital account restrictions. By refusing to make good the bank's foreign exchange debts, the State Council taught a lesson both to domestic banks with similar strategies and to foreign lenders who would put their money at risk despite the questionable legality of their investments.

Evidence of China's effective immunity from serious problems in the Asian financial crisis comes from data on foreign trade, foreign investment and domestic investment funding. Most importantly, the AFC had little impact on China's strong export record in the 1997-98 financial crisis years. China's trade surplus tripled in 1997 because exports increased more than 20 percent; exports held that record level in 1998 as well. To the degree China's economy was having difficulties in those years, its problems were domestically generated and were not due to an export crisis.

China did lose 2.2 percentage points of GDP growth during 1997-98, a drop from 10.0 percent growth in 1996 to 7.8 percent in 1998. This was mild compared to, say, Japan with its 4.6 percentage-point GDP decline, into negative growth territory (again, Figure 4.3), but we must still ask if the AFC caused this Chinese slowing. It is possible that the AFC hurt China through a foreign investment decline. But given the strong domestic contraction already under way in China, we cannot conclude that downward growth pressure was due to the AFC impact.

Total real fixed asset investment had slowed dramatically beginning in 1995 as part of the State Council's continuing anti-inflation campaign. FDI and other foreign funding for investment did decline in 1997-98, but they had already slowed significantly beginning in 1995, before the AFC (Table 4.1). It is reasonable to acknowledge that foreign investment also slowed because it was sensitive to shifts in domestic credit availability. Investment funding from retained earnings and miscellaneous sources ("Other" in Table 4.1) were two-thirds of investment in 1997-98, and it began a significant slowing even earlier, in the initial 1993-94 anti-inflation tightening. So, while the negative turn in foreign funding in 1997 had potential for negative influences, domestic demand factors were significantly stronger.

It is useful to note that even though China largely escaped serious crisis impact, the crisis became entwined in China's macroeconomic policies. By 1998, China's anti-inflation program had gone on for five years. The official description of developments emphasized that China had

Table 4.1 – Real Growth of Fixed-Asset Investment Purchases* by Funding 1982-2016

% Change	Budget	Banks	Foreign	Other[A]	Total
1982	2	42	63	32	26
1983	20	-2	5	17	14
1984	21	43	6	24	25
1985	-11	81	19	30	28
1986	5	22	42	15	16
1987	2	23	24	12	13
1988	-27	-5	28	12	4
1989	-28	-34	-10	-14	-20
1990	5	14	-4	-3	0
1991	-12	36	2	11	13
1992	-21	46	27	22	25
1993	10	10	61	34	28
1994	-1	15	68	22	23
1995	11	1	23	10	9
1995[B]	3%	20%	11%	65%	100%

% Change	Budget	Banks	Foreign	Self-raised	Other*	Total
1996*	-3	5	15	1	48	9
1997	9	3	-4	11	5	6
1998	72	16	-2	12	18	14
1999	55	4	-23	5	4	4
2000	13	16	-16	10	12	10
2001	20	7	2	15	20	14
2002	24	22	20	20	7	18
2003	-17	33	22	35	18	27
2004	15	8	20	24	25	20
2005	26	16	19	31	14	25
2006	11	18	7	27	26	24
2007	21	13	14	24	27	22
2008	25	5	-5	19	-11	11
2009	63	52	-11	33	66	40
2010	-1	8	-2	12	9	10
2011	7	-1	1	20	4	14
2012	26	10	-13	20	12	17
2013	17	15	-4	20	25	20
2014	19	9	-7	13	-5	10
2015	18	-5	-28	11	12	9
2016	18	11	-20	0	31	6
2016[B]	6%	11%	0.4%	67%	16%	100%

* Note: these "fixed asset investment (FAI)" data are transactions data, which include purchases of already existing assets; FAI data are as much as 50 percent larger than the national accounts Investment data, which only record creation of new fixed assets, the actual increase of fixed assets nationwide.

