

1990 Institute Fifth Anniversary Dinner
San Francisco
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Reflections on China

Thank you, C.B. As always, I'm delighted to be here for the 1990 Institute's annual dinner. Tonight I want to give you some of my reflections on China. These reflections are based not only on my own personal interest in China, but also on a number of professional activities that keep me involved with the country.

Of course, the 1990 Institute is an important part of those professional activities. As you know, I've been an Honorary Co-Chairman of the Institute since its founding. And as I look back on the Institute's achievements over the last five years, I am truly impressed. You've not only produced solid research on China--but you've also managed to bring a number of your research findings to the forefront of discussions with policymakers and their advisors in China. I'm sure it was clear from Hansen's report on the two recent law conferences that additional vital channels of communication have been opened, as well. In other words, you are fulfilling to the highest degree the charter of the Institute: That is, to create a people-to-people dialogue--free of threats and intergovernment negotiations--for the sake of building mutual understanding. I think that, considering the high quality of both the Institute's goals and its achievements, we owe great thanks and congratulations to the directors and officers, who have so freely and energetically devoted their time and effort to the organization.

Another important professional activity for me and for the San Francisco Fed is our Bank's Center for Pacific Basin Studies. And there's quite a bit of overlap between the Center and the 1990 Institute—which shouldn't be surprising, since Hanson and my predecessor, John Balles, both were instrumental in getting both programs off the ground. Indeed, the Center, which was established in 1990, carries on the 20-year tradition of our Pacific Basin Studies Program—a program that has made the San Francisco Fed a leader in broadening and deepening our nation's knowledge of the economic, monetary, and financial policy issues of that important region of the world. In addition to its pre-eminence in research in this area, the Center also has established an extensive network of organizations for sharing information and output with one another. And it has worked hard to enhance cooperation among central banks in the region.

Naturally, China--with its great size and phenomenal growth--is an important focus of the Center's research. Perhaps some of you are familiar with a few recent articles we've published in the Pacific Basin Notes series, which is part of our *Weekly Letter*. The Center's close ties to the 1990 Institute have helped foster that research in a number of ways. For one thing, the Institute has helped bridge the gap between these two very different languages and cultures. In addition, the Institute's research on China has become an important source of the Center's information on developments in China. Furthermore, through the Institute we've established many useful contacts with influential people in China, outside of our usual central bank channels.

Finally, I've been fortunate enough in my career to have the opportunity not just to

learn about China from a distance, but to visit that fascinating country in an official capacity. In fact, since I became the President of the Bank in 1986, I've traveled there four times. The most recent trip was last October as a member of the Federal Reserve delegation headed by Chairman Greenspan. This trip was one of the most interesting and exciting of all. Our hosts received us with great cordiality and honor. And we were involved in long, individual discussions with President Jiang Zemin, Premier Li Peng, and Vice Premier Zhu Rongji. We also met Mayor Xu Kuandi of Shanghai--he was Executive Vice Mayor at the time--and I look forward to seeing him again next month when he leads a large delegation to visit San Francisco in a Sister-City program.

So in the time remaining, I'd like to share with you some of the things that struck me on this trip--and they range all the way from remarkable successes to daunting challenges.

I'll start with the successes. Since China began its economic reforms in 1978, the results have been astounding.

- Real economic growth averaged 8 percent a year from 1978 to 1991. In 1992 and 1993 growth exceeded 13 percent, the highest in the world. In 1994 growth "stagnated" to a "mere" 11 or 12 percent.
- A sign of China's increasing role in the world economy is its growing strength in exporting. China's total exports have increased at more than 13 percent per year since 1980, and it's now the world's eleventh largest exporter. More than 80 percent of China's exports are now manufactures, particularly labor-intensive manufactures, such as clothing, footwear, toys, and sports equipment.
- An important consequence of this growth is that China has been the recipient of large capital inflows. Foreign investors have sought to gain from China's favorable long-run prospects, both as a place to produce and as a potential market. In 1991 foreign direct investment in China was over \$11 billion, more than that into any other developing country; in 1993 this figure more than doubled, to \$26 billion; and it rose to \$34 billion in 1994. Foreign borrowing also has increased, making China now the world's fifth largest international borrower.

