Current Issues of China´s Economic Policies and Related International Experiences - The Wuhan Conference 2002 -

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1. From Dual-Track to Single Track: How Will China Continue its High Rate of Growth? The "Wuhan Conference" – Summary and Comment

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1. Introduction

This paper is a summary of the workshop on "Current Issues in International Macroeconomic Policies" (from now on the "Wuhan Conference"), which was sponsored by both the German Foundation for International Development (DSE) and the Zhongnan University of Economics & Law (from now on "ZUEL") and held between March 11 and 13, in ZUEL, Wuhan, P. R. China. Part I offers an historical description and explanations for the "economic miracle" which has taken place in China over the past number of years., Part II analyses the relevant theoretical foundations of both the EU and China's macroeconomic policy experience since the early 1990s, Part III explains why the next five years are crucial for China's development, and Part IV discusses the kinds of macroeconomic policies that China should implement to overcome the continuing problems and potential risks to its development that the country still faces.

2. Types of Transition Economy and China's "Transition Miracle"

China has been gradually carrying out its transition from a centrally planned to a free market economy since 1978. Ten years later, with the collapse of the former Soviet Union, and the socialist East Bloc regimes, countries such as Hungary, Poland, the Czech Republic, Slovakia, as well as former Soviet Republics like Russia, Kyrgyzstan, and the Ukraine also began a process of economic transition. According to Hansjörg Herr and Silke Tober (1999, p.), all transition economies can be grouped into three clusters.

The first cluster is the East European transition type, which includes such countries as Hungary, Poland, the Czech Republic, Slovakia, and Slovenia. During their transition periods, the Czech Republic, Slovakia, and Poland not only avoided the short-term collapse of investment and production, but also quickly succeeded in stabilizing their currencies, although they experienced a 20% to 30% decline in their production in the early years of transition. It was not until 1996 that Poland's productivity returned to the level it was at in 1989.

Russia, Kazakhstan, Kyrgyzstan, the Ukraine and other Republics of the former Soviet Union form the second cluster, namely the Russia transitional type.In order to effectively combat and control hyper-inflation and achieve currency stability, they have paid a high price: investment and production has been falling sharply for nearly 8 years, the growth rate of the economy has been in minus figures for a long time, and output for 2001 has still not recovered to 1989 levels.

[*] Senior Lecturer of Economic of ZUEL (Zhongnan University of Economics and Law), Wuhan, P.R.China. E-mail: nearing5@hotmail.com I benefited greatly in the writing of this paper, form the lectures, insights and comments of Hansjoerg Herr, Jan Priewe, and Zhao Ling-yun. I would like to thank Ms Jody Lan and, Ms Donchevish from the U.S., as well as two friends of theirs, for their careful checking and, editing of my work, and for their helpful comments and advice. I would also like to extend my thanks and appreciation to Mr. Wang Pu for his suggestions on the outline of this paper.

The third form of economic transition is represented by the example of China. As Herr and Priewe have stated, „Unlike any other transition economy, it [China] has succeeded not only in avoiding a severe crisis; it has also apparently managed to make transition a source of growth." (Herr and Priewe 1999, p.303; 2002, p.46) Over the last 24 years, China has experienced more than two decades of rapid growth; its average GDP growth rate per annum between 1978 and 2000 was 9.72%, and even during the period of 1998~2001 period, when worldwide economic growth slowed down and began to slide into recession, China still maintained its GDP growth rate within the relatively high range of 7%--8%(PBOC 2002, p.5). Moreover, China successfully maintained monetary stability both domestically and internationally during the mid-1990s, and had overridden the worst effects of the Asian Crisis by the end of 1997, by continuing to experience a high GDP growth rate while keeping inflation figures low.

China's economic transition, therefore, performs two miracles: Transition without experiencing the sort of crises suffered by other economies undergoing the same processes on the one hand, and on the other, unusually high growth rates, of the kind that are normally associated with advanced economies.

Many explanations, some of them negative, have been proposed to account for these two phenomena. But in Herr´s and Priewe's (1999, p303-310; 2002, pp.46-49) opinions, "they do not touch on the key to the poorly understood phenomenon of economic growth in China." They mainly attribute the high growth exhibited by the Chinese economy to the following four causes. The first cause they cite is the stable social and political situation prevailing in China, the gradual manner in which reforms have been introduced, and the stability of RMB's exchange rate against US dollar, all of which resulted from strong and effective state intervention and offered a macro-institutional base for economic performance and development. The second factor has been high levels of internal investment. Priewe and Herr have stressed that, "Growth in China has, in the first place, been driven by high investment demand." Since 1978, China has had the highest investment ratio (gross fixed capital formation as a percentage of GDP, in most years, reached a level of around 30%) of all large economies. "The high growth rate of investment together with the high proportion of investment in GDP explains why investment demand must have been the backbone of Chinese economic development since 1978." (Herr and Priewe 1999, pp.303-310; 2002, pp.46-49) Foreign direct investment (FDI) constitutes the third source of high growth. "Until 1991 FDI inflows were rather low and never exceeded US$ 4.5 billion. In 1992 FDI inflows began to increase and reached levels of over 45 billion per annum between 1996 and 1998… During the 1980s, FDI was equal to 2 per cent of GDP and to about 6 per cent of gross domestic investment. By 1997, FDI was equal to 5.1 per cent of GDP, and accounted for 14.4 per cent of gross domestic investment." (Herr and Priewe 1999, pp.303-310; 2002, pp.46-49) FDI has had a greater influence on several structural aspects of the Chinese economy, such as technological change and the boosting of productivity, foreign trade expansions, and improvements in the international balance of payments, than on the high quantitative level of investment, which has done much to promote economic growth.

The fourth factor is the financing offered by both the lending institutions, (mainly the "Big Four" commercial banks) and credit markets lying outside the financial establishment.

Zhao Ling-Yun from ZUEL agrees with the views of Herr and Priewe, but his emphasis, while based on an analysis of economic history, was laid on the role of effective state intervention, especially on gradual, flexible and effective macro-economic decision-making. He argued that between 1979 and 1992, macroeconomic policies followed a zigzag pattern. In other words, there were periods when the Chinese economy was faced with "double highs" together with "double lows" over several years; that is, high growth rates combined with high inflation on the one hand, and occasionally, low growth rates combined with low inflation, on the other. In this phase, combating and controlling high inflation rates were as important as maintaining high growth. Lower growth rates were tolerated where an extremely high inflation prevailed (as high as 18.7% in 1989). That is why, between September 1988 and December 1991, the Chinese government adopted a "hard landing" strategy, though the results were not as ideal as had been expected.

Between 1993 and 1997, macroeconomic policies followed a slow-down pattern and a series of highly restrictive measures were put into practice in China. The results somehow turned out to be better than expected. GDP growth rates were relatively high, and inflation eventually decreased. This outcome became known as the so-called "soft landing success". In 1998, in order to reduce the negative effects of the Asia Financial Crisis on China's economy, as well as to cope with potential deflationary tendencies, in addition to fostering effective domestic aggregate demand, the Chinese central government tried switching to a stable, growth-oriented macroeconomic policy pattern, leading to the introduction of positive expansionary fiscal policies and moderate monetary policies. On account of the favourable results it had produced by 1998, this strategy has been continued for 4 years, and has contributed a great deal to China's high rate of growth by creating a favourable economic climate and massive financial support.

3. Theoretical Analysis of Different Types of Macroeconomic Policies: Keynesian or Monetarism?

A wide consensus was reached on among all Wuhan Conference participants that, against the background of a worldwide economic recession, macroeconomic policies and decision-making are becoming more and more important for the fostering of future economic development. In order to make suggestions for decision-making as useful and wide-ranging as possible, the participants examined the macroeconomic policies formulated and implemented by China and the EU since the early 1990s, and considered their theoretical foundations: whether Keynesian, Monetarism, or a combination of both. Their arguments were as followings.

The Chinese experience. Herr from the Berlin School of Economics (FHW Berlin), Pang Jing from the Shangdong Finance Institute (SFI, Jinan), Qian Shan from the Capital University of Economics and Foreign Trade (CUET, Beijing), and Zhou Xu-sheng from PBOC argued in the Wuhan Conference that China's macroeconomic policies since 1995 have been based fundamentally on a theoretical combination of Monetarism and Keynesian, although there has been a change of focus since 1998. Moreover, China's transmission mechanism and tools of monetary policy have their own features: before 1998, the instruments of monetary policy mainly comprised credit plans, i.e. the PBOC issued the aggregate quantitative stipulation of loans for the "Big Four" at the beginning of each year, and permitted no exceeding of the volume plans and the strictly regulated interest rates.

However, since 1998 after credit plans had been abandoned, the regulation of interest rates was chosen as the main instrument of monetary policy. The transmission mechanism is as follows: Central Bank (PBOC) □Interest Rate and/or Volume of Credits□ Aggregate Demand□ Price Stability. Interest rates have been successively lowered by the PBOC 8 times since 1996, and the required reserve rate was taken down from 13% to 8% in 1998 and reduced again to 6% in 2000. All these measures have helped to encourage commercial banks to lend more money to firms and households. Open-market operations, which were introduced in 1994, began to play a greater role in the enactment of monetary policy, though they haven't functioned as strongly as they should have done, on account of the undeveloped state of the financial markets and the lower investment elasticity of interest rates. Before 1998, the fiscal-monetary mix was generally tight or restrictive and achieved good results, i.e. combating and keeping inflation at the expected level, maintaining high and stable growth rates and low inflation, or ensuring the soft landing of the economy. Since 1998, in order to forestall the negative ramifications of the Asian financial crisis and potential deflationary tendencies, the fiscal-monetary mix was essentially rendered expansionary; namely an expansive fiscal policy united with a moderate monetary policy It worked—and was still working at least up until the year 2001. Gradual, flexible and effective state intervention, through the implementation of fiscal and monetary policies, ensured the stability and high growth of the economy, because they succeeded in reducing economic uncertainty and improving individuals' expectations of the future. This phenomenon is one of the major underlying causes of the Chinese economic miracle to date.

The Experience of the European Union. The theoretical foundation of the EUs macroeconomic policies since 1991, in contrast to China, has led, to a greater or lesser degree, to a monetarist and "supply side economics" macroeconomic approach. According to Jan Priewe's lectures during the Wuhan Conference, the theoretical logic underlying the "Maastricht Treaty" is the monetarist and supply-side idea that too great a budget deficit will result in an excess of money supply over money demand, which will necessarily lead to inflation. Thus, the Maastricht Convergence Criteria stipulated that consumer price, as an indicator of inflation, had to be lower than 1.5 percentage points above the average of the three EU countries with the lowest inflation rates. An additional requirement was that the public sector deficit had to be less than 3% of GDP. Furthermore, the ratio of public debt to GDP had to be less than 60%. These measures were implemented with the intention of preventing a rise in budget deficit levels, thereby reducing the threat of inflation. The "Stability and Growth Pact" (SGP), which was agreed upon in June 1997, stressed again that the budget deficit should not exceed the level of 3% of GDP. The aim is that the average budget deficit should be held to about zero percent of GDP. Fines (without interest), which must be paid to the European Central Bank (ECB), are imposed on EU member States whose budget deficits exceed 3% of GDP. These won't be paid back if, after two years, their budget deficits remain higher than the level permitted.

On January 1, 1999, when the ECB was founded, a monetary policy designed to ensure the stability of the new Euro currency was introduced, according to Professor Hansjoerg Herr in his lecture on European monetary policy. This strategy consisted of three main elements: a quantitative definition of the Euro system's primary objective, namely price stability, and the "two pillars" of the strategy used to achieve this objective.

These pillars have a prominent role for money, as signalled by the announcement of a quantitative reference value for the growth rate (4.5%) of a broad monetary aggregate (M3), and a broadly based assessment of the outlook for price development and risks to price stability in the euro area as a whole, including a wide range of indicators such as wages, the exchange rate, bond prices and the yield curve, and various measures of real activities (ECB 1999, p.39, p.49). According to Herr's lectures in the Wuhan conference, monetary policy in the EU, especially the definition of the reference value of M3, typically reflects Monetarist theory. Its transmission mechanism is ECB (interest rate), Monetary Aggregate (M3), Aggregate Demand, Price Stability. In order to maintain its primary objective of price stability, the ECB adopted a tight-money policy, setting the reference value of M3 at 4.5%, though in practice it concentrated not on the first pillar but on the second pillar, by focusing mainly on maintaining the stability of the euro exchange rate against US dollar.

The tight fiscal-monetary mix, in the sphere of macroeconomic decision-making, has led to a declining growth rate in the Euro area and resulted in the recession that the EU has been experiencing since 2000. Hence, both Herr and Priewe urged in the Wuhan Conference that the EU authorities should reconsider and revise their macroeconomic policies as a means of escaping the recession and of achieving the kind of economic recovery and stable growth that has been a feature of the Chinese economy over the past number of years.

China should continue expansive fiscal and moderate monetary policies with some adjustments and improvements over the next five years. In light of the performance of the economy over the last four years, both Herr and Priewe confirmed the success of China's macroeconomic policies, especially of its fiscal policies, compared with the EUs less fortunate experiences in the macro-economic arena. Herr and Priewe (1999, p.136; 2002, p.51) have stated that "to counteract the impending deflationary slowdown, the Chinese government has opted for a traditional Keynesian policy of fiscal expansion. Monetary policy has accommodated the fiscal strategy…a strong fiscal stimulus is undoubtedly the correct approach." Furthermore, they emphasized that "in addition to reducing uncertainty, fiscal policy also entails supply-side improvement…[and] could successfully bridge the difficult transition gap created by domestic restructuring (principally the changing investment patterns of state-owned enterprises, or SOEs) and by exogenous shocks arising from the Asian crisis…its long-term effect would be to keep growth more or less high, along a path that is not quite as steep as it has been, but that is nevertheless sufficient to maintain labour-market stability."

Zhao Ling-yun and Gan Xing-qiong, in the lectures they addressed to the Wuhan Conference, agreed with this point of view, but their opinions went even further. They maintained that an expansive fiscal policy and a moderate monetary policy might be a medium-term economic policy mix in China since they have performed well since 1998, and would have lasted for eight to ten years if 1998 had been chosen as a base year. In other words, an expansive fiscal and moderate monetary policy in China could have continued for the next 5 years, given some adjustments and improvements. They explained their reasoning as follows.

"Development is of the utmost importance to China." (Deng Xiaoping, 1992) Only when the economy grows at a highly stable rate can China, the biggest transition economy in the world and with about 25% of the world's population and human capital, solve such existing and potential problems such as the re-employment of redundant workers in urban areas and the migration of the surplus rural force to cities and towns. Maintaining a flexible fiscal-monetary mix strategy over the next 5 years can help to power economic development, boost economic restructuring, accelerate the liberalization of the economy, and therefore offer a solid basis for solving the profound economic and social problems that have dogged China in the past and may await her in the future. This policy can also create a climate of public confidence, which will encourage small investors to shift put their savings into real and private sector investment. In the mean time, the potentially negative effects of this mix, such as the diminishing intrinsic driving force of the economy and the crowding-out effect of Treasury Bill (T-B) direct investment on private investment, indicate that some adjustments and improvements should be made to this mix..

With respect to fiscal policy, Zhao Ling-yun has stressed that the emphasis should eventually be moved from increasing government expenditure, to reducing tax rates, especially direct taxes such as corporate income tax and personal income tax. These measures would raise the disposable income levels for enterprises and households, stimulating investment and consumption, and ultimately giving rise to sustainable patterns of economic growth. This situation could, in turn, help to boost tax revenues in the medium to long term. T-B direct investment should also concentrate less on continuing to put money into consistently profitable infra-structural development and fixed assets investment, and focus its attention more on the expansion of higher education and promoting the development of Western China. In short, the objectives of the fiscal policy adjustment are to create more investment and consumption demand, raise more tax revenues as the economy grows, and lessen potential budget deficits in the future.

As far as monetary policy is concerned, some participants in the Wuhan Conference suggested that the word "moderate" should be replaced with the word "expansive" or "flexible", because under the description "moderate monetary policy", the PBOC's money supply was relative tight compared with other economic indicators such as money supply plans put forward in advance every year. Others partially seconded this suggestion but claimed that the key issue of monetary policy in China was not the expansion of the money supply but the ineffectiveness of the monetary transmission mechanism. Thus, they proposed that the monetary authority should take effective measures to achieve equilibrium between the money market and the capital market, and to remove obstacles that block the effective transmission channels of monetary policy.

Improvements in the macro-economic regulation system should also be made in China. Since monetary policy works more effectively and sustainably than fiscal policy in advanced market economies like the US, China should gradually change the current situation so that fiscal policy predominates. The government should also construct a macro-regulation system in which monetary policy predominates, while fiscal policy does the job of accommodating and compensating for market failures.

4. The Next Five Years: A Crucial Period for the Chinese Economy

The fact that China finished its construction of the basic framework of the "socialist market economy" in 2000, together with China's entry into the WTO in 2001, indicates that market-oriented reforms and the opening up of China's economy have progressed to an entirely new stage. As it moves ever closer to a fully-fledged market economy, China will have to change from a dual-track to a single track system as soon as possible, in order to respond effectively to present and future challenges and difficulties.

Zhao Ling-yun, Deng Li-li from the Northeast University of Economics and Finance (NUEF, Dalian) and Liu Xin-ying have argued that the next five years will be a crucial period in China's economic development. Their arguments are based on the following reasons.

The next five years will see great advances being made in the development of the present "socialist market" system. Zhao Ling-yun has pointed out that the Chinese economic system has been radically changed from a system of central planning to one where market forces predominate. In this respect, China has achieved extraordinary success over the transition period of the last 23 years. But China still has a long way to go if it is to stand comparison with the world's more advanced free market strategies. Therefore, the primary objective at present is to move the economy from a dual-track basis, namely a combination of planned and free market economics, to a single-track system. The reform process will enter dangerous waters in the future, of the tensions between the planned and market elements of the dual track system will intensify, thus harming the efficiency and effectiveness with which reforms can be instituted.

Herr and Priewe (1999, p.313; 2002, p.49) have argued that the transition from a planned to a market economy has involved the introduction of extensive structural and technological changes, as well as the devaluation and scrapping of fixed capital assets that have become obsolete and beyond practical use. Gradual transition allows a relatively long period for reforms to become effective and for the restructuring of SOEs. The distribution of property rights gives a lot of scope for the *gradual* hardening of budget constraints, and in turn, fully developed hard budget constraints will eventually replace split-budget constraints. China's entry into the WTO means the shortening of the transitional period in the future and as well an acceleration of the reform process. China will have to deal with a severe "late transitional crisis" if it cannot effectively tackle and solve the problems that will accompany its transformation into a market economy, especially if it cannot make breakthroughs in converting its economy from a dual-track to a single track system over the next five years.

Fundamental changes will take place over the next five years that will have implications for the growth of China's economy. Deng Lili has argued that China's entry into the WTO means many opportunities in the long run but great challenges in the short, especially to the steel and automobile industries and the agricultural sector. It also changes the environment within which China's economy must operate. It is China's obligation and responsibility to carry out all its promises to WTO member states, and the five-year period of gradual liberalization set by the WTO as a condition of China's entry as a developing country, will expire by the end of 2006.

The next five years represent a period in which China's internal markets will be driven to increase their openness to the outside world, capital accounts will have to be progressively liberalized , and more and more international capital, including funds to be used in market speculation, will flow into and out of the Chinese capital market in massive amounts. All in all, the Chinese economy will be shunted onto the international economic track to an unprecedented extent, and will consequently suffer from the fluctuations of the global economy, as well as having to deal with from the challenges posed by the vigorous and aggressive competitiveness of the worldwide market that China has now undertaken to enter.

Last but not least, this five year "trial period" happens to coincide with the quinquennial cycle of National Congresses held by the Chinese Communist Party (CCP), to discuss social, political and economic issues of national importance. This is where the policies that will decide the direction the country will take over the coming half decade will be created. The forthcoming National Congress of the CCP, to be held in late 2002, therefore constitutes an ideal opportunity for the party to determine the course that the economy will take under the new conditions of WTO membership. This five yearly round of economic and social planning, is also accompanied by a minor quinquennial business cycle which has been a long-standing feature of China's economy history. Thus, the discussion and formulation of new strategies to enact economic change and introduce technological innovations to China's industries, together with proposed solutions to the problems and potential risks that the country faces, will emerge as one of the primary topics of debate in the run up to and during the course of the 16th National Congress of the CCP.

5. Accumulated Problems and Potential Risks in Future

Deng Li-li, Gan Xing-qiong, Herr, Priewe, and Zhao Ling-yun argued in the Wuhan Conference, that China's continued economic success, and it's avoidance of a late transitional crisis, will depend mostly upon how macroeconomic policy is administered to resolve the problems that have emerged in the wake of the reforms have been carried out so far, and how potential threats to further development will be handled in the future.

To begin with, there is a contradiction between macroeconomic stability and microeconomic efficiency. Herr, basing his reading on Janos Kornai's (1979) analysis, distinguishes between two levels of hard budget constraint (HBC): macro-HBC and micro-HBC. The objective of the former is the achievement of macroeconomic stability, while the aim of the latter is the realization of microeconomic efficiency. He, as well as Priewe, argued in his addresses to the conference that macro-HBC in China works effectively and achieves the objective of stability, but micro-HBC doesn't seem to work very well. Herr concludes that microeconomic efficiency has not apparently been improved. Consequently, there is a contradiction between stability and efficiency, or, in the words of Prof. Lin Yi-fu *et al* (2000, p.6), there is a paradoxical relationship between productivity and profitability. One of these contradictions is that, behind the high investment rates, which have driven growth in China, "much investment behaviour has not been orientated to future profitability …not all of this investment was used efficiently. But this lack of efficiency has to be assessed in the light of the high growth of GDP, which seems to have compensated for the distortions in resource allocation" (Herr and Priewe 1999, p.306).

Another paradox is that the “Big Four”, other commercial banks, and millions of economic entities in China do not respond positively to the moderate monetary policy pursued by the government, although the PBOC has succeeded in stabilizing RMB and has attempted to boost economic growth by applying means such as repeated interest rate reductions, as well as having twice reduced the required reserve rate.

The Chinese “socialist market system” is a one whereby the market, under the macro-regulation of the State, functions as the predominant mechanism of resource allocation. The contradictions between the macro- and micro-economies, although having much to do with the gradual introduction of HBCs or split budget constraints, reflect the extent of state intervention and the existence of relatively weak markets with regard to the regulation of the economy as a whole. This kind of “strong state, weak market” situation conflicts with the original intentions of the macro-regulation system, which was designed to create an economy characterized by a “strong state, strong market”, and to demonstrate that the Chinese government could intervene in the economy more effectively than capitalist governments. (Chen En-fu *et al*., 2000, p.4). Chen also states that China needs to continue pursuing its marketization of the micro-economy.

Therefore, the contradictions that exist between macro-HBCs and micro-HBCs are becoming one of the most important issues that need to be resolved over the next few years, as microeconomic inefficiency will destroy macroeconomic stability, increase economic uncertainty, and worsen private expectations in the long run.

Budget deficit pressures and potential fiscal risks constitute the second kind of problem. Gan Xing-qiong and Priewe point out that China’s budget deficit (2.58% of GDP in 2001) and stock of T-Bs (18% of GDP in 2001) were still within international guidelines (3% and 60% of GDP respectively) but only if narrowly considered. The prospects for the budget deficit and T-Bs do not seem to be quite as optimistic if they are calculated in the light of international statistical criteria; namely public sector deficit ratios, the ratio of public debt to GDP, and invisible public debts such as the huge number of Non-Performance Loans, (NPLs; which account for at least 30% of GDP), accumulated by state-owned financial institutions, as well as the tremendous gap in the social security systems’ contributions (which are reported to be about 25% of GDP), are taken into account. Furthermore, according to Gan Xing-qiong’s lecture, either the aggregate tax revenues, or the ratio of tax revenue to GDP in China is much lower than that in developed countries. The collision between tax revenue growth and economic development still exists, and will intensify in the future. Also, the “crowding-out effect” will most probably be eliminated when expansionary fiscal policy is carried out over the next 5 years.