[A] Note "Other" includes self-raised until 1996; self-raised funds are overwhelmingly corporate *gross* retained earnings, as opposed to profits, which typically refer to *net* earnings – i.e., net of depreciation. [B] Note: These rows present each category's share in investment funding.

Sources: China National Bureau of Statistics Statistical Yearbook 2017 and author calculations. Nominal data are deflated by the investment price index for 1990-2016 and by the retail price index before 1990. Table 4.1

achieved a “soft landing.” This implied that it had controlled inflation without severely affecting growth. But it had become obvious to many that growth had slowed too much, and the landing was not soft at all. Consumer prices were falling, and employment data in 1998-99 showed declining industrial employment, stagnant service sector employment and rising farm employment as rural migrants returned to their villages. To accompany state enterprise labor reforms, in 1998 China reduced central government employment by 50 percent, with local government cuts to come later. Under these circumstances, the Asian financial crisis played a useful dual role. First, it provided a convenient official excuse for China’s economic difficulties in those years. To the time of this writing, this is still the official story, even though China’s economic predicament and its handling were domestic, not international. Second, the AFC strengthened the argument for domestic demand stimulus. Until then, the official line had been that in addition to a soft landing, China’ had achieved a “surplus economy,” with output greater than necessary. But how could an economy as poor as China’s have “surplus capacity”? The alternate, more accurate, observation was that even though domestic demand was paramount in explaining China’s growth, that domestic demand was still inadequate. In March 1998, China announced a three-year infrastructure program to boost growth. Table 4.1 indicates a 1998 surge in state budget and bank loan funding for investment; investment out of retained earnings responded also. By pointing to the supposed external crisis shock, China’s leaders were politically able to launch a domestic stimulus that carried into the next decade.

A similar pattern emerged at the outbreak of the global financial crisis, when China had once again been suffering from anti-inflation policies that had left the economy with insufficient domestic demand. The international crisis legitimized domestic stimulus.

The Asian financial crisis taught China and others a lesson. China had already implemented current account convertibility in the middle 1990s, and it had intentions of implementing capital account convertibility in the not-too-distant future as well. After the AFC, China dropped all consideration of capital account convertibility. At that point, the IMF, World Bank and U.S. Treasury Department also agreed that speedy opening of China’s capital account would be a mistake.

2. China’s uncertain Most Favored Nation (MFN) status

While most Asian economies struggled with crisis in the latter 1990s, the U.S. economy was growing strongly in the midst of its so-called dot-com boom. Chinese exports to the United States were also booming, but they faced an annual U.S. Congressional hurdle – a yearly U.S. decision about whether or not to grant China one more year of most favored nation (MFN) status.

Since the violence at Tiananmen in 1989, and with China’s loss of strategic significance for the United States once the Soviet Union had broken up, U.S. activists and politicians critical of China sought to deny China the favorable tariff and other trade conditions enjoyed by America’s typical trading partners. A ritual routine evolved in the 1990s in which Congress held hearings each year and deliberated Chinese MFN legislation. Parties on all sides of the issue expressed strong opinions. Privately, most agreed engagement was good, and business interests emphasized commercial benefits for American firms and households. Year after year, Congress and the president granted China twelve more months of MFN status.

Despite the political complexity of giving China MFN status each year, the outcome was not really in doubt; too many politicians realized the importance of interacting with China and understood the commercial cost of not doing so. But the process created uncertainty for long-term investors. As long as some political or diplomatic shift might result in cancellation of China's MFN status, few firms were willing to invest the hundreds of millions, even billions, of dollars in direct Chinese investment that they would commit if China had permanent MFN status. Permanent MFN status was integral to a country's membership in the World Trade Organization (WTO), and China's negotiations for joining the WTO occupied most of the latter 1990s.

3. The U.S.-China bilateral agreement on China's WTO accession

China initially applied for membership in the General Agreement on Tariffs and Trade (GATT) in the latter 1980s, but the application process was delayed after the Tiananmen events of 1989. By later in the 1990s, the GATT had been converted into the WTO, with broader jurisdiction – mainly over services and the rights of foreign firms in domestic markets. China's renewed efforts to join the world trade body required bilateral negotiations with all the member countries, and in each case China had to bargain over what each side would permit in terms of market access and privileges.