Clearly, in a decade and a half, China has come a long way. But the question is: Will China continue to enjoy the same rate of progress? In other words, will China's economic miracle continue? The answer is difficult to give, because, in spite of the dramatic changes in the past 15 years, China still faces major hurdles. I'd like to point some of these out.

The foremost problem in the short run is that of inflation. In 1994 consumer prices rose almost 25 percent nationally, the highest rate since the founding of the People's Republic in 1949, and well above the year's target of 10 percent.

The austerity program initiated in 1993 has slowed growth only minimally, and, although there's some evidence that inflation has come down in recent months, it remains high. On our trip last October, I listened to some Chinese officials suggest that inflation is OK--that it's a necessary part of economic development. And I can certainly understand that China's leaders want to avoid the so-called "hard landing" they experienced after the economic booms in 1985 and again in 1988 and 1989. But the experience of other developing countries suggests growth can't be sustained for very long in an environment of high inflation.

And there are significant operational complications for dealing with China's inflation

problems. One of the most serious is that China still lacks most of the instruments for managing aggregate demand that are taken for granted in other market economies. For example, most central banks can mop up excess money by buying it back from the public in exchange for government bonds. But the People's Bank can't do that because China doesn't have developed financial markets.

Another longer-term problem that must be faced is reform of the state enterprise sector. Since 1978, significant progress has been made, as the share of industrial output produced by state firms has fallen in half, from 80 percent to 40 percent. However, the number of workers employed by state sector firms, roughly 100 million, has declined very little. And according to official estimates, nearly half of these enterprises are losing money. As a result, the state sector continues to absorb scarce resources, either through budgeted subsidies or through government-directed loans by the banking system.

This complicates life for Chinese policymakers in two ways. First, it constrains monetary policy, since the People's Bank must ensure that credit continues to grow in order to help support state firms. Second, it complicates reform of the financial sector, particularly banks. A large portion of bank loans in China are to state firms and they're not likely to be repaid. If banks are compelled to roll over or even expand these loans, it will be that much harder to move banks toward a market orientation.

In addition, the high volume of foreign capital inflows is something of a mixed blessing. While it lasts, this surge in capital flows is a good thing: It provides financial resources for investment and injects foreign technologies and management methods. The risk is that it may *not* last. In *that* event, policymakers will either have to replace foreign borrowing out of domestic sources or slow the economy down. The concerns about the effects of such a capital flow reversal have been intensified by the recent experience of Mexico.

The last problem I want to mention is that of growing income inequality. "Communist" China--paradoxical as it may seem--has greater inequality of income than Taiwan and South Korea. This is mainly because of the gap between urban and rural incomes. Incomes are much lower in northern and western regions, which are far from coastal growth centers. And though urban wages are rising rapidly, there's been hardly any movement in the incomes of many people in the countryside--where nearly 80 percent of the population lives. This can have a serious effect on social and political stability, as I'm sure China's policymakers are aware.

I believe China is at a crucial juncture in its reform process. I've tried to describe some of the difficult challenges that I see ahead. And I haven't even mentioned others that are at least as important, such as the country's unsettled political situation.

So, naturally, as I said, it would be very hard to predict how these difficulties and complications will be handled. But, if I might venture a guess, I'd turn to an old saying that's common in Beijing, and that beautifully describes China's penchant for gradualism: We may very well see an approach that's like "crossing the river by feeling for stones." Whatever approach is adopted, however, I believe another saying sums up a guiding principle for the Chinese people and their leaders: When you have traveled 90 of 100 miles, your journey is only halfway done. I wish the country well on its difficult journey forward.