Thereby, macroeconomic strategy in China should try to seek equilibrium between boosting economic growth, fostering more revenue resources, lessening deficit pressure, and avoiding and/or preventing potential fiscal risks and the possible threat of inflation. Otherwise, fiscal problems will endanger economic security and social stability.

Lastly and probably most important is the question of the security of the financial sector. This, as Herr and Tober (1999, p) and Priewe have argued in their lectures, comprises two elements. One is the gradual accumulation of massive NPLs, or heavy debt burdens assumed by the SOEs. The other is the liquidity problem of the banking system; namely the matter of what the banking system should do to avoid accumulating new NPLs while attempting to eliminate existing ones. Other transitional economies like Poland present a good example to China; The Polish government have taken positive steps to resolve their NPL crisis by assuming huge new NPLs and tying them to micro-HBCs. These measures have succeeded in improving microeconomic efficiency, and assisted in the restructuring of the banking system. The best solution to liquidity problems is to offer market-oriented loans to customers. This solution also concerns the issue of HBCs and requires the corresponding reform of macroeconomic and fiscal policy. For example, fiscal policy should pay more attention to raising money for the social security system and for the subsidization of firms. Choosing the right solution to the above-mentioned problems will result in great changes in the organization of China's financial sector (universal banking or specialized banking), in the types of connections established between firms and banks, in the distribution of property rights, and finally, in the overall control of financial institutions.

It was also stressed that China would face challenges due to its liberalization of capital accounts. Both Herr and Priewe suggest that China should learn some lessons from the Asian and Argentine financial crises, and not liberalize their capital accounts in the short to medium term, but lay more emphasis on FDI than on short-term capital inflows.

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2. On the Choices of Current Macro-Economic Polices Facing China

Zhao Ling-yun and Xiang Xin[1]

Abstract

China's macro-economic performance has shown a stable pattern since 1998, which differs considerably from the "zigzag" pattern that was a feature of the period 1978-1992 and the slow-down pattern that characterized the years 1993-1997. The gradual introduction of more flexible and effective macroeconomic decision-making contributed a great deal to the high growth rates experienced by the Chinese economy after 1992. Therefore, it is imperative that the Chinese government continues to adjust and improve macroeconomic policies and control their policy mix in the interest of maintaining a high rate of growth and of more effectively tackling both existing and potential problems that may arise in the future. With regard to the latter, the government should focus its attention on preparing to deal with the challenges that will arise due to China's increasing contact with and participation in the global economy as well as the difficulties thrown up in the period succeeding China's entry into the WTO.

1. Introduction

Following its entry into the WTO in late 2001 and against the background of the continuing development of the global economy, China finds itself faced with an array of opportunities and challenges that, managed correctly, should greatly assist the ongoing process of its economic development. The formulation and implementation of appropriate macroeconomic policy has therefore become an increasingly important aspect of China's economic development. Such policies are essential to ensure that challenges are met, opportunities exploited and risks are reduced in the future.

In the first part of this essay we will present an overview of the growth patterns of the Chinese economy between the years 1978 and 2001, providing details of the historical background as well as an account of the macroeconomic policies that helped shape these patterns. In Part II we will endeavour to answer a crucial question concerning the present day development of the Chinese economy: Will the stable growth pattern that was characteristic of the period 1998- 2001 be sustainable into the future? Part III will deal with the problems currently facing China over the next five years. In Part IV, we will explore the possible macroeconomic paths that China could take in the future. Finally, we will offer a brief summation and conclusion of the matters raised and the points discussed in the foregoing sections of the paper.

2. The Growth Patterns from 1978 to 2001

China has continued to pursue its policy of gradually introducing economic reforms and cautiously opening up the economy since 1978, and its economic growth rates are still relatively high compared with the figures for the rest of the world. Figure 1 shows the growth rate in China since 1978. It can be clearly seen from this chart that China's economic growth has experienced three distinctly different stages.

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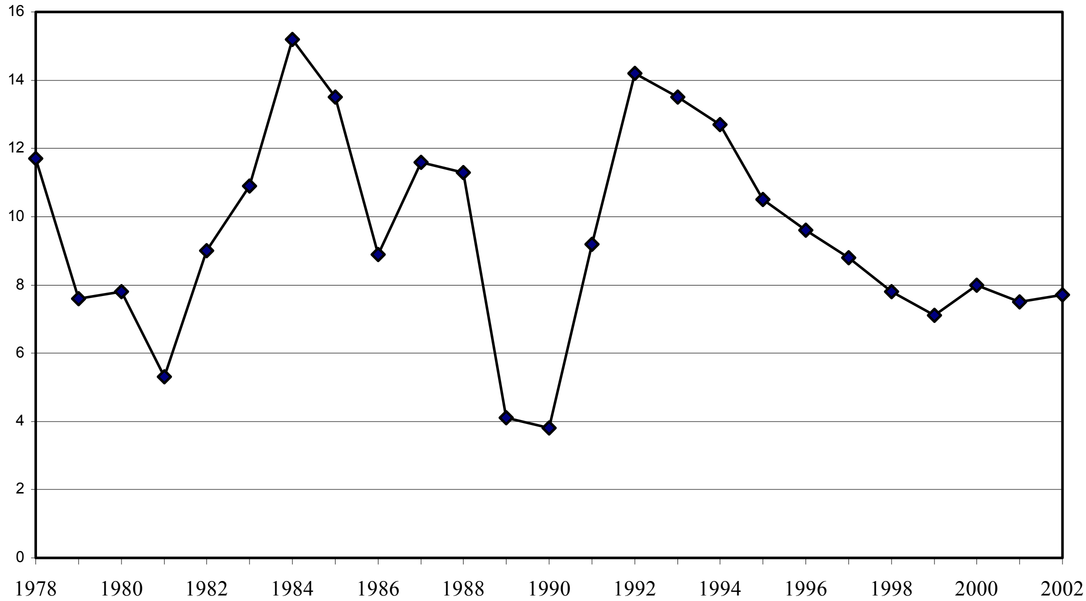
Growth rates fluctuated violently between 1978 and 1992, slowed down in 1993-1997, and then stabilized from 1998 to 2001. We shall refer to the patterns for each of these stages as the ‘zigzag’ pattern, the slow-down pattern and the stable pattern, respectively.

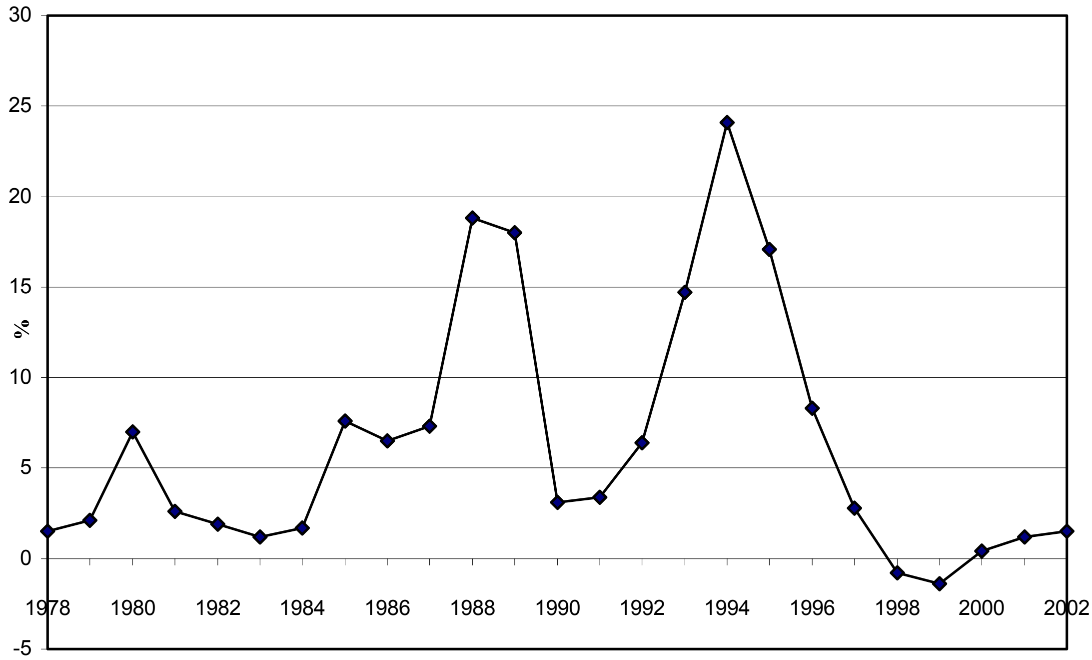
Figure 1: Growth Rate of GDP in China (1978-2001)



Sources: The statistical data before the year 2001 comes from the China Statistical Yearbook (2001, p.52), data for the year 2001 from the Chinese Statistical Communiqué 2001 , and the estimated data for the year 2002 from Liu Guoguang et al (2002, p.277).

The First Stage: The ‘Zigzag’ Pattern, 1978-1992. China’s economic growth during the period from 1978 to 1992, as shown in figure 1was subject to wild fluctuations. As market reforms began to be introduced in China from 1978 onwards, a dual-track system started to appear. As reforms took hold and began to spread, the emerging market forces found themselves existing side by side with the institutions and enterprises of the old centrally planned system, with all the friction and conflict that such a discordant relationship implies. As a result of the “co-habitation” of both systems, the economy grew unsteadily, though growth rates were generally high. These factors produced erratic rates of inflation, making it more difficult for the government to regulate the economy within what we have designated as the “zigzag” period. Figure 2 shows that inflation rates rose rapidly on three occasions over this period. In order to combat rising inflation, the central government had to adopt tight macroeconomic policies on three occasions; in 1980, 1985 and 1988. The main measures adopted by the People’s Bank of China (PBOC) to enforce the aforementioned policies were: 1) the reduction of the money supply, 2) increasing the required reserve rate as well as the regulated interest rate, and 3) the strict regulation of the credit plans as a means of controlling the volume of credit offered by the “Big Four” commercial banks.

Figure 2 The Inflation Rate in China, 1978-2002



Sources: China Statistical Yearbook (2001, p.281), Statistical Communiqué 2001, and Liu Guioguang et al (2002, p.279)

However, these measures didn't work very well, as the fall in inflation rates that they produced, resulted in a sharp drop in the growth rate, giving rise to recessions and violent disturbances in the growth rate. This phenomenon had two causes. First, the process of market reform was still at a primitive stage and, partly as a result of this, the state-owned enterprises (SOEs) remained dominant within the economy. The combination of these two factors meant that the micro economic base on which macro operations function, was lacking. Secondly, policy was dictated "from above", leaving few or no powers of discretion to the administrators of the plan. This inevitably resulted in a degree of inflexibility, which worked against the effective implementation of the policy.

The Second Stage: The Slow-down Pattern, 1993-1997. In 1992, after the publication Mr. Deng Xiaoping's famous speech in Southern China, the process of reform was given a new lease of life leading to increases in the money supply, as well boosting investment and consumer demand. But while these developments became the driving force behind rising growth rates and economic recovery, they also eventually led back to the problem of increasing inflation. "Double highs" (high growth rates in tandem with high inflation rates) took place once again as they had in 1980, 1985, and 1988. From early 1992 to October 1994, the consumer price index (CPI) rose sharply from 6.4 percent to 25.2 percent. In order to combat double-digit inflation, the Chinese government carried out a series of effective macroeconomic policies between 1993 and 1997, comprising restrictive monetary, credit, investment and budget strategies. These policies succeeded not only in bringing inflation rates down, but also in preserving high growth rates. Following the successful implementation of this policy, inflation dropped from a high of 25.2 percent in October 1994 to just 6.1 percent by late 1996.
The average growth rate of GDP between 1993 and 1997 was a fairly consistent 11.6 percent, varying only by a margin of one to two percent over these years. This macroeconomic success has become known as the "soft-landing" by economists and the officials who oversaw the realization of this plan.

Many factors have contributed to this achievement. But we believe that the success of the "soft landing" can be chiefly attributed to three factors. The first is the fundamental changes that were introduced to the overall structure of the national economy. Since 1993 the government has done much to accelerate the development of the agricultural sector as well as creating some important projects to mitigate the "bottleneck" restraints for economic development which had contributed to inflation (*Research Group on China's Economic reform and development Report*, 2002, p.66). Secondly, the economic system has undergone some radical changes since 1992. Compared with the 15 years leading up to this year, the marketization level of the economy during this stage has improved. In 1992 the output of the non-state economy has reached 51.9 percent of the gross output in the industrial sector, which meant that free market operators were increasing in number and influence, and that the market system was beginning to play a progressively more important role in the economy. Thirdly, macroeconomic policies were being enacted in a more flexible and adaptable manner, and their effects were being gradually felt. While restrictive measures were carried out during this stage, discretionary micro-regulations aimed at "fine-tuning" various areas and aspects of the economy, were being carried out. In this way, high growth rates were achieved and sustained, while at the same time inflation was reduced and contained.

The Third Stage: The Stable Growth Pattern, 1998-2001. After the restrictive policies and the soft-landing of the mid-nineties, pinch effects occurred to the Chinese economy to some extent. Growth rates dropped (to below 10 percent in 1996), and aggregate demand also went down. Moreover, the Asian financial crisis aggravated the lack of external demand. In order to cope with these impending and potential problems, and to stimulate domestic demand, macroeconomic policies had to undergo fundamental changes, and to this end, an expansionary/positive fiscal policy and moderate monetary policy was introduced. In other words, a more relaxed fiscal-monetary stance was substituted for the tight stance that had been carried out over the previous five years.

The active fiscal policy, or expansionary fiscal policy included a number of important measures. The first was the issuing of more Treasury Bills (T-B). Between 1998 and 2001, the government granted RMB 510 billion long-run T-Bs and special T-Bs as a means of financing new infra-structural projects, increasing investment in technology, and of recapitalising the "Big Four" banks. The second measure was directed towards raising government expenditure and stimulating domestic consumption. In 1999 the government spend an additional RMB 54 billion to meet unemployment, redundancy and pension payments that had fallen due. In 2001, the salaries of civil servants, and of staff working in the educational sector were doubled, and subsidies and transfer payments to the western and eastern regions of China were also substantially increased. The third measure introduced by this policy was to increase subsidies for some export goods, and to lower a number of investment tax rates, in order to boost the volume of exports and promote private investment *(Xiang Huaicheng, 2002)*.

The moderate monetary policy consisted of a variety of strategies. For one, the PBOC reduced interest rates a total of seven times from 1998 to 2001. In addition, the credit plans imposed by the PBOC on the "Big Four" for nearly two decades were abandoned in 1998, and open-market operations, first introduced in early 1994, were chosen as the main tool of monetary policy from this time on.

Furthermore, commercial banks were encouraged to issue more loans to accommodate T-B direct investments, and to issue more mortgages and personal loans to stimulate the purchase of houses and family cars. The Chinese financial authorities took active measures to drive forward the market reform of interest rates, and to foster the development of the capital market, as well as other such undertakings *(Research Group on Monetary Policy of PBOC, 2002).*

Taken together, these strategies created a favourable policy environment as well as providing the powerful capital support required to sustain China's rapid economic growth in the unfavourable circumstances of a worldwide economic recession. Since 2000, growth rates have begun to recover and are rising once again. GDP increased from 7.1 percent in 1999 to 8.0 percent in 2000, and the Chinese economy, generally speaking, has entered into a stage of relatively high and stable growth.

3. Is a Stable Pattern Possible and Sustainable in the Future?

Against the background of globalisation and entry into the WTO, is it possible for China to maintain its high rate of growth into the future? In other words, will it be possible to sustain stable growth patterns? The answer to this question is an unqualified "yes", due to the presence of certain factors that are currently playing in China's favour.

The first of these is that the inflation rate in China has been kept at a fairly low level in recent years. The CPI slipped into minus figures in 1998 and grew by less than 1 percent in 2000 and 2001; i.e. 0.4 percent and 0.7 percent respectively. Fluctuations in the CPI have remained slight since 1998. Therefore, the stability of the price level as well as the external stability of the RMB provide, both internally and externally, a stable environment for economic growth.

The second factor which suggests that current growth patterns will prove sustainable is the stability of macroeconomic operations. The Chinese economy has grown steadily in recent years, even though most other economies around the world have exhibited more erratic patterns of growth. From the first quarter of 2000 to the second quarter of 2001, GDP rose in each quarter by 8.1 percent, 8.3 percent, 8.2 percent, 7.2 percent, 8.1 percent and 7.8 percent respectively. As can be seen from these figures, the rate of fluctuation hovered around the one percent mark. This kind of macroeconomic performance helps to raise confidence in the economy, thereby facilitating rapid long-term economic growth.

The increasing efficiency of the macro-economy is the third factor that can be presented to support the sustainability argument. Here are some examples: The turnover in industrial output and industrial sector profits increased by a margin of 8.1 percent and 8.9 percent respectively between 2000 and 2001; the number of businesses reporting losses decreased by 70 % from the end of 1997 to the close of 2000 *(National Bureau of Statistics of China, 2001)*; both fiscal revenue and the ratio of fiscal revenue to GDP have increased since 1998. Fiscal revenue almost doubled between 1997 and 2001 *(Xiang Huaicheng, 2002).*

The fourth factor that can be cited in support of the sustainability thesis is the rapid rise in domestic demand that has done much to stimulate economic growth. In the first half of 2001, fixed asset investment increased by a margin of 15.1 percent over the figures for 2000.

The growth rate in commodities retail turnover rose from 9.6 percent in 1998 to 10.1 percent in 2001. Domestic demand has in fact become the main driving force behind economic growth. In the first half of 2001 when GDP grew by 7.9 percent, the contribution ratios of domestic investment, domestic consumption, and net export to GDP growth were 77%, 34% and 11% respectively, if price levels are taken as constant *(Liu Guoguang, et al, 2002, p.10)*.

The fifth development that augurs well for China's economic future is the continuing rise in foreign trade as well as the increasing level of foreign investment flowing into the country. Although Chinese exports declined sharply due to the slow-down in the global economy, there was still a trade surplus of $22.5 billion in 2001, accompanied by a considerable increase in foreign direct investment. In the first half of 2001, foreign capital inflow grew by 21.7 percent, which represented one of the highest rates of foreign capital inflow in the world.

The last, but by no means least factor that must be considered is China's recent entry into the WTO, together with its hosting of the Olympic Games in 2008. It is estimated China's entry into WTO will lead to an increase in the level of exports of one percentage point and a corresponding rise in imports of 0.7 percentage point in 2002. Although the volume of the trade surplus may shrink, growth in the levels of investment and consumption will exceed the predicted fall in exports, resulting in an overall increase in GDP of between 0.1 and 0.2 percent. Meanwhile, the preparations for the hosting of the Olympic Games will see around RMB 280 billion being invested in infra-structural development, construction projects, and environmental protection and clean-up programmes, which should produce an increase in the annual growth rate of about 0.5% from 2002 on *(Liu Guoguang et al, 2002, p.17)*.

All of the above-mentioned factors will help to provide a stable environment for the development of the Chinese economy over the coming years.

4. Problems Currently Facing Economic Growth

The prospects for continued and sustainable economic growth in China are not uniformly rosy however, and there are a number of fundamental and long-standing problems that threaten to upset the happy prognosis outlined above.

The first of these is the pressure that inflation may exert on economic growth. Due partly to the pursuit of expansionary policies, the high rate of growth has produced accompanying fiscal and financial dangers. In 2001, the budget deficit reached 259.8 billion RMB, and the ratio of the stock of T-B to GDP attained a level of 16.3 percent *(Xiang Huaicheng, 2002)*. Moreover, the ratio of non-performing loans to tototal assets in the financial sector is still high, savings deposits - the tigers in the cage - rose rapidly in this year. By the end of 2001, savings deposits had reached a height of 7,376.2 billion RMB; an increase of 14.7 percent over the previous year (*Research Group on Monetary Policy of Central Bank in China*, 2002). All these factors may combine to create potential inflationary pressures in the long-run that may hamper the long-term stability of the Chinese economy.

The second possible constraint on growth is the falling rate of investment. At present, the rapid increase in the level of investment is the main cause behind China's high growth rates. In the first half of 2001, increases in investment contributed 77 percent to the growth rate of GDP. Continued increases in investment, however, are restricted by two main factors:

a. The balance between domestic investment and consumption. In the past , especially in the first half of the 1990s, domestic consumer demand could not keep pace with the rapid rise in the rate of investment. The ratio of investment to GDP has risen constantly since the 1990s, while the consumption to GDP ratio has gradually decreased. This development is detrimental to the maintenance of stable growth patterns in the long-run. Efforts to achieve the correct balance between consumption and investment will necessarily involve the enactment of measures designed to curtail excessively high levels of investment.

b. The decreasing investment of the non-state sector. In the first half of 2001, investment programmes undertaken by the state-owned sector increased by 17.9 percent, while the level of investment engaged in by the non-state sector increased by just 7.5 percent *(Liu Guoguang et al, 2002, p. 11)*. However, the funds made available by T-B direct investment capital and those provided by the state-owned commercial banks on which the state sector investors depend, are not limitless and won't last indefinitely. Therefore, given the drop in private sector investment and the finite nature of the finances available to state sector enterprises, it seems inevitable that the level of investment in the economy will continue to decline.

The third constraint on growth is the slow rate of increase in consumer demand. Consumer demand is another important spur to economic growth. However, the growth of consumption is inhibited by three factors.

a. The excessive rise in investment levels has led to a decrease in disposable income. Since 1998, the ratio of investment to national income has exceeded 36 percent but levels of disposable income and consumer spending have failed to keep up with the high degree of investment in the economy, thereby threatening to undermine the whole process.

b. High levels of poverty remain a pressing problem in China. According to statistical reports released by the World Bank, 18.3 percent of Chinese citizens earn less than a one US dollar a day, which according to the established international criterion, places them below the poverty line *(World Bank, 2000)*. This puts the figures for people living in impoverished conditions at 240 million[2], severely lowering the potential number of consumers in the Chinese economy..

c. The rate of consumer spending in rural areas is increasing only very slowly. From 1999 to 2001, the average growth rate of income in rural districts amounted to about two percent, which was far lower than average growth rate of both GDP and income levels in urban locales, in the same period.
This situation has restricted the level of consumer spending in rural regions. From 1999 to 2001, the growth rate of rural consumption was only 4.2 percent, which was 6.5 percent less than that in urban areas.

[2] According to China's national poverty line of RMB 635 per capita a year, it is estimated that there are 70 million people living in poverty. This figure is much lower than the World Bank estimate (www. Pado.gov.cn).

d. The export rate has also declined due to the slowdown experienced by the world economy. In 2001, the growth rate of exports was a mere 6.8 percent, a decrease of 21.8 percentage points on the previous year. Net exports in 2001 were $22.6 billion, $1.5 billion less than the figure for 2000. As the prospects of an improvement in the world economy are not very promising in the short run at least, and because the Chinese economy has suffered a great deal from the events of September 11th, the future for Chinese exports does look not bright

5. The Choices of Macroeconomic Policies: Continue Expansion

As a means of overcoming the negative factors enumerated above, and of accelerating the growth of the Chinese economy, the government should adopt and put into practice appropriate macroeconomic policies that would serve to promote the process of economic reform. In the interests of achieving this objective it is essential to establish the micro foundations on which the efficient implementation of macroeconomic policy depends.