The most important negotiation was with the United States, and many countries gauged their demands to what the United States could accomplish. A major difficulty emerged in terms of financial services trade – access banks, insurance companies and other financial firms would have to Chinese markets. Banks and insurance companies had been part of the process from its early stages, but investment banks and stock brokerage houses had not, because China had no stock exchange to speak of in the 1980s, and in the early 1990s China's securities markets seemed too small and volatile to be of international interest. By the late 1990s, however, as negotiations reached their end-stage, it had become obvious that China's stock market was large and would clearly become much larger going forward. This rapid acceleration of the securities industry in China caught many American financial businesses by surprise.

As U.S.-China WTO negotiations were reaching their endgame in early 1999, U.S. financial interests made a last-minute effort to win wider Chinese openings for U.S. brokerages and investment banks in China. The Chinese premier, Zhu Rongji, traveled to Washington to complete the negotiations and sign the U.S. bilateral agreement for consideration by the U.S. Congress. He presented his final 17-point concession package to reach agreement, but President Clinton, under pressure from financial interests, demurred. The negotiations stopped, and Premier Zhu returned to China. China was unwilling to restart negotiations from the position left by Zhu's 17-point concession package, so China's president Jiang Zemin took over subsequent negotiations. China and the United States reached agreement in November 1999, without giving U.S. financial interests what they wanted, and China's membership date was set for December, 2001.

Key components of China's WTO agreement include China's designation as a "non-market economy," which in WTO language means that its products' prices can't be trusted to represent their real costs, so trading partners could use prices for comparable products from other countries to establish appropriate tariffs on Chinese imports. In general, China's terms of entry gave up many more rights and protections than had been the case for other developing countries joining the WTO (Lardy 2002). But the effect of successful bilateral U.S.-China WTO negotiations was a signal to investors that annual review of China's MFN status would come to an end in 2001. As a result, foreign investment in China surged in 1999-2001, two years before China's actual WTO accession in December 2001. The limited access of foreign investment banks and brokerages to market access in China remained a subject of diplomatic pressures and negotiations right through the years after the global financial crisis, without China yielding on the basic terms of its WTO accession.

F. Launch of rural and western regional initiatives

Domestically, an important part of preparations for the dramatic 1990s reforms of state enterprises, bank debt and urban labor was control of food prices and prices of other rural products, which had risen dramatically during China's record inflation in the middle years of the decade. By 1996-97, the combination of the governor's grain bag responsibility system and other steps to suppress rural prices were a success, but the cost was stagnation in rural areas. The impact was felt especially strongly in western provinces and regions, where non-farm employment provided less of a cushion for rural incomes. In the last years of the 1990s, China's government began considering policies to correct rural and western region difficulties, including increased rural unrest due to local government fiscal abuses, but implementation didn't come until the next decade (Chapters 5 and 10).

1. Rural poverty and China's end-of-the-decade policy challenge

Government's 1990s anti-inflation preparations for urban reforms hit the rural sector hard. By 1999, farm product prices had declined for three straight years (Figure 2.1 in Chapter 2), and under pressure from weak rural incomes and the government's mid-decade severe credit tightening (Table 4.1), many township and village enterprises (TVEs) had collapsed. Many rural credit cooperatives also failed, and the central bank managed a large program to consolidate accounts from smaller rural credit coops' into larger recapitalized units. The worst floods in 40 years hit the Yangtze River grain basket provinces, triggering a ban on logging in poor upper river valleys. Local government revenues fell into significant difficulty, and to supplement local revenues, a wide range of fees and other charges on rural households became especially burdensome. The central government set limits on such fees (at 5 percent of household income), but the limits were widely ignored (Chapter 10). To make matters worse for rural households, to protect job opportunities for large numbers of laid-off state enterprise workers, most municipalities in the late 1990s introduced restrictions on job availability for non-urban citizens.

