Comments on Yongding Yu, “China’s Rise, Twin Surplus and the Change of China’s Development Strategy”

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Professor Yu's paper is a preliminary draft. For further revision, I expect the paper could provide information on:

(1) how the economy, including the financial system, works in China;

(2) how the state-owned enterprises (SOEs) interacts with state-owned banks (SOBs);

(3) decomposition of the current account balances, investment by ownership and public debt as shown in his Equation Nr. 7;

(4) what are the implications of China accession to WTO agreement that allows penetration of foreign banks starting from 2007?

- Without that information, it is very difficult for a layman to understand the interaction between policies and structural characteristics of the economy of China and their implications to macroeconomic records.

- The WTO accessions must have impacts on the structural characteristics of the economy that subsequently affect policies and future economic growth.

- Stylized facts:
  - China is still a transition economy with closed capital account and significant state-owned enterprise sector, both SOEs and SOBs;
  - quantitative targets are still widely used and enforced by administrative mechanism;

- Marketisation of the economy in China began in 1978 with decentralization reforms rather than promotion of private economic activities.

- Traditionally, SOEs are highly leveraged as their investments are mainly financed by loans from SOBs. SOBs receive guidance from the government both at central and local levels. The greater operational autonomy given to SOEs in 1978 reduced control of the state that allowed them to increase investment.

- When SOEs making losses, the state simply asks the SOBs to give them more credits or permits roll over of the non-performing loans to make them evergreen. As a result, NPLs of SOBs, in reality, are quasi fiscal deficits.

- The current account balance (CA) in Equation (6) of Professor Yu's paper can be simplified by using standard textbook identity:

  $$CA = (T-G) + (S-I)$$

  where: T = government revenues;
  G = government expenditures;
  S = national savings;
  I = investment expenditures;

- The modified Equation (6) can be decomposed to:

CA surplus = (government budget surplus)
+ (savings of SOEs – investments by SOEs)
+ (savings of private sector – investment of the private sector)

As role of the private sector is still insignificant in China, we can ignore its investment expenditures.

The above modified equation (6) indicates that an increase in (a) investment by SOEs; (b) recapitalization of SOBs; (c) losses of both SOEs and SOBs, including transfer of their NPLs to state-owned asset management companies, or (d) combination of (a), (b) and (c), would reduce the surpluses of both government budget and CA and, therefore, affect fiscal sustainability.

This happened in 1997-98 when the authorities in China injected new capital to SOBs and transferred a large portion of their NPLs to the state-owned assets management corporation.

- The important role of quantitative targets enforced by administrative mechanism as policy tools in China was shown by economic stabilization policy in 1993-94. To control overheating, the then Vice Premier Zhu Rongji imposed strict credit quotas to SOBs and enforced by administrative mechanism. Bank officers and provincial officials were removed from office when they allowed over-expansion of credits or rapid increase of NPL.

The impacts of the stabilization policy were immediately felt in the following year. The slow growth of bank credits since 1994 brought about the policies raised national savings (both of SOEs and the private sector) and increased surplus of the current account balances. The increased in savings of the private sector was also due to the loss in workers' pensions and social securities of the privatized SOEs.

It is nor clear how Professor Yu makes predictions about the future. As mentioned by Professor Bosworth "….the comfort of history is not a good guide to the future". Again, Professor Yu's paper provides no information on the likely impacts of WTO accession on economic institutions and development strategy of China. Is the WTO accession going to (a) liberalized the closed capital account; (b) increase the role of private sector and allow the establishment of private banks of domestic origin; (c) increase the use of market mechanism, including in financial sector to allocate credit banks and set interest rates? What are new economic policy instruments available to the authorities?