Adjusting the active fiscal policy. It is argued in some quarters that China's active fiscal policy should not be carried out in the current economic climate, until the perceived threat posed by potential financial risks and inflationary pressure has passed. This point of view is to some extent reasonable, but we are in agreement with the opinions expressed by Premier Zhu Rongji at the People's Congress of March 2002: namely, that the active fiscal policy should continue to be carried out *(Zhu Rongji, 2002)*. Moreover, we argue that the active fiscal policy should be maintained for at least the next five years, as a solid economic foundation is fundamental to the efforts being made to tackle such social and economic problems as poverty, unemployment and inflation. Insufficient levels of domestic demand constitute the main obstacle to China's economic growth right now. Therefore, despite the possible occurrence of some of the negative effects mentioned above, we believe that the active fiscal policy is still the most effective way of stimulating domestic demand in the present economic climate. Nevertheless, a number of changes should be introduced to the expansionary fiscal policy in order to address problems and challenges that have arisen over the past four years. Our proposals to deal with these problems are outlined below.

First, the orientation of T-B investment should be altered. The Chinese government issued over 500 billion RMB special T-Bs between the years 1998 and 2001and will issue another 150 billion in 2002. These T-B funds are mainly invested in infra-structural development. However, the marginal efficiency of capital will fall if such funds are continued to be used in this way. In addition, such forms of investment will not succeed in stimulating consumer demand, and will only exacerbate the imbalance between consumption and investment. Therefore, efforts should be made to adjust the orientation of T-B investment, by, for example, increasing T-B investment in education, science and technology, agriculture, hi-tech industry, the technological upgrading of core enterprises, as well as in the development of the Western regions, while meeting the capital requirements of existing and future projects.

Secondly, it is necessary to exert more control over the rise in the budget deficit that has accompanied the implementation of the active fiscal policy. In recent years, the fiscal burden has been significantly greater than in previous years, and potential fiscal pressures and threats are on the increase. In 2001, China's total budget deficit was 259.81 billion RMB, and the ratio of budget deficit to GDP increased from 1.5 percent in 1997 to 2.7 percent in 2001 *(Xiang Huaicheng, 2002)*. Although the fiscal risks have not yet proven great enough to produce a crisis, they are proliferating too rapidly. Therefore, the capital market must be developed further to relieve the pressure created by fiscal policy.

Reform and reconstruct the financial system to meet the demands of moderate monetary policy. Monetary policy will play an increasingly important role in future years owing to the limitations of fiscal expansion and the diminishing marginal efficiency of the expansionary fiscal policy.

First, financial institutions should be reformed. In recent years, although the Central Bank has introduced a great many measures, the effects of monetary policy have not been satisfactory. The main obstacles to progress are long-standing problems such as the continued prevalence of non-performing loans in the financial system, which block and distort the transmission mechanisms of monetary policy, thus diminishing the positive effects that macroeconomic policy would otherwise bring about. Therefore, it is necessary to make strenuous efforts to reform the financial system by privatising banks and financial institutions, as well as improving the management of state-owned banks and restructuring the admission system for private financial institutions. These measures will enable the transmission mechanism of monetary policy to function more effectively.

Secondly, it is also necessary to develop financial markets and financial instruments. Compared with the development of bank markets and the stock market, other financial markets like the bond market, the floating note market, the discount business and foreign exchange markets, are still clearly at an early stage of development. This fact shows that current financial instruments, especially varieties of financial transaction, are relatively inadequate, and this hinders the effects of monetary policy. At present, in order to make monetary policy function effectively, further steps should be taken to develop various kinds of financial links between the bank markets and the stock market, and to improve financial market structures by increasing the number of financial instruments.

Accelerate the reform of state-owned enterprises in order to provide the micro-foundations required for the efficient functioning of macroeconomic policy. Following years of great effort, remarkable progress has been made in the reform of state-owned enterprises (SOEs). However, there are still some fundamental problems attendant upon the operation of the SOEs. The first task to be accomplished is the modernisation of the of private enterprise system. This process should focus on standardising the body of regulations governing corporate entities. In addition to this, it is imperative that the pace of developing business enterprises to the point where they are capable of performing at an international level, is increased. This would involve restructuring such concerns on the scale of large corporations that could more effectively compete in worldwide markets. Last but not least, the degree of state intervention in and regulation of the economy must be reduced to make way for further free market reforms. These steps will enable SOEs to transform themselves into competitive market operators, and help to lay the microeconomic foundations on which solid and successful macro policies can be built.

5. Conclusions

The following conclusions can be drawn:

1**.** It is essential that the present Chinese government continues its efforts to achieve rapid sustainable economic growth in the interests of effectively addressing social economic problems such as unemployment, inflation, poverty and the like.
2**.** Rapid sustainable growth can be expected in China if the right choices in the area of macroeconomic policy and further economic system reforms are made.
3**.** The tasks facing policy makers in the macroeconomic sphere are a) the control and management of fiscal policy, b) the reform of financial institutions, c) enlarging the role of monetary policy so that it becomes the main instrument of macro-economic regulation, and d) the reform of state-owned enterprises.

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3. Monetary Policy in China
Does the people's bank of china follow a neoclassical or a Keynesian's approach?

Pang Jing[*]

1. Introduction
This article is concerned with an analysis of the economic theories underlying the monetary policies China pursued in the 1990s. I will first define what monetary policy is and discuss current developments, before moving on to an examination of some of the key differences between the Neoclassical and Keynesian approaches. Following this, I will focus on an empirical analysis of the intermediate targets and transmission mechanisms of China's policy, and evaluate the effectiveness of this policy. I will finally conclude that the monetary policy that China pursued in the 1990s was comprised of a combination of elements from both the Neoclassical and Keynesian system.

2. Theoretical Analysis on Monetary Policy
Monetary policy can be defined as the control of interest rates or money supply to manage the economy. Many economists believe that central banks should focus on achieving price stability as the first goal of monetary policy. Neoclassical economists and Keynesian economists hold the different views how price stability can be achieved. There are several main differences between the two schools.

The fundamental difference exists in the theoretical base of these two approaches. Neoclassical monetary policy is based on the Quantity Theory of Money (with M money supply, V velocity of money, P price index and Y real income).

$$MV = PY$$

Increases in the money supply are leading to proportional increases in prices, leaving output and unemployment unchanged. This rise in the price level lasts until real cash balances are reduced to their original level. The transmission mechanism can be explained through the Cambridge-effect:

Increasing quantity of money (cash balance) ⇒increasing commodity demand⇒ increasing prices⇒ declining real cash balances.

This model maintains a direct relationship between nominal cash balances and aggregate commodity demand. The sole effect of an expansionary monetary policy, according to this theory, is an increase in the rate of inflation, whereas all other real variables remain unchanged. So Neoclassical economists recommend that the monetary authorities should control the growth rate of the money supply, ensuring that it remains consistent with the desired rate of inflation (cp. Felderer/Homburg 1997).
Milton Friedman (1968) and others developed the theory of Monetarism and demonstrated a strong correlation between M and Y, which was crucially dependent on the quantity of money being, in reality, exogenous, and the caution run from M to Y.

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He believed that, in the medium and long term, monetary policy has no effect and only works in the short run. Monetary policy, in his opinion, is capable of preventing money itself from being a major source of economic disturbance, and can provide a stable background to the economy. But he thought that monetary policies can't control real variables, and are unable to fix interest rates and the rate of unemployment. So he criticised central banks for accepting interest rates or the current unemployment rate as the basis policy formation. He believed a monetary total is the best available immediate guide for monetary policy and suggested that the monetary authority should do all they can to avoid sharp swings in policy, and maintain a policy of constant monetary growth, which is publicly stated, to achieve a steady rate of monetary growth. The neoclassical approach typically follows a path of constant monetary growth, taking the monetary aggregate as the intermediate target.

The Keynesian approach in the tradition of the Neoclassical Syntheses was based on the IS-LM model, and it describes the connection between the monetary sector and the real sector. Any changes in the monetary aggregate would lead to corresponding changes in the interest rate, affecting investment and consumption, and ultimately leading to an increase in output in case of unemployment. The transmission mechanism can be explained through the Keynesian effect.

Increase quantity of money $\Rightarrow$ create demand for bonds $\Rightarrow$ increase market values of bonds $\Rightarrow$ decrease rate of interest $\Rightarrow$ increase investment and commodity demand $\Rightarrow$ raise output

This model describes the indirect relationship among nominal cash balances, interest rates, and investment demand.

The post-Keynesian approach tends to focus on the interest rate – for example the federal fund rate in the USA – as a means of stabilizing economic activity. Nicholas Kaldor (1985), a proponent of post-Keynesian thinking developed the former theory. He considered money supply to be an endogenous and demand-driven variable, while postulating that the interest rate is an independent variable and totally controlled by the central bank. He advocated that the purpose of monetary policy should be to target the rate of interest, and not the stock of the money, in the interests of maintaining price stability. He further pointed out that the transmission mechanism works in the following manner: a fall in interest rates, brought about by a fall in the bank rate, produces an increase in investment which in turn, causes income to rise by a kind of multiplier process. This increase in income results in an increased demand for transactions balances which, at a given bank rate, is met by the central bank acting as a lender of last resort to the banks. It is clear that the post-Keynesian approach emphasises the effect of monetary policy on output and proposes setting interest rates to control the price level directly (cp. Rousseas1986).

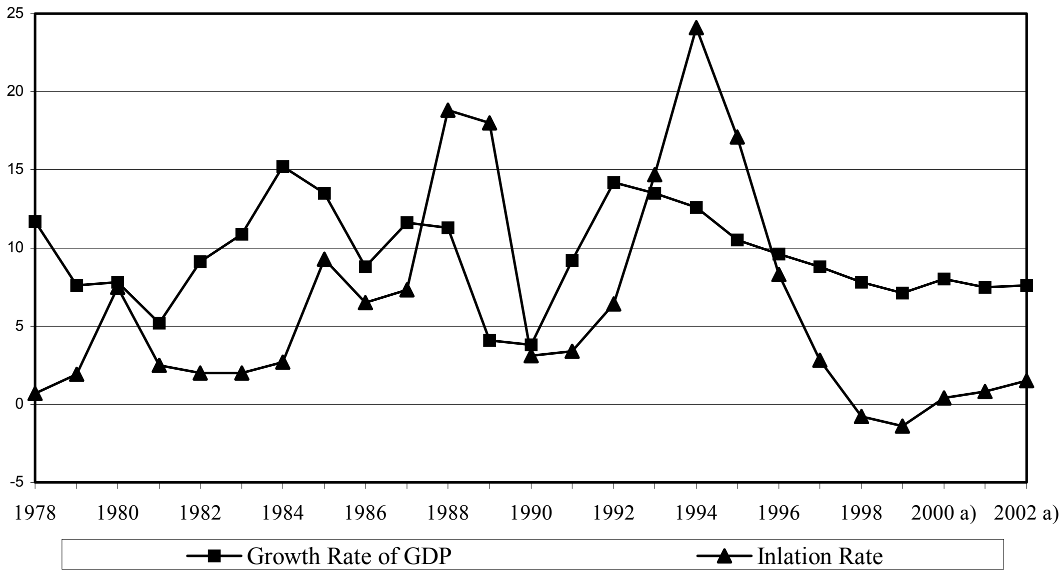
Nowadays the neoclassical approach of monetary policy seems to have lost support, as it has now come to be understood that the relationship between the monetary aggregate and the price level is very weak due to the velocity instability problem, and, moreover, it's difficult in reality, to control the monetary aggregate.

Central banks all over the world have dropped the monetary aggregate as the only intermediate target and have shifted their focus to the direct targeting of inflation, which is characterise by the publication of official inflation rate targets on one or more horizons, and by the explicit acknowledgement that low and stable inflation is the overriding goal of monetary policy. It can operates in this way: the central bank itself sets a target for inflation rates (Bernanke/Mishkin 1997), using a broad range of indicators, such as wages, exchange rate, real growth rate etc. to evaluate trends in the economy and assess the stance monetary policy should adopt. Its major advantages are transparency, coherency, and flexibility. This raises the public's confidence in the management of the economy, as well as strengthening its belief in the likelihood of benefiting form the implementation of the government's policy.

3. A Brief Review of China's Economic Development since the Early 1990's

Since the beginning of reform and the opening-up of the economy, the macroeconomic policy mix has gradually become the Chinese government's most important means of ensuring non-inflationary and stable economic growth. Monetary policy assumed a dominant role in macroeconomic management during the 1990s.

Diagram 1: China's Economic Growth Rate and Inflation Rate in the 1990s



Quelle: China Statistical Yearbook 1999, No. 18, China Bureau of Statistics, People's Republic of China

In 1990, the economic growth picked up from 4.1% in 1990 to 9.5% in 1991. In response to Deng Xiaoping's call to speed up reform and move forward with the liberalization of the economy, China's growth rate shot up to 14.2% in 1992, which quickly led to the overheating of the economy. In 1993, while the economy continued to grow strongly with the growth rate reaching a level of 13.5%, inflation jumped suddenly to 14.7%. In 1993, faced with the upsurge in inflation, the government began to use a tight monetary policy to cool down the overheated economy. However, due to cost-push inflation by high wage increases (including bonus), excess demand and price liberalization inflation continued to worsen. In 1994 the rate of inflation reached 24.1%, the worst on record since reforms began.

In 1995, as a result of the government‘s restrictive macroeconomic policy, the rate of inflation fell to 14.8%. On the other hand, China succeeded in maintaining its growth momentum, with its growth rate reaching a level of 10.8%. In 1996, China's macroeconomic situation continued to improve, and the economy made its soft landing.

In 1997 the Chinese economy slowed down significantly, with excess demand being replaced by excess supply. Signs of a lack of effective demand become apparent, such as overproduction, low productivity and profitability, and low capacity utilization. Prompted by the rapid deterioration and gloomy prospects of the global economy, the government began to progressively cut the interest rate, which signalled a change in the direction of policy, from contraction to expansion. In 1998 the Asian crisis, which arrived late in China, eventually impacted negatively on its macroeconomic situation. China's growth rate in exports, which had fallen since late 1997, continued to deteriorate in 1998. The persistent decline of price levels and the significant slowdown of the economy showed that China was encountering a situation it had never before experienced – deflation. Deflationary pressure was an indication of the impotence of the government's monetary policy, prompting the state to switch to the implementation of fiscal policy to stimulate the economy. China's monetary policy has harmonized quite well with an expansionary fiscal policy, due, especially, to the low interest rate. The increase in government expenditure in public works since the second half of 1998 has succeeded in arresting a rapid decline in investment demand. However, the expansionary fiscal policy has failed to bring about self–sustaining economic growth. The issue of how to build a solid foundation for the Chinese economy which will allow it to grow steadily without heavy government intervention is still one of the most significant challenges that China has to face.

4. Monetary Policies in 1990s

In the 1990s, China carried out a series of financial reforms, causing a gradual shift in the tools, targets and goals of monetary policy, especially since 1998. With the credit ceiling eliminated, required reserve system reform and open market operations strengthened, China's monetary policy effectively completed its transition from the rigidity of central planning procedures to a more flexible market system based on a framework of transparent regulations, and from focusing mainly on the credit channel to stimulate growth to applying monetary aggregates and interest rates to attain price stability.

Since the credit ceiling imposed on the commercial banks has been eliminated, the new intermediate target system has been established which is based on the monetary base as the operating target and the money supply as the intermediate target. This idea is in the tradition of the neoclassical model. At the same time, open market operation has replaced central bank lending and become the primary channel for monetary base injections. But the interest rate at present has not been chosen to be an operating target. As far as the intermediate target system is concerned, the process of monetary policy, in practice, is conducted in the following manner:

monetary instrument ⇒ operation targets ⇒ intermediate targets ⇒ ultimate goal

Since the adoption of the monetary aggregate as the intermediate target of monetary policy in 1994, the monetary authorities have been making great efforts to fulfil the stipulated targets of monetary policy.

The table below shows the track record of the central bank's monetary targeting in the 1990's. Since 1993, the start of an anti-inflation monetary policy, money supply growth has consistently failed to hit the required range.

Table 1: Money Supply: Targets and Actual Development

Year	M1		M2		Inflation rate	
	Target	Actual	Target	Actual	Target	Actual
1994	23	26.8	25	34.5		
1995	21~23	16.8	23~25	29.5	15	14.8
1996	18	18.9	25	25.3	10	6.1
1997	18	16.5	23	19.6	6	0.8
1998	17	11.9	16~18	14.8	Under 3	-2.6
1999	14	17.7	14~15	14.7	Under 2	-1.4

Source: Almanac of China's Finance and banking (1994-1999), China Financial outlook (1994-2000).

Starting in 1997, the target for M2 has been consistently undershot. There are two important reasons for this. On the one hand, due to the existence of the huge amount of the non–performing loans and the government's control over lending, the commercial banks have become much more concerned about lending security than profit. This unwillingness to lend represents a breakdown in the bank-lending channel, which has severely constrained money supply growth and led to an unstable monetary multiplier. On the other hand, due to the problem of overproduction and the heavy debt burden, enterprises are reluctant to borrow. So despite the fact that the central bank lowered the reserve requirement for the commercial banks from 13% to 8% and eliminated the excess reserve requirement, the actual reserve ratios of the major banks were as high as 15%.

Considering the difficulties involved in controlling the money supply and the weak link between expansion of the money supply and price level, the central bank has actually reduced the importance of monetary targeting. But the issue of shifting from money growth targeting to inflation targeting is not on the table.

Interest rate policy is also an important instrument of monetary policy and was most frequently exercised by the central bank. Interest rate cuts were conducive to improving the whole economy in a number of ways. They reduced the heavy burden of debt on the enterprises. The seven rounds of interest rate cuts since mid 1990s have been reducing interest expenditure of enterprises by 250 billion RMB. They also encouraged funds to flow into government bonds and reduced the cost of the expansionary fiscal policy.

Currently there are some problems restricting the effectiveness of interest rate policy. Due to the inelastic response of consumption and investment to changes in interest rates, interest rates have less pertinence to economic activities, and the lowering of interest rates has failed to stimulate aggregate demand in a significant way. The second problem is that the micro economic foundation is not stable.

At present, SOEs and wholly state-owned commercial banks predominate in China's economy. As far as the issue of property rights is concerned, the SOEs and banks do not constitute genuine commercial enterprises, and their leading and borrowing behaviours are not completely subject to the uninhibited interplay of market forces.

In view of the failure of monetary targeting, China will sooner or later turn away from money supply targeting to inflation targeting, and the manipulation of interest rates will become established as the most important monetary instrument, requiring the further liberalization of interest rates in the near future.

Theoretically speaking, the transmission mechanism of monetary policy is an important category of both the Keynesian and the neoclassical approach. As of yet, the transmission mechanism in China remains imperfect, but it basically conforms to the Keynesian approach, which links the following steps: central bank policy ⇒ financial institutions ⇒ enterprises and households ⇒ national income. The transmission mechanism is involved in two sectors: the financial sector and the real sector. Any changes in financial fields will be transmitted to the real economy, and cause enterprises and households to adjust their assets and change their investments and consumption expenditure, thereby influencing overall output and price in society as a whole. In concrete terms, the transmission process actually includes three bodies and two channels: the three bodies are the central bank, credit institutions (financial markets), enterprises and households. The two channels lead from the central bank to commercial banks and from commercial banks to business enterprises and households. If one of these bodies or channels fails, this will result in the disruption of the transmission process and weaken the effectiveness of monetary policy.

In a pessimistic economic climate, where there has been a loss of public confidence and a build-up of uncertainty, lower than anticipated levels of income, deteriorating financial conditions and deflationary expectations, the level of autonomous investment and consumption demand can fall. At the same time it may also cause the marginal propensity to consume to fall, and investment demand to become less interest and credit-elastic. The interest rate channel of the transmission mechanism will become blocked, and limit the effectiveness of interest rate policy. At this point, the efficiency of monetary policy will be determined not only by the marketization of the central bank's monetary policy tools, but also by the response of financial institutions, private enterprises and households.

5. Conclusion

China's economy achieved high growth while managing to keep inflation low, thereby avoiding the threat of economic crisis in the 1990s. One of the most important factors has been the successful macroeconomic management of the Chinese government. As far as monetary policies are concerned, the government's role was effective in curbing inflation and the revival of economic growth. In the 1990s great progress was made in developing modern monetary tools and make the transmission mechanism of monetary policy more market based. Due to its transition from a planned economy to a market-based system, monetary policy in China is still at the development stage, and requires further refinement. If we take an overview of the policies pursued in the 1990s, we can find that they utilised elements of both the neoclassical and Keynesian approach to monetary policy.

On the one hand, the central bank has been using monetary aggregates as its intermediate target, and has made great efforts to implement a neoclassical approach to the achievement of its objectives. On the other hand, as far as the seven rounds of interest rate cuts are concerned, the transmission mechanism exhibited a more Keynesian basis. But due to the weak link between the expansion of the money supply and the price level and the difficulties of controlling the monetary aggregates, the government will, sooner or later, shift from money growth targeting to inflation targeting. With the marketization of interest rates, interest rate policy is assuming a greater importance as the primary instrument of monetary policy, leading to a more Keynesian bias in monetary policy.

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4. The Monetary Policy of the European Central Bank during the "Weak Euro" Period of a 1999/2001 - Theoretical Approach and Reality

*Hansjörg Herr**

1. Introduction

The European Monetary Union (EMU) was established in January 1999. In its first Monthly Bulletin the newly created European Central Bank (ECB) presented its theoretical approach towards monetary policy (cf. ECB 1999). The first aim of this paper is to present the theoretical approach adopted by the ECB and to show that the ECB follows a strategy that makes it difficult for the public to understand the monetary policy pursued by the governments and central banks of Europe. The second aim of the paper is to demonstrate that the effectiveness of ECB monetary policy in the period under discussion was restricted by the relative weakness of the euro against the dollar. I will argue that the ECB followed – without clearly informing the public – an exchange rate oriented monetary policy.

In the following section the theoretical strategy of the ECB is described and analysed. In the third section the actual policy of the ECB is explained. The final section draws on the points raised and a conclusion reached in the previous two parts, and offers some recommendations for future policy.

2. The theoretical approach of monetary policy

The inflation aim

The ECB has explicitly defined its criteria for inflation. "Price stability shall be defined as a year-on-year increase in the Harmonised Index of Consumer Prices (HICP) for the euro area below 2%" (ECB 1999, p. 46). The inflation target "is to be maintained over the medium term" (ECB 1999, p. 46). Deflation has to be avoided. In comparison with international norms, this inflation target is very ambitious. Many central banks do not have an explicit inflation target, as is the case with the Federal Reserve System; or, they have a higher inflation target. The Bank of England, for example, has an inflation target of 2.5%.[3]

Concerning the ECB's inflation target, two points must be criticized. First the ECB's inflation band of between zero and two percent is too narrow. During a business cycle a certain fluctuation of the price level is normal and should be allowed. A strong investment boom will lead to a temporary instance of demand inflation, which will be reduced when capacities increase. Such demand inflation is not dangerous as long it does not trigger off a cost inflation that may lead to a wage-price spiral.[4] Keynes (1930) as well as Schumpeter (1934) argued that economic development leads to temporary inflation. If a slightly inflationary boom is arrested prematurely, it may keep an economy in a permanent semi-slump (cf. Keynes 1936, p. 322).

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[3] For an overview of different inflation targets cp. Bernanke/Mishkin (1997).

[4] Keynes (1930) referred to demand inflation as "profit inflation", since excess demand leads to an increase in the price level and an increase in undistributed profits. Similarly cost inflation became "income inflation" as wages and interest constitute both costs for enterprises and income for households at one and the same time.

Secondly, the inflation band of the ECB is to close to the level of deflation. The possibility that a very low inflation rate will produce a price shock leading to disastrous deflation cannot be discounted. The ECB is quite content with an inflation rate of say 0.3%, and will not act to increase the price level, as this figure falls well within the accepted range. In the same situation, the Bank of England, for example, would have to carry out expansionary measures to reach the 2.5% inflation goal it has set.