Official national accounting statistics show that real rural consumption declined for three straight years from 1997 to 1999. As measured by China's rural income poverty line, rural poverty increased in 1999 for the first time since the late 1980s (Chapter 9). That year, however, government changed its measure of rural poverty to a new standard that considered rural households poor only if a certain combination of both income and consumption were below the poverty line.2 By this new measure, government could announce that rural poverty was less than reported in earlier years. It was nevertheless clear to policy makers that the rural economy was suffering.

Policy makers in the late 1990s prepared long-term and short-term policy steps. Based on a major Party reassessment in late 1998 and State Council directives in late 1999, the new farming policy concept became "strategic restructuring," with a shift in production toward meeting market needs (Chen 2002). The long-term goal was to correct the structure of production in favor of higher-value products, especially in densely populated areas in eastern provinces. Among other things, this implied reducing output of grain, and low-quality grain in particular, in favor of other products. The strategy also sought ways to strengthen off-farm employment growth as a way of reducing farmland's high population density.

The major immediate step in restructuring output, however, was to relax requirements for planting land to grain in 2000. These requirements, beginning with the governors' grain-bag responsibility systems in 1995-96, had forced farmers to take land out of high-profit uses and put it into low-profit (and even zero-profit) grain. The 2000 grain planting relaxation began a precipitous series of annual declines in grain crop area that lasted four years. Once again, rural households were able to increase their farm incomes by putting more land into fruits, vegetables and fish ponds. This trend created its own typical grain-cycle problems in the next decade, but together with other rural reforms under preparation for the 2000s, farmers' living standards at the end of the 1990s were poised to begin rising again.

2. The plight of western regions and preparations for a new "Go west!" policy

In the late 1980s, China had introduced a regional development strategy based on "three belts," which were basically the coastal, middle and western regions of the country. The strategy at the time was that the coastal region should have priority in development, the middle region would enjoy some development trickle-through, and the western region "would have to wait." Deng Xiaoping is quoted as saying in 1988 that China had two major situations: one was the priority of rapid development in coastal regions, and the other was, once coastal regions were sufficiently developed, for them it to channel resources to the development of the middle and western regions (Zhu 2008).

By the end of the 1990s, with the most difficult urban reforms well under way and with pending WTO accession clearly going to boost coastal development, Chinese leaders turned attention to

[2] There was a good reason to do this. Looking at the structure of China's population in a matrix showing both income and consumption measures reveals that a significant share of the population with non-poor consumption levels nevertheless have low incomes that year – a transitory phenomenon for individual households but a standard feature of the income distribution. Hence, by an income standard some, households always appear poor but are in fact not; they are in between jobs or otherwise living off savings. The same phenomenon appears the other way with even greater severity. The "poor" end of the consumption distribution includes a significant number of households with non-poor incomes who happen to be saving for future needs that year, causing a consumption-based measure to overstate poverty's incidence. China's solution in the late 1990s was to consider poor all households with income below the poverty line and consumption below 1.2 times the poverty line, or with consumption below the poverty line and income below 1.2 times the poverty line (Zhang 2010).

poverty in the western region, initially in a speech by China's president, Jiang Zemin, at the NPC in March 1999 (Zeng 2010). At the turn of the century, the population of western regions was less than one quarter of the national total, but 62 percent of China's poverty by China's own extreme poverty definition lived in the west (Hu 2003). Over the 20 years leading up to the year 2000, only 5 percent of foreign investment in China had gone to western regions (McNeal 2001).

In January 2000, after numerous planning sessions, Beijing issued its first document on the western development program (西部大开发); it established a ministerial leading small group, opened a western development program office and held a three-day conference on launching the program. The western development program would become a major part of China's economic development strategy over the next decade and beyond.

The 1990s had produced a rural economy whipsaw. Price liberalization for grain and oilseeds first triggered a rural boom, but anti-inflation tightening and grain-planting requirements brought years of rural income stagnation by 1999. With policy shifts in 2000 and after, the next decade returned to a better balance in rural-urban development.