The first pillar of monetary policy – pure Milton Friedman

The ECB follows a so-called two-pillar strategy. The first pillar is based on traditional monetarism. "Inflation is ultimately a monetary phenomenon. (...) To signal the prominent role it has assigned to money, the Governing Council has announced a quantitative reference value for monetary growth as one pillar of the overall stability-oriented strategy." (ECB 1999, p. 47) M3 was chosen as the best monetary aggregate. According to the ECB, the growth rate of M3 should be set at a level of 4.5% per annum. The thinking behind the first ECB pillar is derived completely from the tradition of the quantity theory of money. According to this thesis, inflation is always assumed to be a monetary phenomenon – the result of an excessively large money supply. A stable relationship between the monetary aggregate and the inflation rate is assumed. A stable growth rate for the monetary aggregate is recommended, in order to keep the public from getting confused. It was Milton Friedman who made this means of determining monetary policy popular (cp. Friedman 1969).

The growth target of 4.5% is based on the following medium-term assumptions:

a) a price stability range of between zero and two percent,
b) the trend of real gross domestic product will lie in the 2-2.5% per annum range,
c) over the medium term, the velocity of circulation of M3 will decline by about 0.5.1% every year.

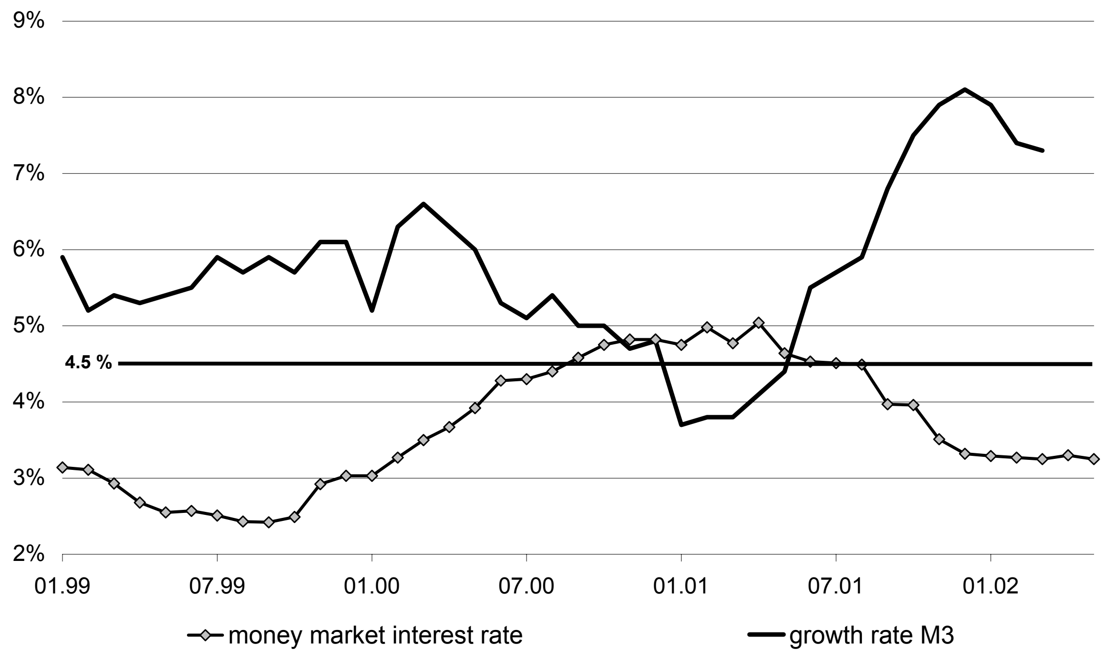
Taking these three factors into its calculations, the ECB produced a figure of 4.5% for projected growth (ECB 1999, p. 48f.). The reference value of the ECB is therefore even stricter than the monetary target of the former German Bundesbank. The latter set growth rate targets for M3 from year to year, basing its criteria on the economic conditions that prevailed in any given year. The ECB however, continues to adhere to the 4.5% reference value of M3 it set back in 1999.

These calculations are based on weak methodological foundations. It should not be assumed that past tendencies will necessarily repeat themselves in the future. For example there is no good reason to suppose that real Gross Domestic Product trends will be confined to the 2-2.5% per annum range, and not rise as high as those that obtained during the nineties in the USA. Nobody can calculate the future potential growth rate of real GDP in Europe. The danger is that the ECB's low estimate for GDP growth will prove to be a self-fulfilling prophesy, as a higher growth rate than that calculated will automatically lead to a restrictive monetary policy that could force growth down to the level erroneously established by the ECB. It is in the absence of potential growth rate targets for GDP, that central banks can carry monetary policy flexibly and effectively.

The assumption concerning the velocity of circulation of M3 is also dubious. In the past the M3 velocity of circulation (or of any other monetary aggregate) has not been stable.

Even if it had been stable, this would not in itself have guaranteed that the velocity wouldn't have changed sharply at some point in the future. In any case, as things stand, the ECB cannot be pleased with the manner in which M3 has evolved.

Diagram 1: Money Market Interest Rates in the EMU and the Percentage Change of M3



Source: European Central Bank; several Monthly Bulletin

In diagram 1 the unstable development of the growth rate of M3 becomes clear. During the second half of 2001 especially, M3-growth rates exploded as households switched form long term investment in stocks etc. to short term liquidity. Such movements between "long" and "short" are typical for market economies and it was Keynes (1930) who first stressed the destabilizing effects of these types of portfolio shifts by the public (cf. Leijonhufvud 1968).

From diagram 1 it is obvious that the ECB did not much care about the development of M3-growth rates. In the year 2000 when M3-growth dropped and came close to the reference value, the ECB increased money market interest rates. In the second half of 2001 when M3 rose dramatically, the ECB sharply reduced interest rates. In other words, the ECB simply ignored the first pillar of its monetary policy strategy. The German Bundesbank didn't hesitate to return to its former practice of pursuing a discretionary and "extemporary" monetary policy, violating the rules set down by the monetarist-inspired agenda of the ECB in the process, as it could realize its own monetary aggregate growth target in only about half of the period that this strategy was followed.[5]

The failure of the M3-rule *a la* Milton Friedman is not surprising. Monetarists seem to think that M3 is some kind of exogenous "money supply" that has to be kept by the public – like the helicopter money of Friedman's thinking (cp. Friedman 1969). But M3 is not a supply category.

[5] From 1974 until 1998.

It is determined by portfolio decisions of the public and depends on the level of demand for demand deposits, time deposits, money market papers etc. If quick and strong portfolio shifts occur, neither M3 nor any other monetary aggregate can remain stable.

The second pillar of monetary policy – Unadulterated Greenspan

The ECB offers a second and completely different approach to monetary policy: "In parallel with the analysis of monetary growth in relation to the reference value, a broadly based assessment of the outlook for price developments and risks to price stability in the euro area will play a major role in the Eurosystem's strategy. This assessment will be made using a wide range of economic indicators." (ECB 1999, p. 49) Some of the future price development indicators mentioned in the bulletin are wages, exchange rates, bond prices and yield curve, various measures of real activity, fiscal policy indicators, price and cost indices and business and consumer surveys (cp. ECB 1999, p. 49). This second pillar of monetary policy has a discretionary character that owes nothing to traditional monetarism. It is, rather, in the tradition of Alan Greenspan who favours discretionary monetary policies that do not follow a monetarist-like ethos. Discretionary monetary policy is also in keeping with the tradition of Keynes and Wicksell. Both argued that monetary policy in a capitalist society has to be capable of stabilizing all kinds of shocks – for example, sudden changes in the natural rate of interest (cf. Wicksell 1898) or the marginal efficiency of capital (cf. Keynes 1936). Stabilizing monetary policy is only possible if central banks can act freely and are not forced to follow a rigid rule. This implies that monetary policy is an art to be practised by the right hands, and not merely a task that to be surrendered to the clumsy ministrations of civil servants.

The strategic orientation of the ECB is not very clear as the bank follows two contradictory policies – a monetarist monetary law on the one hand, and a discretionary monetary policy inspired by the tenets of Keynesian economics on the other. How, one may ask, is it possible for the pubic to understand a muddled and makeshift policy that appears to be based on the confused teachings of John Maynard Friedman (Heine/Herr 2002)? The understanding of ECB policy could be improved if it abolished the first pillar of its monetary policy strategy and at the same time followed a more pragmatic approach concerning the target inflation rate.

To sum up: The ECB has not adhered to the first pillar of its theoretical approach. Monetary policy has, in fact, been shaped by the discretionary considerations that characterised its formulation in the past. The question that remains to be addressed is: which indicators mentioned by the ECB as forming the second pillar of its strategy were the most important elements in the creation of its monetary policy? This topic will be discussed in the next section.

3. The monetary policy of the ECB – price-level led or exchange rate oriented?

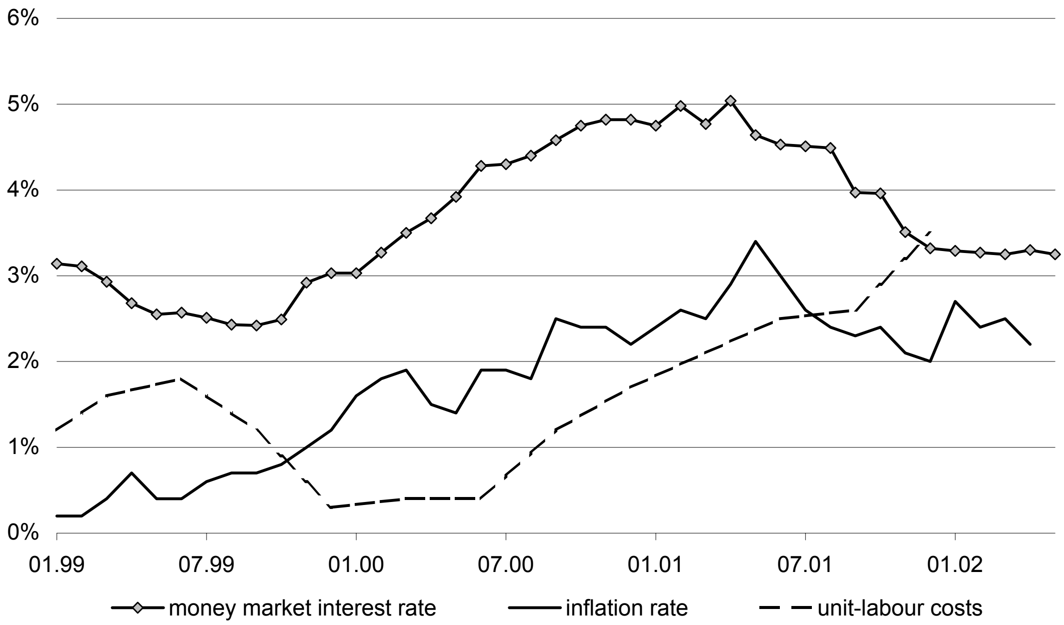
For the ECB two indicators seem to be of special importance: prices and nominal exchange rates. These indicators are not independent of each other but they can be discussed separately.

Let us start with the price level. Diagram 2 shows that the ECB has not been able to achieve its inflation target.

About mid 2001 the inflation rate rose above 2% and has remained at this figure until recently.[6] Interest rates have matched the inflation rate dynamic quite well. It would not be unreasonable to conclude that the ECB has kept interest rates in line with rising inflation rates in order to bring the latter back within the target zone. It could also be argued that the moderate price increases looked much more dramatic to the ECB than they really were, only because the ECB had adopted such tight inflationary parameters. When the inflation rate started to drop in 2001 the ECB immediately followed suit and reduced interest rates; an occurrence that would appear to confirm the argument outlined above.

Let us look at the factors behind the increase in price levels. Demand inflation was not one of the factors that led to higher price levels. There were some regions in Europe that experienced an economic boom – Ireland, for example – but in general economic growth rates were low. There were no signs of excess demand. The increase in the inflation rate was due to higher costs. Two factors were important: First in 1999 the euro lost about 17% against the dollar (cp. diagram 3) and this pushed up import prices. But the euro was not only weak against the dollar. In 1999, the nominal effective exchange rate showed a fall in the external value of the euro of around 8% (ECB 2000, p. 42). Also in 1999, there was a sharp increase in the price of oil. As oil prices are fixed in dollars this added to the inflationary push. Over the course of 1999 the oil price jumped from □ 10.3 per barrel in the first quarter to □ 23.0 in the forth quarter. Excluding the prices for energy and seasonal foodstuffs, the inflation rate in the EMU was only 1% (ECB 2000, p. 24).

Diagram 2: Money Market Interest Rates in the EMU, and Percentage Changes in Price Levels and Unit-Labour Costs



Source: European Central Bank; several Monthly Bulletin

[6] The small inflationary jump of the inflation rate during the first months in 2002 is due to the introduction of euro cash. In some industries - especially in industries offering services - the change form the still circulating national currencies to the euro was used to increase prices.

During the second half of 1999 it became clear that the weakness of the euro would lead to ever greater inflationary pressure. The ECB took immediate action. On November 5 the ECB increased the interest rate from 3.5% to 4%. This was the start of several interest rate increases in early 2000. The ECB left no doubt that the weak euro triggered off the restrictive monetary policy that began in late 1999: “The exchange rate of the euro depreciated further in this period. The Governing Counsel took the view that such a prolonged phase of depreciation combined with the significant increase in oil prices could have medium-term inflationary implications in a period of strong economic growth, and this could give rise to second-round effects on consumer prices via wage increases” (ECB 2001, p. 84f.). The German Bundesbank came to the same conclusion: “The interest rate increases were intended to prevent external price pressures from influencing price and cost developments in the euro area and to safeguard price stability in the medium term” (Bundesbank 2000, p. 34). The arguments used by both the ECB and the Bundesbank to justify their actions were therefore derived *in toto* from the Keynesian thesis that a wage-price spiral could be triggered-off by a devaluation (see below).

The euro remained weak throughout 2000.Diagram 2 shows that unit-labour costs increased very slowly in 1999 but started to increase sharply in 2000. In 2000 the first signs of a wage-price spiral became evident, despite the efforts that had been undertaken to avoid this eventually. Wage increases in this period were not the result of high employment. They were stimulated, as Keynes asserted (1930), by other sources of increasing prices (cf. Herr 2002). The devaluation that took place at this time led to a price increase which in turn stimulated a rise in nominal wages. Unit-labour costs have continued to go up. Starting in mid 2001 the sharp rise in unit-labour costs is indicative of a slowdown in the growth rate of real GDP rather than of a dramatic increase in nominal wages.

In the summer months of 2000 the ECB felt that “the exchange rate of the euro [had] moved out of line with the sound fundamentals of the euro area” (ECB 2001, p. 85). The problem was addressed at the G7 meeting on 22 September 2002. On the initiative of the ECB a concerted intervention in the exchange markets by the monetary authorities of the EMU, the United States, Japan, and the United Kingdom took place. In November 2000 the ECB intervened again to strengthen the euro (ECB 2001, p. 85). This was a clear sign that the ECB was worried about the weakness of the euro and was concerned about the exchange rate. The interventions in the exchange markets had some effect as the falling external value of the euro was arrested and finally halted.

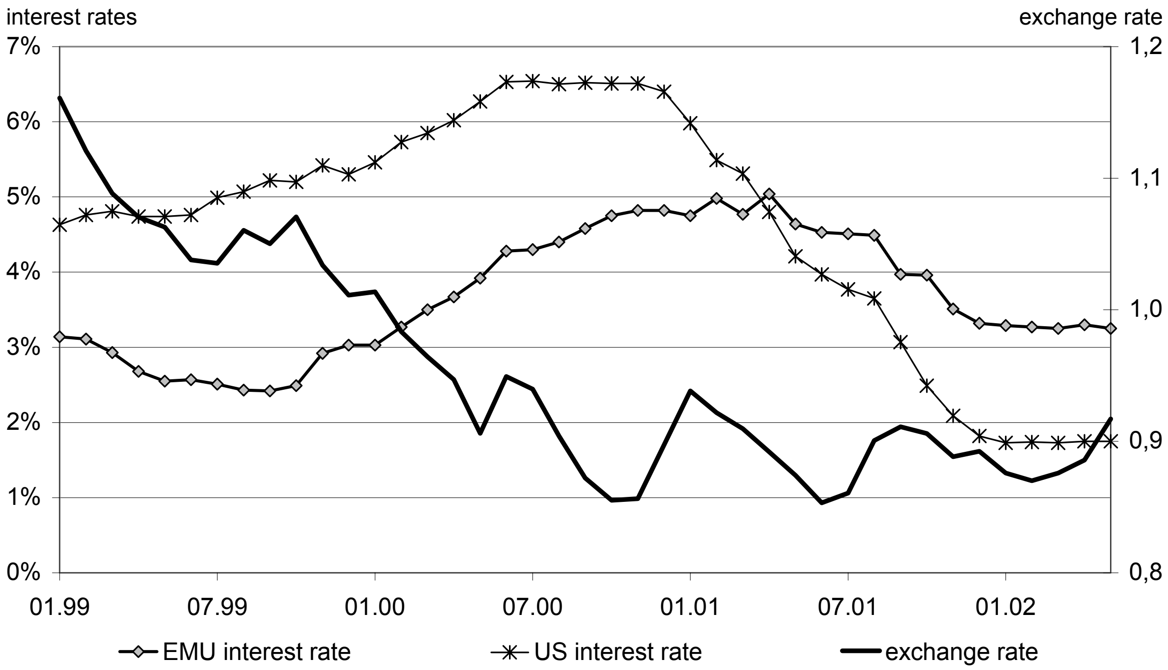
The key to understanding monetary policy in Europe is the weakness of euro. From early 1999 until autumn 2001 the value of the euro fell against the dollar by around 27%. Following this, the euro-dollar-exchange rate levelled out, although it was still subject to frequent fluctuations. Central banks have to attend to nominal exchange rates for two reasons: 1) the stability of the price level, and 2) the stability of the domestic asset market.

Let us start with the goods market. If a country devalues its currency, import prices directly or indirectly increase the domestic price level. The higher the import quota of a country, the stronger the tendency towards inflation. As higher prices reduce real wages, it is very likely that devaluation will trigger a wage-price spiral. If the devaluation becomes pronounced, nominal wages cannot usually remain stable, as real wages would otherwise fall drastically.

The higher the rate of inflation, the greater the likelihood of further devaluation, as the international competitiveness of the country would decline if such steps were not taken. In these circumstances the country in question finds itself trapped in a devaluation-inflation spiral, combined with a wage-price spiral. It can hardly be argued that the EMU was caught in a strong devaluation-inflation-wage-price spiral, but it has to be admitted that the first signs of such a development had begun to emerge. In such a situation the Central Bank has to act very cautiously to maintain its control over the exchange rate and price level, as discussed above.

The stability of the Asset Market is of even greater importance than that of the Goods Market. Fluctuations of exchange rates influence not only the price level and the international competitiveness of a country. They also determine the quantity of foreign wealth that can be obtained in exchange for one unit of domestic wealth. A devaluation of the euro against the dollar means that "euro wealth owners" become poorer in relation to "dollar wealth owners". If wealth owners expect a future devaluation and are not compensated by relatively high interest rates in the weak currency, they will buy assets whose value is embodied and expressed in the strong currency. There is a particular danger that a country that continuously devalues its currency will be confronted with a sharp shift in expectations. Confidence in the currency may break down and trigger a destabilising flight of capital out of the country. The reaction of exchange rates to this event will exert an intensely negative effect on price levels and the cost of living of the population. Here, there is no "natural" equilibrium of the nominal exchange rate, in direct contradiction of the thesis forwarded by the neoclassical purchasing-power-parity theory (cp. Robinson 1938). This means the exchange rate may respond to the sequence of events set out above, in an unpredictable and extreme way. In such situations the central bank may be forced to increase interest rates to very high levels in an attempt to stabilise the exchange rate. But in terms of growth and employment the costs of such an action are very high.

Diagram 3: Money market interest rates in EMU and in USA and exchange rate Euro per Dollar



Source: European Central Bank and Federal Reserve Bank of St. Louis

Of course in 1999 and the years that followed, the EMU was not confronted with a cumulative flight of capital. But there was the danger that the loss of external value of the euro could have gone out of control. Let us analyse the situation in 1999. In the autumn of that year, following a brief period of stability, the euro became very weak again. As well as this – and this is the key point – interest rates in the USA started to rise as the US Central Bank took measures to prevent the economy from overheating. A central bank confronted with a weak domestic currency and increasing interest rates in the leading reserve currency has not many options: It has to follow the interest rate policy of the leading currency.

It is frequently argued that the ECB pursued a dysfunctional monetary policy. If it had not increased the interest rate it would have created higher growth in Europe. Higher growth in Europe – so the argument goes– would have increased confidence in the euro and made it a stronger currency. I do not believe this argument, even in cases where growth rates are –and this also applies to both longer and short term periods – the key factor influencing expectations with respect to the vicissitudes of the exchange rate. The problem is that it often takes some time for growth to take place – if it occurs at all. Where the ECB policy is concerned, it is clear that the euro would have lost even more value against the dollar in the short term, if interest rate increases hadn't been introduced at the time. A failure to impose such increases would have stimulated inflation and led to the very real possibility a complete collapse of the euro. Let us remind ourselves of what happened to the USA towards the end of the seventies under President Carter's administration. At that time the USA was confronted with a devaluation-inflation spiral and the flight of capital from the country. In an effort to prevent this from happening, Mr. Volcker, president of U.S. central bank at that time, implemented a very restrictive monetary policy, which was costly for the USA and the world economy as a whole (cp. Minsky 1979).

During the year 2001 the economic situation changed as US GDP growth rates began to drop, and the US entered a recession. The Federal Reserve cut interest rates in several steps from above 6% to below 2%. The ECB reluctantly followed the US-interest rate policy: it too implemented interest rate cuts, but at a later date and to a lesser degree. The result was that by early 2001, interest rates in the EMU had risen to a higher level than those in the United States. At this stage it might have been expected that the dollar would have started to decline in value in relation to the euro. Such expectations, however, were not met. The exchange rate between the euro and the dollar stabilized overall but without the euro gaining in value against the dollar (cf. diagram 3). The generally accepted explanation of this phenomenon, is that the euro was not enjoying a very good reputation on the money markets and that relatively high interest rates in Europe were therefore needed to prevent the euro from falling any further in value.

It is not however quite such an easy matter to account for the weakness of the euro. Models like the purchasing-power-parity theory, which stress economic fundamentals, are not a very useful means of explaining the exchange-rate movement between the euro and the dollar. In the end the problem of the euro seems to be a political one. It is true that it is a new currency that has to establish and consolidate its reputation over time, but an even more decisive reason for the weakness of the currency is the current institutional and political vacuum in Europe. In the spheres of currency and trade Europe functions effectively as a unified state.

However, in nearly all other areas – for example fiscal policy or political institutions – there is no such unity. The ongoing enlargement of the European Union and the EMU etc. continues to make matters even more complicated.

The clear conclusion to be drawn from the progress of events that have followed the introduction of the euro is that the dollar has dominated the new currency ever since its inception. In the hierarchy of world currencies, the dollar has proven itself to be the leader and this has meant that all other currencies, including the euro, have had to submit to being dragged along in the wake of the Federal Reserve's interest rate policy.[7] So far the recession in the USA has not weakened the dominant role of the dollar in the world economy.

There is no guarantee that the dollar will remain a stable currency into the future. The US-current account deficit is too large to be sustained indefinitely, and any reduction of net capital flows into the USA will weaken the dollar. If the dollar starts to fall in value, how will the Federal Reserve respond? It is very unlikely that a restrictive monetary policy will be used to stabilize the exchange rate, for the following reasons: Foreign debt in the USA is denominated in the domestic currency. This means that the USA is untouched by a real-debt effect, which can result in such disastrous consequences when countries, whose debt is denominated in foreign currencies, are compelled to devalue.

a) As a strong devaluation would harm the economies in Europe and Japan, it is likely that the central banks in these countries would start to buy dollars.
b) At the close of the seventies, the devaluation of the dollar failed, as it led to an inflation-devaluation spiral that ruined its reputation as a stable international reserve currency. From 1985 onwards, the devaluation of the dollar succeeded, as it did not trigger off inflation and, hence, did not destroy confidence in the dollar. It is very likely that a possible future devaluation of the dollar would have equally benign results. It seems from the evidence that there is very little chance that inflation will represent a danger to the USA in the future.
c) Higher interest rates would harm the highly indebted enterprises and households in the USA. There is therefore a strong incentive for the Federal Reserve to accept less preferable terms of trade in exchange for lower interest rates and a weaker dollar.

The worst case would be one where devaluation drew the USA back into a constellation reminiscent of that which prevailed at the end of the seventies. Then, the necessity of imposing a restrictive US-monetary policy would lead to a world recession even greater than that of 1980/81. This would lead to conditions of economic hardship worldwide that would be particularly aggravated in developing countries.

4. Conclusion

The ECB has been compelled to follow the interest rate policy of the USA. Due to the weak external value and low reputation of the euro, the dollar has incontestably occupied the position of the world's leading currency. At the time of writing (mid 2002) the euro remains a long way away from challenging the international role of the dollar.

The euro offers a good example of how flexible exchange rates do not automatically increase a nation's ability to autonomously pursue a domestically- oriented monetary policy. Even such a strong currency area as the EMU cannot ignore nominal exchange rates. It was obviously a big illusion –one that succeeded in deceiving a great many people in the Bretton Woods period (cp. Friedman 1953) – that flexible exchange rates would allow individual countries the freedom to implement domestically-oriented monetary policies independently of each other.
During the period under discussion, the ECB more or less followed a rational strategy to control the external loss of the value of the euro, especially against the dollar. Throughout these years there was hardly any room for manoeuvre, and the ECB had little option but to enact the policy it did. As it happens, the ECB did not inform the public of its strategy. Even worse, the inconsistent manner in which the ECB implemented the first strand of its monetary strategy only succeeded in causing confusion. In addition, the second strand of its policy was never made clear, as the ECB would not openly admit that the weakness of the euro was the key factor in the determination of the monetary policy that Europe pursued at this time.

What the world economy lacks is a cooperative monetary policy, at least between the countries that produce key international reserve currencies. Exchange-rate movements cannot be explained by fundamentals. Purchasing-power-parity theory - the nucleus of any neoclassical exchange-rate model-cannot, for example, adequately account for exchange-rate movements between the euro (pre D-Mark) and the dollar (cp. Isard 1995). Since the breakdown of the of the Bretton Woods system, exchange rate movements have caused shocks and disturbances to national economies, which have often led – judging by domestic needs - to dysfunctional monetary policy. Better cooperation between the Federal Reserve and the ECB in the field of monetary policy, including early interventions particularly from the country confronted with appreciation, would have increased growth performance in Europe without at the same time, harming the economic performance of the USA. In such a cooperative regime of course, it would also be the ECB's responsibility to "scratch the USA's back" and help to stabilize the dollar in times of weakness.

[7] For a discussion of the concept of a currency hierarchy cp. Herr (1997).

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5. Fiscal Policy in China Since the Mid 1990s: Experiences & Perspectives

*Gan Xingqiong**

Since the start of reform and the opening up of the economy in 1978, China has experienced more than 20 years of continuous high growth. By the end of 1996, the Chinese government had succeeded in controlling the severe inflation that had started in 1992. However, Chinese economic growth had started to slow down since 1997. GDP growth was 9.6% in 1996, 8.8% in 1997, 7.8% in 1998 and 7.1% in 1999 (Xiang Huaicheng 2001, p. 37). In other words economic growth had dropped by 2.5% within three years. Price levels also began to fall continuously, retail prices had actually fallen into negative figures since October 1997, and producer prices had also began to drop into minus figures ever since April 1996. In the face of such a macroeconomic situation, the Chinese government adopted aggressive fiscal and accommodative monetary policies, among which fiscal policy played a dominant role. Some notable achievements resulted from these measures; economic growth rates rose to 7.8% in 2000, and 7.3% in 2001.

1. Fiscal measures in recent years

Theoretically, there are three different kinds of policy tools associated with the implementation of an expansionary fiscal policy. The first of these involves the reduction of taxes and increased spending. The second involves a combination of increases in spending and an unchanged tax revenues, and the third concerns increasing taxes as well as spending, at the same time. The Chinese government partly chose the third kind of policy tool, namely, raising expenditure together with the imposition of tax increases and the partial adjustment of tax policy. The Chinese government has also had to increase deficits and to issue treasury bonds to raise spending since the second half of 1998 because there have been difficulties in the Chinese fiscal situation and a gap has opened up between public revenues and spending.

In 1998, RMB 100 billion worth of treasury bonds were issued to state-owned business banks and the revenue generated from this issue was invested specifically in infra-structural development. Alongside this, the Chinese government issued RMB270 billion worth of special treasury bonds for the recapitalisation of the four big state-owned banks with the object of realising the capital adequacy rule of banks – 8 percent equity to loan –, which is a requirement of the Basel Accord I (cp. Xiang Huaicheng 2001, p. 17-20). In 1998, the Chinese government allocated RMB 18 billion of the central budget to workers laid off from state-owned enterprises (SOEs) as well as to retirees as a pension payment, in order to ensure a basic level of maintenance that would work in the interests of preserving social stability.

In 1999, there was a further issue of RMB 110 billion treasury bonds. The receipts were invested in the realisation of those projects started in 1998 (cp. Xiang Huaicheng 2001, p. 25). Tax measures in 1999 were as follows: In September 1999, the Chinese government changed its income policy and increased the wages of those on medium and low level incomes in towns and cities.

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More precisely, the salaries of government employees experienced an average increase of 120 yuan. The basic social welfare provisions for redundant SOE employees, other unemployed workers and retired workers were raised by an average of 30%. This item of government expenditure amounted to RMB 54 billion, which brought benefits for 84 million people in China. In order to encourage individual consumption and investment and to reduce the income gap between high and low earners, savings in bank accounts began to be taxed at a rate of 20%. Such a tax both increases government revenues and relieves the pressure on government expenditure.

In order to raise the level of imports and exports, the tariff rates on some imported products were lowered, and the customs drawbacks of value-added tax on some important export products like machinery, electronic goods, textiles, coal, cement and steel were increased several times. In an attempt to encourage domestic fixed asset investment, the fixed assets investment tax was lowered twice. The rate of the latter was halved in July 1999. The Chinese government ceased to impose the fixed assets investment tax on those investments that served to stimulate and support technological innovation in 2000. In order to encourage innovation and to develop new advanced technologies, the Chinese government decided to provide financial assistance to support the development of new technologies in research institutions and universities. As a further measure, business enterprises can, to a certain extent, have the cost of supporting affiliated research institutions written off as a tax deduction. The income accruing from technology transfers, and developments, as well as from consultancy and services is also exempt from business tax. In addition, there is no export tax imposed on technological products. Value-added tax is levied on software products at a comparatively low rate of 6%. The equipment and technology, imported by enterprises in order to produce the products listed in the "*National High-Tec Product Catalogue"* are exempt from tariffs and value-added tax. Individual rewards for technological achievements, awarded by research institutes, universities etc., in the form of shares, are not considered a part of taxable income, for a stated period of time.

In order to stimulate the real estate market and to encourage residential housing consumption, tax policies concerning the real estate market were changed. Ordinary residential housing, which has been owned and lived in for over a year, as well as accommodation that has been built by the owner are exempt from sales tax. Following purchase, private homes are temporarily exempt from property value-added tax. These and some other similar measures are aimed at supporting housing reform and fostering economic growth.

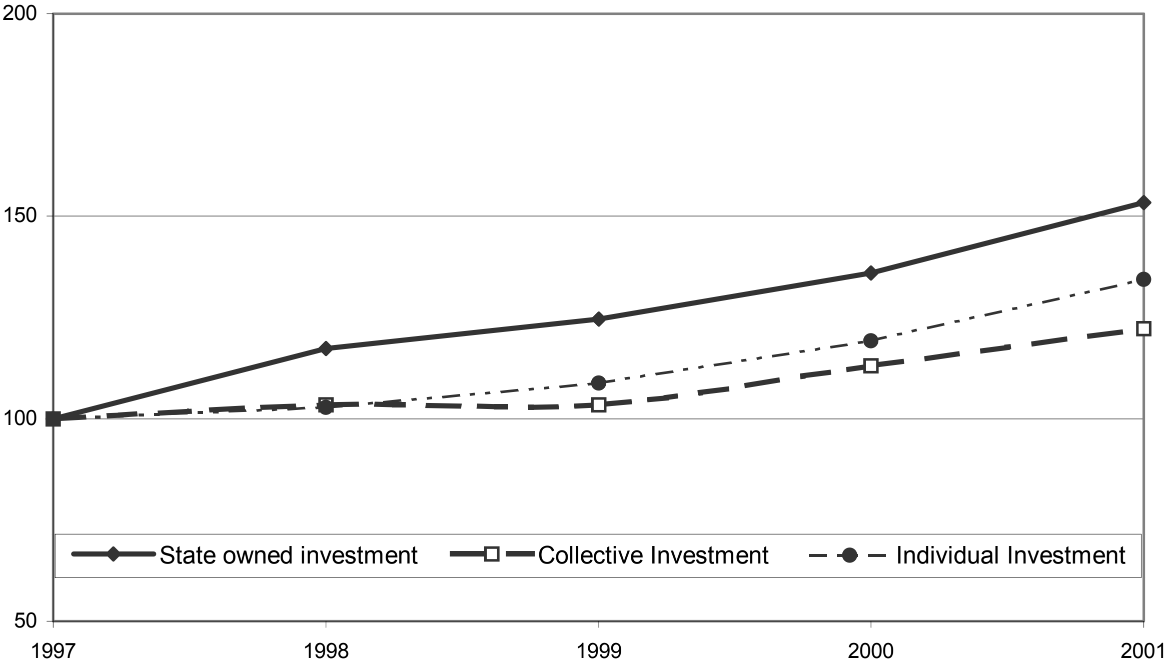
In order to encourage redundant workers to become more involved in community services, a number of tax-break incentive schemes have been introduced. These schemes include provisions whereby the income earned by redundant workers through community service work is exempt from several tax payments.

The Highway Law, which was passed at the 12th National People's Congress stipulates that the maintenance of the state's highways will be financed by a special tax, namely a fuel tax. Agreement was also reached on reducing the tax burden of farmers at the above-mentioned Conference (Xiang Huaicheng 2001,p. 25-27).

In 2000, there was a further issue of treasury bonds to the value of RMB150 billion (Xiang Huaicheng 2001, p. 29). In 2001, the Chinese government issued treasury bonds to the value of RMB 100 billion for the purpose of improving infrastructure (Xiang Huaicheng 2001, p. 33). The revenue generated from the latter has been used to support the development, in Western China, of projects such as the development of the gas pipeline and electricity networks linking East and West, water supply pipelines between the North and South, a new rail line connecting Qinghai with Tibet, as well as the environmental renewal of parts of Western China, amongst other things. The government has also provided 80 billion yuan RMB in a measure to increase the wages of the Chinese public sector workforce, as a means of further stimulating consumer demand.

This active fiscal policy has served a dual purpose. On the one hand, the aggressive fiscal policies, consistently pursued over four consecutive years, have effectively increased internal demand, driven economic growth and helped maintain social stability. The fiscal policies have contributed 1.5% in 1998, 2.0% in 1999, and 1.7% in 2000 to the rate of GDP growth (Xiang Huaicheng 2001, p. 38). The target growth rate of 7.3% set for GDP was met in 2001. In 2000, the market prices, which had been falling for two years, began to stabilise and increase slightly. In this year domestic consumer prices rose by 0.7% (Xiang Huaicheng 2001, p. 37). Foreign trade returned to its previous levels of high growth, as domestic and foreign markets grew rapidly, and a series of policies to raise export levels came into effect. Exports grew by 0.5%, 0.6%, 27.8% between 1998 and 2000 respectively (Xiang Huaicheng 2001, p. 37) and by 6.8% in 2001 (Xiang Huaicheng 2002). Fixed investment also grew faster with the implementation of the new proactive fiscal policies. The situation of low fixed investments has changed for the better resulting in faster and higher rates of growth. The total growth rate of overall fixed investments was 8.8% in 1997, 13.9% in 1998, 5.2% in 1999, 9.3% in 2000 (Mi Jianguo/Li Jianwei 2000) and 12.1% in 2001 (Xiang Huaicheng 2002). For the growth structure of all fixed asset investments in recent years, see diagram 1.

Diagram 1: Growth of fixed investment 1998 unitl 2001, 1997 = 100



With the assistance of the interest subsidy policy, the structure of investment has been optimised; the proportion of technological innovation and technological reform investment to overall social investment has increased from 15% to 15.6%. On the whole, the Chinese government issued 510 billion yuan RMB treasury bonds from 1998 to 2001. Total investment amounts to about 2400 billion yuan RMB, if the loans from banks and the funds from local government are counted together (Liu Lifeng 2001).

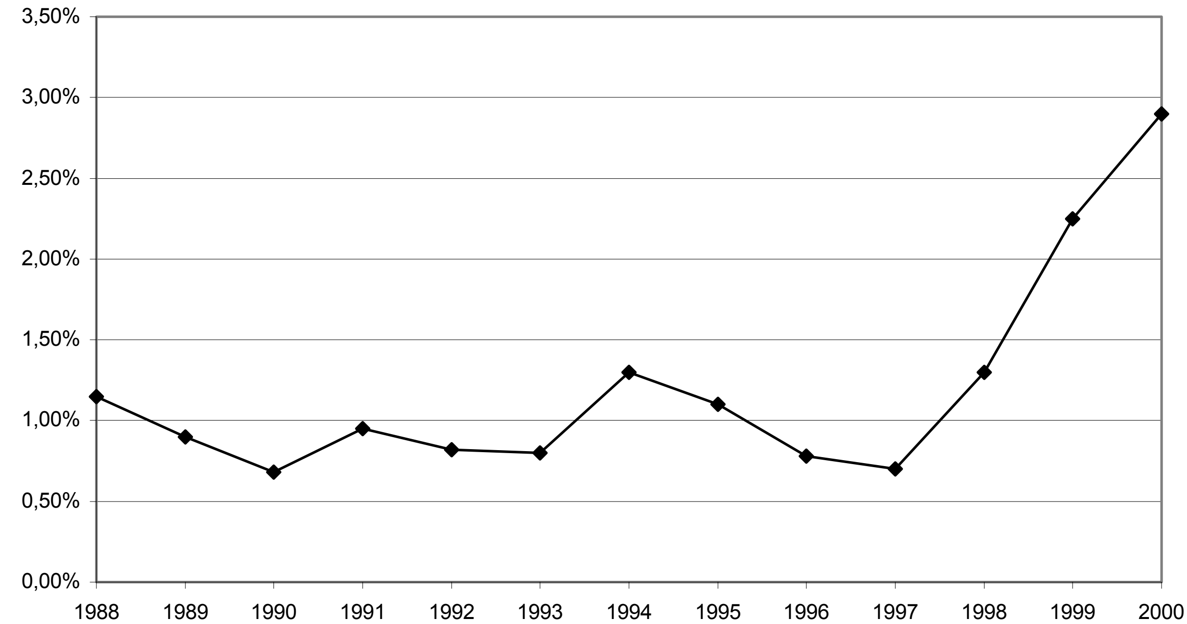
The expansionary effects of the proactive fiscal policies have become evident. The growth of consumption has strengthened, and the hard constraints on economic growth due to insufficient consumer demand have started to weaken. The average disposable income per capita among urban dwellers was 6860 yuan RMB in 2001, an increase of 8.5% over the previous year. Levels of rural income averaged 2366 yuan RMB in 2001, an increase of 4.2% over the figures for the previous year (cp. Xiang Huaicheng 2002). Consumer confidence has grown as disposable income has risen, and policies designed to increase consumption and to augment the level of transfer payment to medium and low level income groups, have come into effect. Aggregate sales in the domestic market have levelled off.

The economic performance of businesses has improved. There were big increases in the profits of the industrial sector. In 2000, the profit of large industrial enterprises was 4262 yuan RMB. This represented an increase of 86.2% over the previous year, the greatest such increase since 1990 (Xiang Huaicheng 2001, p.3). The composite index for the economic performance of industrial enterprises in 2000 was 99.3, a rise of 8.4% (Xiang Huaicheng 2001, p. 42). On the other hand however, the new fiscal policies have inevitably increased the fiscal burden of the government.

The fiscal burden chiefly concerns public deficit and debt problems. There have been many difficulties in the Chinese fiscal situation since the start of reform and the opening-up of the economy. The ratio of public revenue to GDP has continued to drop. The structure of public expenditure is faulty. The limited financial resources of the Chinese government have not been allocated efficiently. There are many things that should have been done by the government but have not yet been done, and many things which should have been done by the private sector, but that already have been done by the government, and administrative spending has continued to rise.

All manner of planned social and economic reforms cannot be brought into effect without the necessary fiscal support. Thus, a large gap arose between public revenue and public spending between 1978 and 2001. Surpluses were recorded in only three of these years, namely: 1978, 1981 and 1985. The level of public deficit has grown at a very rapid rate since the active fiscal policy began to be implemented in 1998. The budget deficit in 2000 was 259.8 billion yuan RMB (Xiang Huaicheng 2001, p.3), or 2.9% of GDP (see diagram 2), which touches the 3% maximum figure permitted by the EU, as detailed in the Maastricht Convergence Criteria. But if we take the hidden deficit of local governments wage arrears into consideration, as well as other arrears and the debts resulting from the central government's diverted special appropriations, it will be seen that the deficit figures surpass the official public figures, and certainly exceed 3% of GDP.

Diagram 2: Central Government Deficit as a Percentage of GDP



Source: Finance Yearbook Of CChina, 2000/2001

The level of public debt in China is heavy. By the end of 1999, the stock of public debt was 936.27 billion yuan RMB. The debt to GDP ratio in 1999 was 13.1%, and 13.5% in 2000 (Wu Junpei 2001, p. 12). Obviously, this amount is considerably lower than the 45%-60% or even higher of the level for some developed and developing countries (cp. Liu Rongcang 2001) and also much less than the 60% allowed by the EU according to the Maastricht Convergence Criteria. Nevertheless, public debt has been increasing at a rate of 30% a year since the Chinese government started to implement its active fiscal policy over the past few years (cp. Wu Houde 2001). The ratio of public revenue to GDP is generally between 30% and 60% in developed countries (cp. Xu Jian 2000), but the ratio of public revenue (including extra budgets) to GDP is only about 20% in China. This being the case, total public debt should not be permitted to exceed 20% of GDP. In fact, the proportion of total public debt to GDP is close to 60% in China if all hidden public debts (e.g. the bad debts of the banking system, and the debts of state enterprises and local government as well as the arrears of the social security system) are taken into account (cp. Xu Jian 2000). It is evident that this indicator is very close to surpassing international levels.

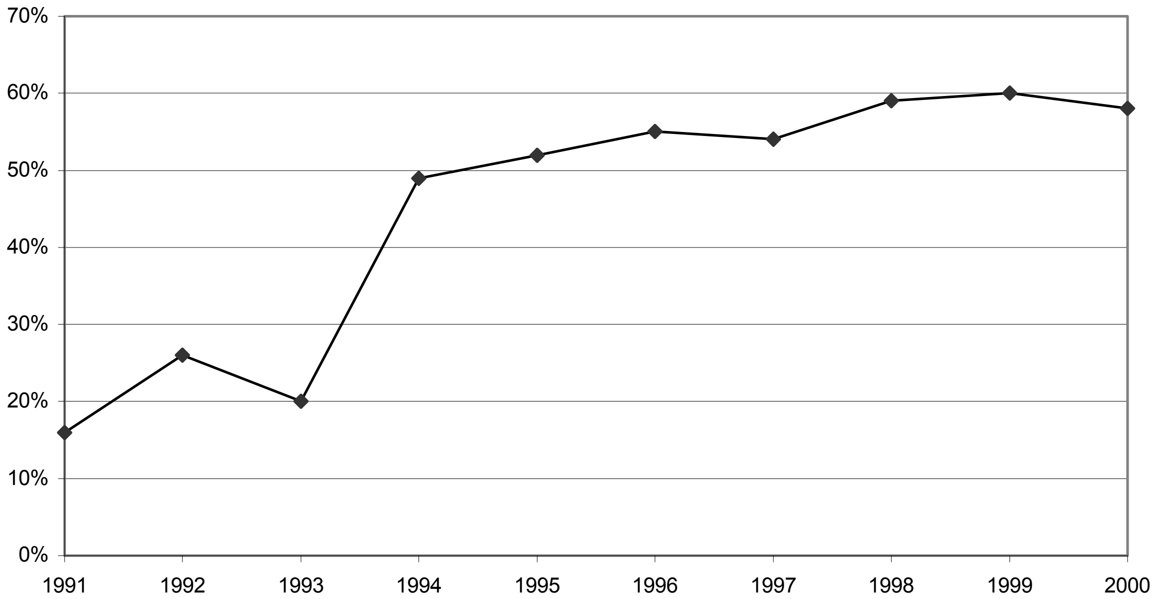
At the same time, the ratio of the annual public debt issue to the central government's yearly budget expenditure (including principal repayment plus interest payments) is too high; 51% in 1995 and 59% in 1999, which is 20% higher than accepted international norms (cp. Liu Rongcang 2001, Yan Kun/Xu Guirong 2000). In other words, in 1999, the Chinese central government spent 100 billion yuan RMB, of which 59 billion was raised by loans, further increasing the level of debt (see diagram 3).[1]

Of the new public debts issued in 1996, 66.2% was used to service old public debts. The corresponding figures for 1998 and 1999 were 70% and 47.8% respectively (cp. Wu Houde 2001).

[1] See table 1 in the appendix.

Because the tax system cannot adapt quickly enough to the changes in the structure of the economy, new loans have to be taken out to service old debts, creating a vicious circle of debt generation and regeneration. But it should be considered that this is the case in all industrial counties, including the USA and Germany.

Diagram 3: Annual Issues of Central Government Debts as a Percentage of its Annual Expenditures and Principal Repayments plus Interest Payments.



Source: Finance Yearbook Of CChina, 2001

2. Experiences and Evaluation

All in all, the Chinese government has pursued a rational and workable macroeconomic policy. It adopted tight macroeconomic policies and succeeded in controlling inflation from 1993 to 1996. It also adopted modest fiscal and relaxed monetary policies between 1996 and July 1998, but without these producing the expected results. Following this, from August 1998 on, it implemented both an active fiscal and a modest monetary policy in an effort to control deflation, with a clear degree of success. The Chinese did not, though, first invent the stimulation of internal demand through fiscal policy. For example, the USA adopted expansionary fiscal policies as a means of raising internal demand in the 1930s. The Japanese government followed such a policy in the late 1980s. China is regarded as representing one of the most successful examples of the implementation of this kind of fiscal policy. The facts enumerated below serve to back this up.

First of all, there have been a series of favourable basic conditions that have facilitated the government's efforts to implement its policies of boosting internal demand, such as unused capacity, an absence of inflationary problems, control over international capital movements.

When the Chinese economy began to experience an upturn in 2000, some people argued that the proactive fiscal policy should be discontinued. Nevertheless, the Chinese government continued to implement its expansionary fiscal policy in 2001, and this helped keep economic growth stable.

Secondly, the active fiscal policy has "joined forces" with other macroeconomic policies, especially monetary policy, income distribution policy and foreign trade policy, and this mix has produced good results. For example, public investment has been concentrated in the development of infrastructure. Fiscal subsidies and bank loans have supported technological reform and innovation in enterprises. Further reductions in the RMB interest rates of deposits and loans in 2002 reduced the borrowing costs for the treasury and the business sector. In particular, monetary policy has been made to work in concert with active fiscal policy in the form of low interest rates, personal loans etc. In addition, it is also very important to use income distribution for fiscal purposes. In recent years, the Chinese government has manipulated income distribution as a means of stimulating consumer demand. For instance, the levels of the so-called three lines of social security (the maintenance benefits for redundant SOE workers, unemployment security and the minimum level of benefits provided for rural and urban inhabitants) have been raised. The salaries and pensions of government employees have been increased, and some relevant measures have been made to reduce the financial burden on farmers.

Thirdly, the implementation of the fiscal policy was combined with structural adjustments and system reforms in all fields. In theoretical terms, the active fiscal policy can be traced to the demand management policy posited by the Keynesian School, and is based on the mechanisms of a mature market economy. The macroeconomic situation in China in recent years has been different from the conditions that obtained in the period of the Great Depression of the 1930s, and also different from the stagflation of the 1970s. The present deflation in China originated not only from the oversupply of goods but also from dislocations in the supply structure, which has made the problem of insufficient demand worse. So, economic objectives cannot be met solely through the application of Keynesian fiscal policy, nor through introducing tax reduction measures of supply-side economics. And although significant progress has been made in the marketization process, the latter still cannot be compared on an equal basis with the mature market economies of the West.

We can say that the macroeconomic problems in China at present have resulted not merely from market failure but mainly from government inaction and mistakes, as well as the underdeveloped state of the markets. Theory and practice have shown that active fiscal policy can only function as a short-term means of stimulating the economy. China's case is no different in this respect. Future long-term economic growth will have to rely on maintaining continuous market-oriented economic reforms (CP: Wu Junpei 2001, p. 3).

3. Perspectives

How long should an active fiscal policy continue to be applied in China? It is evident that it depends on the extent of advances made in economic development. So, it is very important for us to develop a proper understanding of the condition of the Chinese economy at present. The internal economic situation is good on the whole. The national economy has been growing steadily, economic performance has improved:

However, these improvements in the Chinese economy originated from adjustments made in domestic macroeconomic policy and also from a number of favourable international economic factors over the past few years.

These improvements do not mean that the desired radical change in the Chinese economic situation has been achieved. Statistics show that prices started to fall again from the second half of 2001 after the cessation of deflationary trends in 2000. People are afraid that domestic prices will have proved to have dropped again in 2002 because of the close relation between domestic prices and the international price of oil.

Obviously, there is as yet no firm foundation to economic growth, and the internal drive of economic growth is as inadequate as it has been in the past. First of all, investment growth has depended on public investment to a large extent (see diagram 1). On the whole, private investment has not proven high enough, and the growth in total social investment is slow. Statistics have shown that government investment has been the dominant factor in economic growth in recent years. Furthermore, the increase in consumption will not be very rapid, as the inequities in income distribution tend to reduce the marginal propensity of consumption. Presently, some primary consumer items have not yet reached an advanced stage of development (for example, education, IT, and tourism). The new market economy cannot be said to have taken off as yet in rural areas. The purchasing power of farmers is still very low, and their income levels have increased at an excessively slow rate. In recent years, the income of urban dwellers has increased only slightly.

The Chinese system of central planning is largely responsible for the low level of consumer demand, due to the prevalence of high savings, high investment, low income and low consumption resulting from this form of economic planning. The proportion of final consumption to GDP is 11% lower than the global average (cp. Wang Tongsan, Li Tao 2001). The main cause for this situation lies in the growth rate of private income, which is much lower than that of economic growth, due in some part to the effect of unfavourable influences on consumer confidence.

It is clear that the growth in exports over the past few years has chiefly come from the government's policy of refunding or reducing the taxes on exports, as well as the rise in external demand. Since 2001 the world economy has been falling into a new recession, which will have negative ramifications for the Chinese economy, China's export will face more threats than opportunities in the years directly succeeding its entry into the WTO. It is very likely that imports will grow at a faster pace than exports. The role that exports will play in contributing to economic growth, therefore, cannot be overestimated.

In addition, some lessons from the Japanese macroeconomic policy of the 1990s have showed that deflation can return when the focus of economic policies is turned away from tackling inflation. Given the current domestic and international economic climate, deflation will likely raise its head again. Therefore, current macroeconomic policies have to focus on how to continue coping with deflation as well as stimulating consumer and investment demand, particularly internal consumer demand, in order to provide a stimulus to economic growth.

It is necessary to continue implementing active fiscal policies and an accompanying monetary policy over a longer period.
The Chinese government has started to implement a macroeconomic policy that combines an active fiscal policy with a loose monetary policy, since February 2002.

The People's Bank of China have announced a plan to reduce the RMB interest rates on deposits and loans, which is a good way of stimulating consumption and investment demand as a means of boosting economic growth.

1. Fiscal policy should shift away from increasing direct government investment to introducing private investment (cp. Zhang Hejin/Zeng Shan 2001). Direct government investment should be reduced and some government money could be released to work in the form of a fiscal subsidy and guarantee. The government should continue to invest in infrastructure, which can have a high multiplier effect.

2. Stimulating investment demand should be combined with stimulating consumption demand (cp. Qiu Huabing/Liu Ye 2001). Some active measures have to be made to stimulate consumption demand so as to alleviate the dependence of economic growth on ever rising levels of government investment. Government spending designed to stimulate consumption, especially transfer payments to those on low incomes, should be significantly increased. The banks' increasing the availability of personal loans could play an important role. Tax reform should be pushed forward to relieve the burden on farmers, and to increase their disposable income.

3. The drive to stimulate internal demand should also be accompanied with the active promotion of exports (Wu Junpei 2001, p. 3). Tax policy has to be changed to encourage exports. The tax on export goods should be eliminated, in accordance with WTO rules. The coverage of drawback has to be extended from the present VAT (value-added tax) and consumption tax, to all indirect taxes.

4. The proactive fiscal policy has to shift from short-term demand management to long term supply incentives, which aims at promoting economic restructuring and upgrading (cp. Xiang Huaicheng 2001). In fact, the micro causes of the present Chinese macroeconomic problems lie in the dislocation between the supply and demand structures. The importance of economic restructuring should not be underestimated. The active fiscal policy can work very well, not only to stimulate demand but also to improve supply. In particular, a series of fiscal tools such as tax exemption, accelerated depreciation and fiscal subsidy can be used to support the technological reform of the SOEs. The provision of financial assistance from the government can contribute significantly to the modernisation of production techniques, and thereby help to maximise industrial capacity.

5. The fiscal system has to be subjected to more rigorous reform to make it function more effectively. The roles of tax policy and fiscal automatic stabilisers have to be strengthened if they are to function properly as tools of macroeconomic adjustment. The existing Chinese tax system, which is characterised by the imposition of indirect taxes, tends to discourage investment and has to be changed. Public debt must be spun out over the longer term.

6. Active fiscal policy has to be co-ordinated with other macroeconomic policies including monetary policy and income distribution policy so as to ensure the effective overall functioning of the economy (Hiang Huaicheng 2001, p. 3).

Personal loans, education grants, medium and small enterprise loans should be increased. Commercial banks should be encouraged to increase the number of loans on offer to the private sector.

7. Income distribution has to be reformed. The notion of high saving and low consumption has to be changed. Income distribution has to assume an egg-shaped form rather than the current pyramid structure (cp. Lu Jianglin 2002). Fiscal policy can be used to reach this aim. The related measures are as follows: providing tax preference treatment for low-income earners as well as increasing their transfer payments; raising the tax burden of high-income earners; and increasing government investment in agriculture to raise farmers' income.

8. Active fiscal policy has to be combined with system reform in all fields (cp. Gan Xingqiong 2001). At present, the macro policy adjustment and micro mechanism reform should be pursued simultaneously, and short-term stabilisation measures should be pressed forward with a view to long-term development. Steps should be taken to advance marketisation in all fields (cp. Wang Yiming 2001). In particular, reform of the investment and financing systems has to be deepened and extended. Efforts should also be made to push through the deregulation of these spheres. Private and state owned enterprises should be treated equally with respect to loans, taxes, and import and export regulations. More industries should be opened up to private enterprise. Private operators ought to be encouraged to participate in public projects, infra-structural development and new high technology projects. SOEs should be reorganised along modern corporate lines in the interests of imposing higher standards of financial discipline and in improving financial performance. Further work needs to be done on developing the social security system. Sound social security systems contribute to the settling of income expectations, and therefore, to the proper functioning of fiscal policy.

Appendix:

Table 1: Annual Issues of Central Government Debts as a Percentage of its Annual Expenditures and Principal Repayments plus Interest Payments

Year	Annual issues of Central government debts 1) (100millions yuan) (•)	Annual expenditures of central government 2) (100millions yuan) (b)	Annual principal repayments and interest payments of central government 3) (100millions yuan) (•)	Annual issues of Central government debts as a percentage of its annual expenditures and principal repayments plus interest payments. (a /(b+c))100
1991	199.30	1090.81	156.69	16%
1992	395.64	1170.44	342.42	26%
1993	314.78	1312.06	224.30	20%
1994	1028.57	1754.43	364.96	49%
1995	1510.86	1995.39	784.06	52%
1996	1847.77	2151.27	1266.29	55%
1997	2412.03	2532.50	1820.40	54%
1998	3228.77	3125.60	2245.79	59%
1999	3702.13	4152.33	1792.33	60%
2000	4153.59	5519.85	1552.21	58%

Notes: 1) domestic public debts.
2)data from 1991 to 1999 excludes principal repayments and interest payments of both domestic and foreign public debt. Data from 2000 includes the interest payments of both domestic and foreign public debt.
3) data from 2000 includes only principal repayments.

Source: Finance Yearbook Of China, 2001

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6. Fiscal Policies in the European Union in the 90s

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1. Monetary Union and the New Fiscal Policy in Europe

In the preparations leading up to the formation of the monetary union in Europe, which resulted in the creation of the Euro as a common currency, a provision whereby all prospective members were required to adopt a uniform fiscal policy from 1992 onwards, was incorporated into the *Maastricht Treaty* (MT). Countries wishing to access the monetary union had to meet the so-called convergence criteria which included - besides an established record of low inflation - two fiscal targets which became well-known all over the world. These were: that the budget deficit in relation to GDP should not be higher than 3 percent (this figure has even been adopted by many countries around the world as a norm for their own budgetary policies); and that the accumulated debt had to fall within a limit of 60% of GDP. In 1997, shortly before the third phase of the European Monetary Union (EMU), in which the European Central Bank was established and exchange rates were irreversibly fixed, the Maastricht criteria were hardened by the so called *"Stability and Growth Pact"* (SGP) which stipulated that EMU member states implement a balanced budget in the medium term. However, the budget performance since the beginning of the 90s in Europe shows that despite vigorous efforts and the instigation of tough austerity policies in many countries, these targets cannot be achieved. Some argue that fiscal policy practice is too lenient and should be made tougher, while others call for the abolition of the criteria altogether.

This paper first provides a critical analysis of the economic rationale for the fiscal criteria of the MT and the SGP (sections 2 and 3). Section 4 gives a political explanation for the fiscal policy guidelines of the MT and the shift to the SGP. Following this, in section 5, the performance of the fiscal stance of the EU countries in the 90s is discussed. Finally, the paper concludes with a recommendation on how current EU fiscal policy should be amended to avoid the problems that will otherwise emerge, if it continues to be pursued in its present form.

2. The Economic Logic of the Fiscal Criteria of Maastricht

2.1 Searching For the Implicit Economic Rationale

Any discussion of the fiscal policies undertaken by the EU in recent years must open with the question of why the fiscal policy provisions of the MT 1992 and the SGP 1997 were put on the policy agenda of the European Union in the first place, in view of the fact that all the member states had managed their affairs in this area for decades without the benefit of such a strict code of regulations. It was chiefly Germany, with the best price stability record since the end of World War II, and with either no or somewhat soft budget criteria in the national legislation, who called most vehemently for the new fiscal policy. The supposed economic justification of the authors of the MT provisions was based on three *implicit* arguments. However, there is little evidence of an explicit rationale for the fiscal criteria that have been adopted, to be found in the official documents.

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Sustainability: The target of fiscal sustainability was pushed through due to the fact that the debt to GDP ratio had persistently risen, in almost all European countries since the early 70s. Therefore, the burden of interest payments in the budget had increased. If fiscal sustainability is defined as a constant debt to GDP ratio which had reached an EU average of around 60 percent in the early 90s, and if the expected nominal average growth of GDP in the EU is roughly 5 percent p.a., then only 3.0 percent annual deficit is compatible with the threshold of 60 percent of the debt-to-GDP ratio. The underlying formula is very simple:

b is the debt/GDP ratio and so $b = D/Y$ (D is the stock of public debt, Y is nominal GDP), d is the deficit quota $d = \Delta D/Y$ with ΔD as the current budget deficit, the GDP growth rate is $n = \Delta Y/Y$. If b is supposed to stay constant in the long run, D must not grow faster than Y, or:

$\Delta D/D = \Delta Y/Y$

Multiply the equation by D/Y:

$\Delta D/Y = \Delta Y/Y \times D/Y$ or

$d = n \times b$

In other words: if 0.6 is given for b and n is estimated at 0.05, d is only sustainable at a value of 0.03.

So the 3 percent-line depends on the arbitrary assumption that b should be stabilised at 0.6 and on the equally arbitrary supposition the long-run nominal growth rate will establish itself at 5 percent. These targets, calculated at the European average, were imposed uniformly on all countries, although the value of b varied greatly between the different EU member states (Belgium at one extreme with 125% and Luxemburg at the other with 4.5%, in 1990). What might be sustainable for Europe as a whole may not necessarily be sustainable for each and every country. It should be observed, that if 3 percent or 60 percent are regarded as sustainable, this does not imply that they ought to be perceived as upper limits, but rather as long-term reference values which should be *averaged out*, and targeted on this basis. Since in the MT these criteria are used as *ceilings,* one might justifiably question whether they are really derived from arguments which expound the concept of sustainability.

Inflation fears: Continuous high budget deficits were suspected of being sources of inflation, which could have undermined the monetary policy of the ECB or – before 1999 – prove incompatible with fixed exchange rates. There are two stages to this argument. First, if all or a majority of the member countries pursue lax fiscal policies, this is regarded as endangering price stability or provoking an excessively tight monetary policy reaction, which restrains economic growth. The second stage of this argument asserts that if only one or a few member countries practice low standards of fiscal discipline they could exploit a free rider position: taking advantage of low average inflation in Europe and rather low corresponding interest rates (which are uniform across the EMU), they would cause some domestic inflation, thus contributing somewhat to the average European inflation rate.

The fiscal criteria were therefore put in place to deter such countries (the chief suspects being mainly southern European countries with presumably lower levels of monetary and fiscal discipline), from opportunistic behaviour and moral hazard. The provision of a "no-bail-out clause"(that is, debt-ridden countries are prohibited from receiving financial support from other European countries or the European community as a whole), incorporated into the MT was regarded as an insufficient means of enforcing fiscal discipline.

Crowding out effects: Excessively high budget deficits might crowd out private production and thus lower GDP growth. Although the long debate on "crowding out" did not produce clear theoretical results and the empirical evidence is very sparse, the orthodox concept is generally posited, which implies a variety of crowding out mechanisms. One is the rise in interest rates (even if price stability is not endangered) which impedes private investment, another is that budget deficits might lead to "too much government" with an overextended public sector which is thought to reinforce aggregate consumption at the expense of aggregate investment.

From my own point of view, these economic arguments are not very convincing, neither for the 3 and 60 percent criteria of the MT nor for the balanced budget target of the SGP. The latter target, especially, is bereft of any sound economic legitimisation. And if it were justified, then why didn't the "founding fathers" of Maastricht make use of it? Perhaps, it was just a matter of political wheeling and dealing? That this was precisely the case shall be seen below.

What are the economic shortcomings of the three arguments? Let us review them step by step.

2.2 Three Criticisms of the Maastricht Fiscal Guidelines

Sustainability: Although the sustainability-argument sounds plausible, as it guarantees a stable portion of the budget respective to GDP that has to be paid for debt service (assuming constant interest rates), it is tied to the arbitrary assumption that the debt-GDP-ratio should be frozen at 60%. There is no economic argument to support the proposition that a figure of sixty percent would be better than seventy percent, or that fifty percent would be better than sixty percent. The corresponding deficit quota would be 3.5% or 2.5%, respectively. The higher the sustainable debt-GDP-ratio, the higher the proportion of GDP needed for debt servicing, so that tax revenues have to be commensurately higher. In the case of the EU, it seems quite problematic to use a uniform debt-GDP-target for all countries alike. The very high debt-stock of Belgium and Italy, for example, is due mainly to historical reasons that do not impact on these countries' current macroeconomic performance.

In the above mentioned sustainability argument, the long-term GDP growth rate is set at the average expected EU growth rate. The growth rates of less developed countries (e.g. Portugal or Greece), which are perhaps running on a catch-up track, may rise faster than the rates that apply to the more advanced countries; in order to secure sustainability, they could afford to incur higher deficit levels. Furthermore, growth rates and deficit quotas are interlinked and cannot be viewed independently, as is the case above. Recessions, exogenous shocks etc. will hamper growth and increase the budget deficit. If the deficits are much too high, according to the Maastricht criteria, tight fiscal constraints will diminish growth, perhaps for longer periods than would otherwise be the case.

If economic growth slows down, the sustainable deficit shrinks and this requires the application of a more intensive regime of fiscal discipline – a vicious circle could emerge. So the sustainability argument contends that the deficit quota can exogenously be steered by adequate policy, and is not the endogenous result of market processes.

Inflation: There is no clear-cut relationship between budget deficit, debt stock and the inflation rate. Highly indebted Japan has suffered deflation since the 90s, and when the US was running a budget surplus at the end of the 90s, inflation soared. Ireland has recently experienced an inflation rate that is well above the EU average, although faced with a budget surplus, whereas Germany and Italy almost touch the 3% threshold but enjoy low levels of inflation. Of course, budget deficits *can* cause inflation. The most important condition is a boom constellation with full capacity utilisation and high employment. Even if one follows the (outdated) monetarist view that all inflation is always caused by unduly high quantities of money and an exogenous money supply that is under the full control of the central bank, under conditions where direct central bank loans to the government are prohibited – and this is the universally accepted rule in all European countries – high budget deficits will not increase the amount of money in circulation (however, interest rates might increase under certain conditions, see below). If it is true that the closest interaction between inflation and budget deficits (i.e. expansionary fiscal stimulus), takes place in a soaring boom with strong employment, then it should also be conceded that this constellation occurs rather rarely since high growth induces low deficits or even budget surpluses. In order to curb inflationary pressures stemming from the demand side of goods markets, it makes sense that a restrictive fiscal policy would serve to support the central bank. In such phases a 3 percent budget deficit might be much too high, and even a certain budget surplus could prove too low. The question of which fiscal policy ought to be adopted, under such constellations, is a matter of discretion. Rigid and uniform policy rules will not suffice, and they could even turn out to be harmful.

Can a single European country cause inflation through a budgetary policy of lax deficit spending? Even given constellations where demand inflation emerges or is reinforced by fiscal policy, any country in which such conditions come to prevail, will be immediately punished by competitive market forces in the goods markets. With fixed exchange rates or a single currency, this country's suppliers would lose out to a degree proportional to their exposure to European competition. That this would be the case is due to the highly developed state of intra-European trade. So the demand-side causes of such inflationary pressure would be immediately eliminated by a deteriorating trade balance that would reduce growth rates. Specific rules for budget deficits are in such cases superfluous.

Summation: The 3-percent-rule for the budget deficit levels in Europe is not a sharp sword against existing inflation, as in most cases inflation is not caused by budget deficits. In general, sustained inflation has its roots mainly in steady costs-price-spirals, including inflationary expectations.

Crowding-out: Indeed, interest rate hikes due to immoderately high budget deficits would be harmful. However, there is no direct channel of influence from public deficits to interest rates. Short term interest rates are chiefly determined by the monetary policy of the relevant central bank, and in global financial markets, the central bank of the leading currencies.

Long-term interest rates depend largely on short-term interest rates because of the commercial banks' opportunities for arbitration, at least in the long run. As long as there is no argument for increased inflationary expectations, nominal long-term interest rates need not come under pressure through deficit spending. However, if the latter triggers inflation (or expectations of inflation), short- and long-term interest rates will certainly go up.

There are quite a few additional arguments that oppose the simple saving-investment-determination of interest rates thesis, which can be found in many standard textbooks. If government demand for loans increases and this triggers off a multiplier process, aggregate income increases which yields higher savings (in the textbook-figures the S- and the I-curve shift simultaneously to the right).

If the budget deficit is high, the deficit of the enterprise sector is normally rather low since the savings surplus of the private household sector remains mostly stable. So, in this case, budget deficits will act as a substitute for the low investment demand of companies. However, if there is an existing or increasing foreign debt, which impacts on the exchange rate, budget deficits must be looked at much more critically. But in Europe the proportion of non-European creditors in public debt is rather low.

Eventually, the empirical evidence shows that there is no clear relationship between public deficits and interest rates. All kinds of constellations are possible. At one extreme, Japan presents a good example of this: high deficits correlated with almost zero nominal interest rates in the 90s. At the other extreme we need look no further than the US: With increased budget surpluses at the end of the 90s, interest rates were hiked up. It was not the budgetary stance in both cases that caused these phenomena – it was the central bank, stupid!

3. Why Should the Budget Be Balanced? The Economics of the Stability and Growth Pact

3.1 The Implicit Logic

When approaching the third decisive phase of the EMU, which resulted during 1998 in the selection of the participants of the EMU, it was the German government and the Deutsche Bundesbank who contended that the Maastricht fiscal criteria were insufficient for a hard currency union and needed to be tightened. Against the (rather weak and more tacit) opposition of the majority of the EU member countries, the SGP was adopted (or could not be prevented) which established the mid-term guideline of balanced budgets under normal macroeconomic conditions. In the event of recession, up to 3 percent budget deficits would be allowed; higher deficits were to be sanctioned with a set of monetary punishments, governed by a rather complicated, awkward and opaque body of rules. Whereas the German side appealed for automatic sanctions in the case of the 3 percent deficit being exceeded, the final outcome was a mixture of rules and discretionary sanctions based on case-by-case judgements. All governments must report regularly on the steps they have taken to achieve balanced budgets. Budget surpluses are more or less openly welcomed. The compromise that was finally reached, favours, in principal, balanced or surplus budgets but allows, in times of recession, for automatic stabilisers of up to 3 percent of GDP, i.e. the Maastricht limit. The debt-to-GDP ratio is now no longer mentioned. From the official side there have been few explanations for the policy shift from Maastricht to SGP. The *implicit* logic seems to be based on three core arguments:

1. The sustainability of public debt is now interpreted as a constantly *diminishing* debt/GDP ratio. If the deficit quota is zero and GDP growth is positive, the debt stock is frozen whereas GDP rises. Budget surpluses are used for the repayment of debt. Sometimes this policy is supported by its proponents with the argument that it produces more of inter-generational justice: future generations shall no longer suffer from the high debt burden imposed on them by present and past generations. However, it is standard wisdom of public finance that there is no *inter*-temporal burden shift (if you exclude foreign debt). On the one hand, future generations have to pay for interest and redemption (if it can be said that the debt is ever really repaid), and on the other hand the same generation receives the interest and redemption payments. So it is a matter of *intra*-generational redistribution. Independently of its misguided rationale, this argument is commonly used by politicians to justify severe austerity policies that are mainly oriented to cutting budget expenditures.

2. The balanced-budget doctrine stems from the classical economics formulated by Adam Smith, David Ricardo, John Stuart Mill and their successors. Here full utilisation of resources including labour and capital is assumed. Government expenditure is seen as a form of unproductive consumption that is undesirable but to a certain extent unavoidable. In such a system all increases in government activity due to budget deficits cause lower capital accumulation because fewer economic resources are utilisable for private purposes. What the government appropriates is no longer available for private investment or consumption. So, the doctrine of dominant capital accumulation preaches that a *minimal state* underpinned by a balanced budget most closely approaches the ideal scheme of things. In addition, it is argued that deficit spending induces more state activity since politicians can spend greater sums without raising taxes, which voters normally dislike. So budget deficits are seen as a device for producing a more and more profligate, spendthrift and unproductive state.

3. The classical budget doctrine is supplemented by the somewhat Keynesian idea of *automatic stabilisers* during recession. If, in a recession, the under-utilisation of labour and capital expenditure cuts lead to less tax revenues and hence less government expenditures, the aggregate demand shortage will be exacerbated. A vicious circle will evolve and deepen the crisis. Therefore, budget deficits, caused by revenue setbacks and expenditure increases (like unemployment insurance payments) that are themselves generated by downturns in the business cycle, are deemed to be acceptable, as are budget surpluses in upswing phases. In other words, the balanced-budget concept has now been made to embrace the business cycle (the so-called *cyclically balanced budget*). In this way, Keynesian and classical economic doctrines have been yoked together and made to appear to complement each other, thereby gaining widespread public acceptance, as well as the support of many economists.

To me these concepts and arguments are not convincing; they represent a relapse in macroeconomic thinking to pre-Keynesian doctrines of macroeconomic *laissez faire*.

3.2 A Critique of the SGP

A permanently or cyclically balanced budget in a growing economy will yield a continuous decline of the debt/GDP-ratio. Why should this be advantageous for the economy? The burden of debt service as a percentage of the budget or the GDP shrinks permanently as do the returns on government loans to the state's creditors.

So the tax burden can be lowered constantly, all other variables assumed constant. This may be justified from a distributional point of view, but this is a political judgement. There is no economic necessity to lower the debt/GDP-ratio permanently, ultimately to zero. In any case, the balanced-budget proposition (even in the cyclically adjusted version) cannot be justified by sustainability arguments.

The classical argument that public debt always crowds out private activities, hampers capital accumulation and triggers inflation, is tied to certain fixed assumptions. The main ones are full employment and full capacity utilisation. Indeed, in such constellations public deficits are unfavourable, but most advanced Western economies only very rarely find themselves under these high growth conditions. It is only if unemployment is defined away by the notion of "natural" unavoidable unemployment, which is regarded more or less as a form of fake unemployment, that the idea of the full use of all resources can be brought in line with the real world. As mentioned above, most crowding out arguments are rather inconsistent, or based on a generalisation of specific cases that are not supported by empirical evidence.

The balanced-budget doctrine in the cyclical variant confines budget deficits to passive stabilisation policies. According to this view, governments should accept cyclical deficits and provide cyclical surpluses in the upswing. The real world will not always conform to the notion of a symmetrical balance between deficits and surpluses. Moreover, this concept does not allow for the financing of public investment by loans. Tax-financed public investments require prior public saving. Why should the government not use private household savings for their investments? Besides that, the public finance economists have developed many arguments as to why the pay-as-you-go financing of public investment by credit has positive distributional effects. There is much scope for permanent budget deficits for this purpose, particularly in countries where large-scale investment in infrastructure and other areas of public funding is required. It was Keynes, who called for the debt financing of public investment and the tax financing of public consumption. Therefore, the concept of the cyclically balanced budget is not compatible with Keynes´ ideas. Some constitutions, such as the German *Grundgesetz*, contain provisions that allow for the generation of public debt in the interests of meeting public investment requirements. This limit can be overdrawn to the extent of cyclical deficits in macroeconomic disequilibrium (i.e. recessions) according to traditional German law (which, in this regard, has been superseded by the new body of EU regulations).

Equally important to the neglect of the debt financing of public investment may be the renunciation of active anti-cyclical short- or even medium-term countermeasures against recessions and slumps. Only passive acceptance of cyclical revenue losses is allowed. It was the monetarist Milton Friedman and his disciples who had warned of activist fiscal policies that would produce more harm than good. However, Friedman was convinced of the inherent stability of a fully-fledged market economy. This may have applied to whatever planet he was on when he dreamt up this notion, but it is nowhere to be found on earth.

My final criticism is the one most relevant to the conditions that have prevailed in Europe over the last few years.

After practically all present day member countries had met the 3 percent targets (sometimes with the aid of a few statistical tricks performed under the blind eye of the European authorities) by 1999, which had required substantial budget restraint in the 90s, the new target was set at zero percent until 2003 or so. Again, this provoked another period of painful fiscal austerity. The option of tax increases was mostly neglected (due to high tax and social security burdens amounting to 50% of GDP in some countries), so expenditure cuts were favoured. This contributed to slow growth in Europe and, in most countries, a failure to achieve the balanced-budget target. In addition to this, restrictive fiscal policies aimed at budget balancing, had a pro-cyclical effect and dampened upswings as well as downturns (see below section 5). So even if one accepts the concept of cyclically balanced budgets, it is only the *transition period* from deficit to balance which diminishes aggregate demand and causes economic hardship; under certain conditions, determined by the magnitude of the budget multiplier, restrictive fiscal policy can even be counterproductive *("budget paradox")* and increase the public deficit. With realistic assumptions there will be a rather small contribution to the target (low or non-budget deficit), but the eventual result will be much smaller than the primary impulse because of negative macroeconomic repercussions. In periods of high growth it is much easier to rapidly improve the state of the budget.

Some economists who follow the school of *rational expectations* believe that restrictive fiscal policy will immediately cause strong expansionary effects. First, the crowding-out argument is reversed: less public deficit is seen to alleviate the pressure on interest rates. Secondly, lower inflationary expectations are perceived to reduce interest rates, which in turn, strengthen investment and consumption. Even if such expectations were created (a curious presumption of omniscient economists pretending to know what all economic agents expect!) they would have to be stronger than the short-term restrictive demand effects in order to improve the macroeconomic situation. So many mainstream economists argue that the possible restrictive demand effects of SGP-induced fiscal policy will be weak and only of short duration. They convey this message: don't worry about fiscal constraint but believe in the rational instinct of investors and consumers whose behaviour is always heading towards the full employment of all resources. Does this suggest that the workings of a particular ideology are at play here? Yes, it most certainly does.

4. The Political Rationale of MT and SGP

The two fiscal criteria of the MT were moved to the centre stage of the political debates about the EMU in the early 90s. It should not be forgotten that the Deutsche Bundesbank was opposed to the project of monetary unification and that influential elements within certain interest groups, belonging to the conservative faction of German politics, disliked this project, as it was feared it would endanger the status of the DM as one of the world's hardest currencies. Furthermore, they were concerned that the influence of the Deutsche Bundesbank would be undermined, and finally transformed into a kind of subsidiary of the European Central Bank (ECB). Amongst the German public and the then ruling party coalition of Christian Democrats (CDU) and Free Democrats (FDP), there was a widespread distrust of the feasibility of a currency union, which would require a high degree of macroeconomic discipline from all the participating governments. Italy, Spain, Greece and other countries had had indeed a dubious record on inflation over the preceding decades. Had the German government not been such a strong advocate of the currency project, it would never have come into existence.

With the cooperation of his finance minister (Theo Waigel) and the Deutsche Bundesbank, the then German chancellor Helmut Kohl, who was in favour of intensifying European integration, hammered out a compromise that came to be enshrined in the MT. At the time, most observers expected that only a minority of EU countries would eventually clear the hurdles of the convergence criteria. When, during the 90s, the majority of EU countries fell within the 3 percent budgetary deficit limit, it became apparent that monetary union with a number of the 12 access countries could not be prevented. So the German government pushed for the adoption of the balanced-budget doctrine and the SGP, thus hardening the regulations of the MT. Meanwhile in the US, a substantial body of Republicans were also striving to attain the goal of a balanced budget. With the high growth experienced under the Clinton administration, a budget surplus was almost reached, and a political movement for lower budget deficits gained momentum in Europe. The majority of conservative European governments fiercely attacked all attempts to re-introduce Keynesian fiscal policies.

According to the tenets of supply-side economics, which originated with Margaret Thatcher in the UK and the Ronald Reagan administration in the US, rough and schematic policy guidelines were strongly advocated: cutbacks in the supposedly overdeveloped European welfare states, government downsizing, deregulation and privatisation, accompanied withal by a strict monetary and fiscal policy that was aimed at achieving an inflation rate close to zero. Macro policies were regarded as an inappropriate and ineffective means of stimulating and directing economic growth, and suitable only for securing price stability. This sort of thinking corresponded to the principles of orthodox neoclassical and monetarist theory. Viewed from this perspective, budget deficits were looked upon as a means whereby the government could lever a greater share of GDP. According to the strictures of this so-called neo-liberal approach, production and employment could only be strengthened by lowering real wages, promoting deregulation and pursuing a policy of "less government". The influence of this viewpoint has typically resulted in the neglect of macroeconomic policies. This neglect has been based on erroneous monetarist concepts of the role of the central bank in the macroeconomic sphere. According to this interpretation, the SGP has its roots in supply-side economics based on simple pre-Keynesian free market rhetoric. There was never a serious attempt to actively use fiscal policy to combat unemployment or to rejuvenate sluggish growth.

The seemingly Keynesian concession that cyclical deficits should be tolerated was just a matter of realism and political compromise: in cyclical downturns, as experience has amply demonstrated, it is virtually impossible to immediately curb deficits. In addition to this, many European member states rejected the balanced-budget concept. After the unification of Germany, when public debt doubled within a few years there were strong popular fears that public debt was soaring out of control. In this atmosphere the SGP was established.

Let us now look at the real performance of public debt and fiscal policy achievements in Europe.

5. Some Empirical Evidence on Budget Deficits in Europe since the 1990s

In the 80s the debt/GDP-ratio in the Euro-area increased rapidly, and despite the targets set down by the MT in 1992, the upturn did not come to a halt until 1999. Since then a slight reduction down to 69% has taken place (see table 1).

The sharp hike in the first half of the 90s was due to the recession of 1992/93, which triggered cyclical deficits and absolute GDP relapse. Moreover, in the years of upswing, 1990-92, consolidation was postponed and in Germany a massive expansionary policy was carried out due to the unexpectedly high costs of unification, financed primarily by debts. The slow and feeble upswing of the economy after the recession was not supported by fiscal policies, and so the growth record in the Euro-area from 1991-96 of 1.8% p.a., was far below capacity and much worse than in the 70s and 80s. After the acceleration of the cyclical upswing by the end of the 90s, the fiscal situation improved somewhat, especially in 2000 when a GDP growth of 3.4% was achieved.

Table 1: Debt/GDP-Ratio in Per Cent in International Comparison

	Public debt as a percentage of GDP							
	1980	1985	1990	1995	1999	2000	2001	2002*
Germany	31.7	41.7	43.5	57.1	61.3	60.3	59.8	60.6
Belgium	76.6	119.3	124.7	129.8	115.0	109.3	107.5	105.0
Denmark (1)	37.6	70.4	57.7	69.3	52.6	47.3	43.4	39.6
Greece	23.6	50.9	89.0	108.7	103.8	102.8	99.7	95.5
Spain	16.8	41.9	43.2	63.2	63.1	60.4	57.2	57.5
France	19.3	30.3	34.8	51.9	58.5	57.4	56.9	55.3
Ireland	67.6	98.6	92.6	80.8	49.6	39.0	36.6	34.5
Italy	57.9	81.9	97.3	123.2	114.5	110.6	109.4	106.5
Luxembourg	11.8	12.3	4.5	5.6	6.0	5.6	5.5	5.5
Netherlands	45.1	68.7	75.6	75.5	63.1	56.0	53.2	52.5
Austria	35.8	48.8	56.8	68.0	64.9	63.6	61.7	59.5
Portugal	31.9	60.8	64.2	64.7	54.2	53.4	55.68	53.5
Finland	11.5	16.2	14.3	56.9	46.8	44.0	43.6	42.5
Sweden (1)	39.6	61.6	42.1	76.6	65.2	55.6	53.4	49.1
UK (1)	54.7	54.1	35.0	52.0	45.7	42.9	38.3	35.4
Euro-Zone	34.6	51.8	58.0	71.4	72.0	69.5	69.1	68.4
EU 15 (1)	37.8	52.9	54.4	69.5	67.5	64.5	61.7	59.3
Japan (1)	51.2	64.2	61.4	87.1	120.3	130.4	139.5	145.2
USA (1)	37.0	49.4	55.3	72.9	63.2	57.3	53.8	50.6

*Estimate for 2002 by DIW et al. 2002, p. 123 (1) estimates for 2000, 2001 and 2002 by BMF 2001 (from August 2001)
Source: BMF 2001, DIW et al. 2002

As a result of high growth in the US in the 90s (mainly in the latter half of the decade) and a balanced combination of tax increases and expenditure cuts (primarily in military spending) during the period of the Clinton administration, the debt stock rose much less than GDP. During the US recession at the beginning of the 90s, massive fiscal deficits of up to 6% of GDP were used to initiate the GDP turnaround. Conversely, Japan fell into extreme debt as the country experienced a long term slump (1.0% growth in the 90s) and ongoing expansionary deficit spending.

If we look at the deficit quotas in Europe (see table 2), we can see that most European countries suffered from high deficits in the first half of the 90s and then turned to consolidation policies at the close of the decade. In 2000 the Euro-area almost succeeded in balancing its collective budget, achieving an average figure of 0.8% of GDP.

However, this was mainly driven by strong growth fuelled by the US boom and the support provided through the monetary policy of the ECB. In most Euro-accession countries, interest rates were lowered to the comparatively low German level, generating a strong expansionary effect that also dampened the interest burden of public debt in public budgets. These were the strongly positive macroeconomic results produced by the creation of the EMU.

Table 2: Deficit Quotas in Public Budgets in International Comparison

	Budget deficit as a percentage of GDP							
	1980	1985	1990	1995	1999	2000	2001	2002*
Germany	-2.9	-1.2	-2.1	-3.3	-1.6	-1.3	-2.7	-2.3
Belgium	-8.6	-9.0	-5.4	-4.2	-0.6	0.1	0.0	0.0
Denmark (1)	-3.2	-2.0	-1.0	-2.3	3.1	2.5	2.9	2.9
Greece	-2.6	-11.6	-15.9	-10.2	-1.7	-0.8	-0.2	-0.2
Spain	-2.5	-6.1	-4.1	-6.9	-1.1	-0.4	0.0	0.1
France	0.0	-2.8	-1.5	-5.5	-1.6	-1.3	-1.4	-1.9
Ireland	-11.6	-10.2	-2.2	-2.5	2.3	4.5	1.7	0.4
Italy	-8.6	-12.5	-11.0	-7.6	-1.8	-1.7	-1.4	-1.9
Luxembourg	-0.4	6.2	4.7	2.2	3.8	5.8	5.0	4.0
Netherlands	-4.1	-3.5	-4.9	-4.2	0.4	1.5	0.2	-0.1
Austria	-1.6	-2.4	-2.4	-5.1	-2.2	-1.9	0.1	-0.1
Portugal	-8.6	-10.3	-5.0	-4.2	-2.2	-1.8	-2.4	-2.5
Finland	3.3	2.8	5.3	-3.7	1.9	7.0	4.9	2.3
Sweden (1)	-3.9	-3.7	4.0	-7.9	1.8	4.0	3.9	3.4
UK (1)	-3.9	-2.9	-0.9	-5.8	1.3	2.0	1.0	0.9
Euro-Zone	-3.4	-4.8	-4,2	-4.9	-1.3	-0.8	-1.3	-1.4
EU 15 (1)	-3.4	-4.5	-3,5	-5.1	-0.6	0.0	-0.3	0.0
Japan (1)	-4.4	-0.8	2,9	-3.6	-7.0	-8.6	-7.7	-7.7
USA (1)	-2.6	-5.1	-4,4	-3.1	1.0	2.0	1.9	1.8

*estimate for 2002 by DIW et al. 2002, p. 123 (1) estimates for 2000, 2001 and 2002 by BMF 2001 (from August 2001)
Source: BMF 2001, DIW et al. 2002

After the recession in the US in 2001/2, European growth rates came down to 1.5% and 1.4% respectively, in 2001 and 2002 (estimate for 2002 by DIW et al. 2002), and in Germany, as the most influential European economy, to 0.6%. In almost all European countries fiscal policies adhered to a restrictive line of consolidation, despite the quasi-recession. The values of budget multipliers vary according to the size and openness of the different European economies. Therefore, the macro impact of fiscal constraint on small open economies like the Netherlands or Ireland is rather negligible, allowing them to attain their fiscal targets without incurring negative repercussions. For the three large Euro-area economies Germany, France and Italy (accounting for 70% of the Euro-GDP) the multipliers are much higher. The paradoxical result is that consolidation in periods of recession in the larger countries is counterproductive, and does not reach the required target. Therefore the EU aim of being “close to balance” in 2004 will most probably not be met. Some countries, Portugal being the first, are about to reach the 3% margin and will be fined. Apart from Portugal, it is Germany, of all countries, the most vocal proponent of the SGP since 1998, even under her social-democratic government, who has come closest to the 3% threshold, despite the introduction of massive austerity and strict fiscal disciplinary measures.

In mid 2002, there being no sign of an upswing but rather of a continued slump, several European governments, for the first time, have started to express their discontent with the SGP regulations. The SGP in its present form prevents the implementation of active fiscal policies that could act to curb economic downturns and recessions. There are not many instruments in capitalist economies that can be used to control and direct macroeconomic performance. Besides monetary policy, it is mainly fiscal policy that can help if the instruments of the central bank are blunt (e.g. low interest elasticity of investment) or paralysed (e.g. in order to defend the exchange rate). Certainly a simple return to the undisciplined and unwieldy budget deficits of the 80s or early 90s should not be advocated. The situation calls for the implementation of a number of measures. First, it is necessary to adopt a collective European approach to the matter of instituting a more coordinated, uniform and active fiscal policy programme designed to strengthen growth, which would overcome the restrictions of merely "passive stabilisation". Secondly, the prevention of pro-cyclical fiscal policies by all or some member countries is a step that needs to be taken. Thirdly, the constraints on the debt-financing of public investments should be eased or lifted. This latter measure would require a departure from the balanced-budget doctrine that currently serves as the economic creed for "normal" macroeconomic constellations. Europe can learn much from US fiscal policy of the 90s, which, without loosening control over public debt, has not hesitated up until now (apart from the occasional outburst of budget-balancing rhetoric), to delve deeply into deficits (or into surpluses) if they prove beneficial to macroeconomic performance. However, the way the Bush jun. administration is going to conduct fiscal policies is still open. The readiness for active countercyclical measures in case of recession or sluggish growth seems rather limited, and the structure of recent tax cuts or repayments seem to primarily support households with above average saving ratio.

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7. The Chinese Economy After WTO Entry – Chances and Risks

*Deng Lili**

China finally became a member of the WTO (World Trade Organisation) on December 11 2001, following fifteen years of hard struggle to gain entry. China was one of the last major trading nations to be admitted to this organization. It would not be an exaggeration to say that if Deng Xiaoping's economic reforms and policy of openness signalled China's willingness to embrace the outside world, then its accession to the WTO will allow it to develop into a fully-fledged trading partner in the global market. WTO membership is certain to generate tremendous benefits and bring great opportunities to China. It will help to expand trade, spearhead further economic reform and to attract ever higher levels of foreign investment, amongst other things.

At the same time, WTO membership will undoubtedly make exacting demands on China, requiring the government and the economy to meet the new responsibilities and surmount the fresh challenges that have suddenly been thrust upon them. China must now meet its WTO obligations and implement its commitments to the other WTO members. In the short term at least, China will be faced with the necessity of making painful sacrifices in the interests of developing its economy into that of a modern trading nation. Some traditional sectors will lose the protection that they have heretofore enjoyed under the old system and will have to take their chances as they bear the brunt of direct competition. The economy will have to adjust itself to the dynamics of the free market, and to this end, the Chinese government has agreed to implement measures that will liberalise its economy and administration and render its administration more open and transparent. Intensive and wide-ranging reform is required, and this will prove to be an arduous undertaking..

1. China's Responsibilities Under the WTO

WTO membership not only confers certain rights but also imposes specific responsibilities. China laboured through 15 years of tough negotiations, particularly with the United States and the European Union, to achieve WTO membership. The commitments China has made are extensive. For a comprehensive understanding of them, one could pore over the thousand or so pages of China's Protocol, Working Party Reports, and Schedules of Commitments on Goods and Services. Short of doing this, we can summarise the key components of China's accession package as follows:

1.1 Tariff Reductions

China has to lower its average tariff rate to 10% by 2005. One of China's main trading partners, the United States, for example, will have the industrial tariffs on its most important exports reduced from 25% to 7% according to the bilateral agreements made between the two countries.

Agricultural tariffs, of greatest importance to U.S. farmers, will be reduced from 31% to 14%.

1.2 Services Commitments

These include the substantial opening of a broad range of services sectors, including banking, insurance, telecommunications, and professional services.

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1.3 System Reforms

Broad reforms in the areas of transparency, monitoring and reporting, the uniform application of the law, and measures to restructure the judiciary will help to lower the barriers to foreign companies doing business in China.

1.4 Adhering to Existing WTO Agreements

China will take on the obligations of numerous existing WTO agreements covering all aspects of trade, such as agriculture, import licensing, trade-related aspects of intellectual property rights, technical barriers to trade, and trade-related investment measures.

Trade-Liberalising Provisions Specific to China

· Right to import and export directly to customers in China within three years.

· Right to engage in the distribution of all products throughout China within three years of accession (except chemical fertilizers, crude oil, and refined petroleum which will be permitted to be distributed at the wholesale level five years after accession).

· Investment and import approval will no longer be subject to trade-distorting requirements such as technology transfer, foreign exchange balancing, export performance, and local trade requirements.

· Right to export to China without establishing an investment presence there.

· Phasing-out of non-tariff measures (NTMS) such as quotas and licenses on hundreds of products, with all WTO-inconsistent NTMs eliminated by January 1, 2005.

· Elimination of state trading import monopolies for agricultural and industrial products.

· Requirement that state-owned enterprises must base their purchasing and selling activities solely on commercial considerations.

· Elimination of export subsidies on agricultural goods and the elimination of import substitution and export subsidies on industrial goods.

Safeguard Mechanisms

· Other WTO members can continue to use special non-market economic methodology to measure the extent of dumping in anti-dumping cases against China, for the next 15 years.

· Under a safeguard mechanism that applies specifically to China, the other WTO members can prevent China from increasing exports that may disrupt their markets, for a period of 12 years.

2. China Enters the WTO: An Overview of the Changes

Although the battle for entry to the WTO was hard fought, another challenge, in many respects as important and difficult, confronts the nation. As can be seen from the above list of commitments, China is making enormous changes to meet its WTO obligations. Some of these changes will come about immediately, while others will be phased in over a period of several years.

2.1 LiberalisingTrade

China will undertake major changes in import and export rights. No longer will trading rights be granted only to certain PRC entities for a fixed range of products. Instead, at the end of a three-year period which started upon accession, China will extend trading rights to all types of enterprises; firms supported by domestic or foreign investment finance, as well as foreign companies with no presence in China.

Government approval will no longer be necessary, and the right to import or export will be extended to all companies regardless of what they process. Products reserved for state trading have been identified and restricted in number.

In the meantime, however, trading rights are still very much subject to government approval, with only foreign minority-owned joint ventures permitted in the first year after accession. Foreign investors may take a majority interest after two years, and establish wholly foreign-owned subsidiaries after three years. During this period, the established foreign investment approval process will still apply.

2.2 Distribution, Wholesale and Retail Trade

The plan for liberalising distribution services, including wholesaling and retailing, is following a similar pattern: foreign minority-owned joint ventures will be permitted in the first year after entry, followed by majority-owned joint ventures and eventually wholly foreign-owned enterprises. Although certain products will be excluded from wholesaling and retailing activities, almost all of these special exceptions will be withdrawn after five years. The key difference here between these reforms and those that apply to trading rights is that the government approval process will remain in place, although it is expected that the authority to determine these decisions will be delegated to local government level.

2.3 Highlights in Service Sectors

· Banking: Renminbi business is currently permitted with foreign clients and will be expanded to include Chinese business clients within two years, and private customers within five years. Initially foreign financial institutions dealing with Renminbi business will be restricted to Shanghai, Shenzhen, Tianjin and Dalian, with three to four cities added each year until the eventual removal of all geographical restrictions within five years. Since China’s entry to the WTO, currency trading has been permitted without geographical restrictions.

· Insurance: Foreign life insurers are now permitted to take a 50% interest when establishing joint ventures. Foreign non-life insurers may establish branches or joint ventures with 51% ownership. These activities have been initially restricted to Shanghai, Guangzhou, Dalian, Shenzhen and Foshan. Ten cities will be added after two years, with nationwide activities permitted within three years.

· Securities: Foreign firms will be permitted to hold minority stakes in fund management joint ventures. The range of business is restricted to the underwriting of A-share, B-share and H-share issues, domestic and foreign government and company bonds, as well as the trading of shares and bonds in its own or others’ accounts. However, foreign firms are not permitted to trade in A-shares.

· Telecommunications: China has undertaken separate commitments for mobile voice and data services, value-added and paging services and domestic and international services. For mobile voice and data services, foreign investors may establish joint ventures for services in and between Beijing, Shanghai, and Guangzhou, taking a 25% interest initially and moving up to 35% and 49% stakes over a three-year period. The number of permitted locations will be increased after one year, with all geographical restrictions to be removed five years after accession.

For value-added and paging services, foreign investors will be permitted to take a 30% interest initially in joint ventures in Beijing, Shanghai, and Guangzhou. These areas will be expanded after one year to include 14 additional cities, when foreign investors will be permitted to take a 49% share in the ownership. Within two years, a 50% share will be possible, with all geographical restrictions removed. For domestic services and international services, foreign investors will be permitted to establish joint ventures in and between Beijing, Shanghai, and Guangzhou within three years, with the initial limit of 25% interest raised to 35% after five years rising to 49% after six years, when all geographical restrictions will be lifted.

2.4 Conditions on Investment

China must now fully comply with the Agreement on Trade Related Investment Measures (the *TRIMS Agreement*). Significant TRIMs obligations include the elimination of foreign exchange balancing, export performance and local content requirements. These commitments apply not only to foreign-investment enterprises, but also to Chinese enterprises which have often been required to operate under local content and import substitution regimes, curbing their purchase of foreign goods. Here, China has made specific commitments in the car sector.

China has also promised not to make the approval of joint ventures and wholly foreign-owned enterprises conditional on technology transfers or the pursuit of research and development activities.

2.5 Protecting Intellectual Property and Information Technology

China has also agreed to implement from the date of accession the Agreement on Trade Related Intellectual Property (*the TRIPs Agreement*). In support of those obligations, China has amended the *Trademark Law,* the *Copyright Law* and the *Patent Law* over the past months to expand the scope of protection and raise the level of enforcement.
China will also now participate in the *Information Technology Agreement* and ensure that no tariffs are imposed on specified information technology products.

2.6 Non-Discrimination and National Treatment

China must now provide non-discriminatory treatment for all WTO members, putting them all on an even footing, except where special conditions have been imposed. This agreement includes Hong Kong and Macao, which are members of the WTO as separate customs territories, and Taiwan, which will become a member during this period.

China will also begin to apply the same rules and regulations to Chinese enterprises, foreign-owned enterprises, as well as foreign firms and individuals. Non-discriminatory treatment will extend to the procurement of goods and services required for production, as well as to the conditions under which goods are produced, marketed and sold. Dual pricing structures are to be eliminated.

2.7 Transparency

Transparency is a fundamental principle of the WTO. Under the Accession Documents, China's obligation to establish transparency extends to four areas: trade in goods; trade in services, intellectual property rights and foreign exchange.

The China-WTO Inquiry Notification Office has been established at the Ministry of Foreign Trade and Economic Cooperation to handle inquires from enterprises, individuals and WTO members. China has promised that it will enforce the laws and regulations in these areas that have already been established. With regard to laws in these areas, a reasonable period of time for public debate will be provided before the law or regulation is adopted, except in cases where foreign exchange rates are concerned or national security is involved. Clearly there will be some questions as to which areas of the law "pertain to or affect" trade in goods and services, but these developments are encouraging.

2.8 Uniform Administration

China's WTO obligations apply to the entire customs territory of China, including special economic zones and autonomous regions. China has promised on numerous occasions to ensure that its WTO obligations are complied with throughout the country, stating that local regulations that fail to comply will be overruled or revoked by the central government.

2.9 Monitoring Compliance

An extensive Transitional Review Mechanism is being put in place to monitor China's compliance with its obligations under the WTO Agreement and Accession Documents. The transitional reviews will take place annually for the first eight years followed by another in the tenth year. Sixteen separate WTO councils and committees are responsible for organizing these reviews according to their specific mandates. Information to be provided by China and issues to be reviewed are set out in the Accession Documents.

2.10 Claims and Disputes

China is establishing both administrative and judicial review channels to allow parties the opportunity to seek reviews of administrative actions undertaken in the implementation of laws, regulations, judicial decisions and administrative rulings relating to China's WTO obligations.

China has also signed the Dispute Settlement Understanding, the main WTO document on settling disputes between members. The rulings established under this agreement are binding on all WTO members. Claims and disputes between member states may be mediated according to procedures established under the provisions of the WTO dispute settlement agreement. Such disputes typically arise when a problem affects a number of participants in a service or industry sector.

3. How WTO Membership Affects China - the Opportunities

Undoubtedly, WTO membership will generate tremendous benefits for China's expanding trade, spearheading further economic reform, attracting even higher levels of foreign investment, and enforcing the rule of the law.

3.1 Surer and Speedier Economic Reforms

The experience of many countries undergoing economic reform has been that external pressure and the obligation to meet the conditions set out by an independent international body have proven useful in countering the opposition of powerful domestic interest groups.

In the case of China, the state-owned enterprises are a powerful force against China's march toward a market economy. It would not be an exaggeration to say that the bilateral and multilateral agreements behind China's accession to the WTO provide a summary of the reforms that China plans to undertake in the next decade or so. They not only constitute a road map for economic reform in the coming decade, but as international treaties, they also serve as a concrete statement of the country's willingness to commit itself to systematic reform and the restructuring of the national economy.

Given the conditions of the WTO membership, there will be greater competition between Chinese firms and foreign firms, both in China's domestic market and in foreign markets. As a result, there will be a large scale re-structuring of industry. Except for a small number of designated infant industries that have been granted some temporary protection, the restructuring will be based, to a large extent on China's comparative advantages and disadvantages vis-à-vis other economies. For example, China enjoys certain advantages in the field of labour-intensive industries, but does not enjoy such advantages in the areas of natural resource-intensive, capital-intensive, and technology-intensive industries. In the sphere of skilled labour China can compete effectively with the rest of the world in some areas, but less effectively in others.

If firms are rewarded and disciplined mainly by market forces, then the ownership structure of firms in China will tend to reflect their relative efficiency in organizing production and the delivery of goods and services. More efficient ownership structures will increasingly be adopted while that less efficient ownership structures will diminish in importance. Since capital flows into and out of China will continue to be restricted before liberalisation measures are fully implemented (which may take up to ten years), the banks will be a key factor in deciding which types of ownership will win out. If the four state owned commercial banks continue to play a dominant role in the supply of investment funds, their attitude toward firms with different ownership structures is crucial. If their lending decisions are not based primarily on commercial principles, then progress toward the establishment of more efficient ownership structures may be slow. Evidently, ownership structure also depends on the government's policy on national and regional government-owned monopolies.

In any event, sectoral restructuring based on comparative advantages will lead to improved efficiency due to the re-allocation of resources across all fields of industry. In addition ownership changes based on market competition will result in the improved efficiency of resource re-allocation across firms.

Although China is still far behind the developed market economies, the latter are definitely the benchmarks for China's own process of regulatory reform and institution-building. WTO membership will contribute to regulatory reform and institution-building in China because WTO rules will be translated into national laws and regulation. In addition, good regulatory practices must be adopted to avoid the occurrence of failures in the system. Finally, WTO membership will help to speed up the enforcement of existing legislation.

A better legal system, facilitating the effective enforcement of the law, will not just benefit foreign investors, but also protect honest Chinese companies and business people from becoming the victims of poor ethical standards and outright fraudsters.

3.2 Stability in External Economic Relationships

WTO membership will give China more stable access to foreign markets because it will reduce the disruptions in foreign trade that are caused by unpredictable policy shifts. WTO membership will make China more attractive to foreign investors. Higher levels of investment will mean more well-paid jobs, increased tax revenues for the government, and more technology transfers. China will be in a better position to attract foreign investors who want to use China as an export platform. In addition, membership of the WTO will attract foreign investors who will consequently feel more secure about developing China's domestic market.

It would be unrealistic to expect WTO membership to eliminate trade and investment frictions between China and other economies since such frictions are already quite common between existing members. But these frictions will be better managed under the WTO's trade rules and the organization's dispute settlement mechanism. China will be able to defend its trade interests using this system of conflict resolution. Chinese exporters will benefit from the certainty that their trading partners must obey WTO rules. This means, for example, that WTO members will not be able to discriminate against Chinese products in their markets. This will be a big improvement over the existing relationships, in which trade and investment disputes tend to be settled by mutual threat and brinkmanship.

3.3 Improved Welfare

China’s WTO commitments will facilitate increased competition in every sector of the economy. Chinese consumers will be the direct beneficiaries as competition increases the range of choice, lowers prices and improves product quality, not to mention the greater awareness of and respect for consumer and intellectual property rights that WTO membership and the unleashing of competitive forces will bring about. Competition will raise levels of efficiency and productivity, which will have the effect of gradually strengthening China’s economy and enhancing the ability of Chinese firms to compete with the best multinationals in any market.

China’s economy will benefit from an expanded range of services – in the insurance, financial, and distribution sectors after foreign companies begin to enter the Chinese market, following China’s accession to the WTO. Competition in this area will, in turn, stimulate China’s home-grown services sector, giving companies and consumers an even broader range of choice.

Most importantly perhaps, consumers and companies alike will benefit from the more effective application of the rule of law that China’s implementation of its WTO commitments will bring; particularly those measures designed to foster the highest degree of transparency and non-discrimination in trade.

3.4 Long-Term Growth

The economic benefits derived from China's WTO membership will not be confined to static gains in efficiency from the re-allocation of resources across industry and individual firms.

In the long run, the dynamic gains from increased competition brought about by China's entry into the WTO will be even more important. Increased competition on level playing fields will reward efficient and innovative firms, regardless of whether they are local or foreign, private or public. At the same time heightened competition will weed out inefficient firms and technological laggards. The protection of intellectual property rights for both multinational corporations and indigenous Chinese firms, will help to build an engine of economic growth based on technological progress. The serious problem of investment duplication and excess capacity in many industries is due largely to the wasteful investment of public funds. But the fact that there is too much money chasing a limited number of viable investment opportunities may also be a factor. To the extent that this is true, the problem of duplicated investment should be lessened as the range of industry expands and more opportunities to invest become available.

4. The Risks China Faces Following WTO Entry

Although WTO membership is certain to bring China enormous benefits, especially in the long run, China’s WTO deal does not come free of charge. A massive investment of will, energy and commitment is needed if China is to succeed in overhauling its economy in compliance with WTO requirements. The costs, in social and financial terms, of enacting these reforms will be very great. WTO membership will eventually lead to China’s entry into and embracing of the outside world. China will experience a thoroughgoing transition from a centrally-planned economy to a market-oriented economy. This phenomenon will also cast a harsh light on some of the structural weaknesses in China’s economic system, particularly in agriculture, finance, and state-owned enterprises. The dilemma for China is how to keep the dual momentum of economic growth and structural reform going. Quite a lot of adjustments will have to be made. This will cause the generation of some potentially unstable factors. So while the benefits lie on one side of the coin, the risks are to be found on the other.

4.1 Industrial Restructuring

The further opening-up of the economy that China’s entry into the WTO will bring, will force the country to accelerate the pace of its industrial structuring. Direct competition from outside will affect different industries in different ways.

Some labour-intensive industries such as textiles will profit most from WTO entry, but negative effects are expected in industries such as agriculture, telecommunications and automobile production. It is estimated that in the first number of years following entry, the latter may suffer a loss. These industries will also experience great changes. The re-allocation of resources will cause bankruptcy and unemployment in certain sectors and in individual enterprises. Companies with a reasonable prospect of survival are likely be re-organized, whereas the bankruptcy of unviable firms will release resources which will enable new and existing firms to grow and expand.

For example, some capital-intensive and technological sectors, like banking and insurance, automobile production, telecommunications and the pharmaceutical industry, will find the advantages they currently enjoy, as well as their share of the domestic market reduced.

Some State-run enterprises will close, many people will lose their jobs, the banking system and the agricultural sector, where it now costs more to produce crops than can be earned from them, will be turned on their head. This will prove to be a very painful process.

Compared with State-owned enterprises, private enterprises are more receptive to new innovations, more able to adapt to the ever-changing demands of the market, and therefore exhibit a stronger market competitiveness. State-owned enterprises are currently undergoing a restructuring and organizational overhaul. Compared with private enterprises, State-owned enterprises are probably more conservative in terms of their market concepts and operational mechanisms, and will sustain more damage in the violent process of reform. External pressure may speed up the progress of change, but it can also worsen the situation.

4.2 Redistribution of Wealth, Unemployment, Social Security

China's accession to the WTO will also see a major redistribution of wealth, resulting from its transition from the old economy, with its reliance on heavy industry, grain production and government projects, to a new service-based economy and non-governmental jobs. The further opening-up of the market will trigger major readjustments in the distribution of income between different interest groups.

A significant loss of jobs, particularly in rural areas, is anticipated. The cut in tariffs will greatly increase the pressure on the agricultural sector. Agricultural output growth will be severely reduced. The area of land given over to agricultural production will also diminish. The income share of rural inhabitants will fall. It is estimated that the scale of bankruptcy and redundancies will lead to the loss of over 11 million jobs, and a large number of labourers will be shifted from the agricultural sector to other sectors.

As tariffs fall, competition will speed up the dismantling of China's state enterprises. This will mean that tens of millions of Chinese citizens will no longer be able to rely on the government for everything from their pay check, to their housing, to their health care.

Industrial restructuring will result in job losses. For instance, automobile manufacturers as well as oil refineries and steel plants will reduce the number of enterprises in their operations, which will lead to a lot of unemployment in these sectors. On other hand, there have been massive redundancies in the labour-intensive sectors. These workers are not sufficiently skilled to participate in areas of the economy that have not been so badly hit by unemployment, such as the technological and capital-intensive sectors. At the same time, jobs cannot be created for them in other sectors either. Thus, the issue of unemployment will become a serious social issue in the years to come.

A social security system and health care system will be necessary to provide a safety net for the unemployed. The government should make great efforts to address the problem by reforming the systems of income distribution, personnel management and training.
Workers laid-off in the course of structural readjustment will receive modest levels of income support through improvements in the social security system.

China is trying to fulfil this task. Because of the difficulties involved and China's lack of experience in this area, failures will be encountered and mistakes made.

4.3 Reorientation of the Functions of Government

There will be tremendous changes in the management of China's economy now that it has entered the WTO. The government should minimize its intervention in micro-economic activities but will still work to ensure economic stability, and complete the transition into macro policies from the micro central planning policies of the past as soon as possible. Hence, the establishment of an effective macro-control policy will be its primary task.

The government should concentrate more on economic regulation, market supervision and public service, while reducing administrative examination and bureaucratic procedure in the economic field. In addition, the government should also play its role transparently and fairly.

The government has to commit itself and become accustomed to this transformation in its role and function. But at various levels of government there is a lack of awareness of the many changes that need to be made as well as the wherewithal to effectively implement such change. There will be some contradictions between the sphere of market-oriented economics and that of the somewhat bureaucratic government, which still thinks to a large degree in terms of the old central-planning strategies. This may hamper the progress of China's economic reforms.

4.4 Ideological Changes

The accession to the WTO doesn't just mean the liberalisation of the economy for China. More important is the shift in ideology and values that economic change on this scale will bring, affecting all levels of society; from the government, to businesses to ordinary individuals. Economic activities should be allowed to be directed by market forces, and the function of the government should accord with this liberalisation process. The way of life of ordinary people will also have to accommodate the new order of things. It is true that this kind of change can improve the efficiency of the economy, but in the meantime it also exerts greater pressure, which may bring about a certain degree of economic destabilization.

The above accords well with the message delivered by China to the WTO during the Bangkok Conference in 2001. This asserted that the trade liberalisation policies pursued by the WTO contributed significantly to the following results: (1) Growing impoverishment and discontent among the majority of people. (2) Increasing inequality in income distribution within countries, which is masked by economic statistics that indicate economic recovery, but do not show how the urban poor and rural communities have been pushed ever further into misery and despair, partly through having to carry the burden of the affluent sectors of society and business. (3) Accelerated destruction of environment and ecological systems, which particularly affects the livelihood and health of the rural and suburban poor, especially in the western part of China.

(4) Trade liberalisation exacerbates the culture of consumerism and threatens the very survival of the fragile traditions of ancient Chinese cultures and religions.

4.5 The Reform and Improvement of the Legal System

An open market is susceptible to risks because trade liberalisation does not guarantee fair competition. Loopholes in the market will have to be plugged by means of legislation and necessary intervention. Steps will be taken by China to improve its legal system in accordance with the relevant WTO agreements. The further opening of the market will lift the floodgates to certain imports. China will have to resort to anti-dumping and countervailing measures to safeguard its domestic enterprises and it's workers from the full onslaught of the import surge. China should also expedite the enactment of its Law of Safeguard Regulations based on the WTO Safeguards Agreement. A mechanism for handling complaints and standardizing investigative procedures will also be established. While China welcomes and encourages investments by multinational companies, it must guard against large companies monopolizing the market and jeopardizing the interests of small and medium-sized domestic enterprises. China must draw on established international models and create an environment for domestic enterprises by improving the Law Against Competition by Inappropriate Means, and by formulating and instituting anti-monopoly laws within a reformed legal system.

Following its entry into the WTO, China will benefit from the most-favoured-nation status in its trade with member states. This will give a big boost to its overseas investment and export trade. However, Chinese enterprises may face unfair or discriminatory treatment by their trading partners. At present, many countries, especially developed countries, still impose discriminatory trade restrictions on China. Since the Product Specific Safeguard provision and Non-Market Economy Anti-Dumping provisions directed against China will remain in force for 12 and 15 years respectively after China's WTO entry, discrimination will still exist during these periods. In the light of this, China will have to establish a self-regulating mechanism to prevent excessive price competition between different enterprises. China must also make good use of the WTO's dispute settlement mechanism and take prompt action against trading partners who abuse safeguards and anti-dumping measures.

In short, China should construct a comprehensive legal framework within a stated period of time, in accordance with the continued opening-up of its economy. China's lawmakers are busy checking the country's trade laws, regulations and policies to see if they conform to World Trade Organization rules. Drafts of new laws, such as the anti-dumping and anti-subsidy codes, are ready for submission. The country is also drafting laws to complete its foreign trade and investment-related legal framework.

Furthermore, the transparency of laws and regulations, an improved business environment, and a system of timely notification to creators of policy are also required. Foreign businessmen's complaints about the lack of transparency and consistency in the legal system are increasing pressure for better foreign trade and investment laws.

More hard work is required in the actual implementation of the law. The impartiality and independence of the judiciary is also a basic condition of further reform of the legal system. Governmental interference should be prohibited.

All of the above pose serious challenges to China, which lacks a strong and developed legal tradition.

APPENDIX:
Main sections (according to Shaun Donelly 2002):

TEXTILES. With WTO membership, China's export quotas will grow annually to about 25 or 27 percent by 2005, as established by other quota-setting members in the Uruguay Round Agreement on Textiles and Clothing (ATC). However, with China's tariff-rate decline, foreign high-grade textile products will flow into China, competing with domestic products. Therefore, domestic manufacturers will have to speed up their technical upgrading.

AGRICULTURE. The relatively low prices of foreign crops could bring great pressure on China's production of wheat, corn and soybeans. But entry has also meant the creation of export opportunities for crops such as rice, fruits, vegetables, animal by-products, and fish products in international markets. Therefore, China can adapt to market needs by reducing wheat and corn production and developing its food processing sectors. According to U.S. estimates, China's wheat imports from the U.S. will increase to a figure of 5 million tons, from the current level of 2 million tons, costing Chinese farmers $650 million annually. The number of surplus rural labourers may increase from about the present figure of 200 million at present. However, under the agreement, China can still implement a tariff-rate quota (TRQ) system to keep imports of products like grain, cotton and edible oil at bay during the transitional period. WTO entry will compel China to improve the quality of its agricultural products and introduce new technology and more modern means of production. Chinese-made products will have to improve their packaging, labelling, hygiene and quality before they can effectively compete with the competition abroad.

TELECOMMUNICATIONS. China will allow foreign investment amounting to 49 percent in all telecom services, and will allow 50 percent foreign ownership for value-added activities within two years and paging services within three. China will also allow foreign investment in the country's Internet-provider sector. Foreign telecom operators' involvement, however, will exert great pressure upon the country's State-owned service providers, China Telecom and China Unicom. Since many foreign telecommunications equipment manufacturers have begun to localize their production in China, domestic telecommunication equipment suppliers, especially service providers, have been struggling to survive. More foreign venture capital will flow into China and more Internet portals will be established. One of the areas that will be most profoundly influenced is electronic commerce, where a significant disparity exists between China and the advanced economies of more industrially developed states. Online payments, off-line distribution and network operation platforms, factors that have bottlenecked online stores within Chinese e-commerce, will be upgraded to international standards. A great number of ICPs (Internet Content Providers) including those that own market-leading interactive technologies and which, in addition, enjoy large website clienteles, will enter into a market battle with Chinese ICPs.

AUTOMOBILES. Chinese automobile prices are two to three times higher than international norms. But with tariffs on car imports set to drop from 80 to100 percent to 25 percent by July 2006, prices should go down across the board as the domestic auto industry is forced to become competitive and provide opportunities for ordinary citizens to own cars.

BANKING. The transitional period between China's admission to the WTO and the complete opening of its financial sector is crucial. In order to integrate its domestic financial markets into the international system, China needs to implement modern financial regulations and reduce financial risks within this transitional period. China's four State-owned commercial banks will be the first to face competition from foreign financial companies. Once powerful foreign banks are allowed to handle both local and foreign currency transactions, these four institutions will lose customers and have to substantially improve their financial services. In addition, State-owned banks will face a brain drain as foreign banks offer higher salaries to their best and brightest. The State-owned banks must accomplish their commercialisation in three to five years. Foreign banks will be allowed to take Renminbi deposits two years after accession and enter retail banking after five.

CAPITAL MARKETS. China's capital markets, money markets and foreign exchange markets will also be largely reshaped by WTO entry. Along with a rapid increase in volume, direct foreign investment should decrease but securities investment should soar. It is estimated that the inflow of foreign capital will double in three years, which would also remove many barriers in the stock and foreign exchange markets. An open financial market will lead to the efficient distribution of resources. Many problems in capital markets, such as lack of transparency and supervision will be solved in this manner.

INSURANCE. Foreign insurance firms are expected to win a substantial share of the market with the help of their advanced technologies and end the monopoly of State-owned companies. Better management and service will result. Chinese insurance firms still possess the advantages of low costs and a familiarity with the culture. Foreign equity participation will be capped at 50 percent and restrictions on where to locate eliminated. Non-life insurers may take 51 percent ownership upon accession, and may establish wholly owned subsidiaries after two years. Foreign property and life insurance firms will be able to insure large-scale risks within three years. The reinsurance market will be open upon accession.

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