

China: One Country, Many Systems

Introduction

There is no such thing as one China. Before Xinhua starts to get excited and accuse us of being running dog, splittists, we would emphasise that we are using this terminology purely in a macroeconomic sense and in no way wish to step into the minefield of territorial integrity. However, we do feel it is a point worth stressing since once again, we are witnessing a whole new generation of investors falling in love with the 1.2 billion cans of coke concept. Far be it for China to disabuse them of course. For if foreigners have been willing to accept average returns on invested funds of around 3% over the past decade (and even this number is biased upward by Taiwanese and Hong Kong operations which tend to have a superior track record), and are still ready to come back for more, then who are the ultimate beneficiaries? The Chinese people of course, akin to the manner in which American citizens reaped the rewards of similar wide eyed investments by foreigners in their economy 150 or so years ago.

There is no such thing as one China

In this report, co-authored by Raphael Wu and Simon Ogus, we delve into China's regional statistics to investigate the social and economic impact of rapidly widening income inequality. It remains our contention that this remains the single biggest obstacle to China delivering on its WTO-imposed obligations at anything approaching the pace that outsiders are hoping for. We would stress that China continues to move in the right direction. We merely caution about potentially overoptimistic expectations and rising regulatory risk once the PRC is admitted to the club. For virtually nobody gets kicked out again once they are in.

Regional inequalities are widening. This remains the single biggest obstacle to China delivering on its WTO-imposed obligations at anything approaching the pace that outsiders are hoping for

WTO should doubtless create many jobs over time but near term, the potential for job destruction, especially in the poorer, inner regions should not be underestimated. The continued hope is that new industries can continue to absorb surplus labour from the old. Next month we intend to publish an in-depth analysis of developments in China's domestic service sector along with an assessment of the implications of creeping privatisation.

Regulatory risk will rise once the PRC is admitted to the WTO club for virtually nobody gets kicked out again once they are in

Currently, China appears to offer somewhat of a safe-haven in an environment of slowing global demand. Although economic growth is moderating on the back of decelerating external demand over the past few months, the steady upward momentum in the broader economy continues to be supported by increasing evidence of strengthening domestic demand and easy monetary policy settings. Moreover, foreign direct investment (FDI) commitments in anticipation of China's accession to WTO (if realised of

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course), suggest that the balance of payments may be rather better supported than elsewhere in the region.

Excess capacity remains widespread across many industries but nonetheless, deflationary pressures are easing somewhat; the consumer price index was rising again, by 1.5% YoY by the end of 2000, with the help of higher commodity prices and effects from various administrative initiatives such as wage hikes and (downward) price controls. Meanwhile, significant progress in economic reform continues suggesting the authorities retain a constructive restructuring game plan (albeit one that is hard to implement speedily) to clean up many of the structural problems inherited from the old system. And finally, needless to say, China continues to loom ever more important on the international stage as it attempts to broaden its regional influence and contemplates its putative WTO entry in the near future. Foreign investors are correct to view great potential from the further liberalisation of the country's closed domestic markets although whether they are correctly pricing the returns that will accrue to outside parties, remains a moot point.

The authorities retain a constructive restructuring game plan, albeit one that is hard to implement speedily, to clean up many of the structural problems inherited from the old system

This article does not seek to delve into the country's current cyclical position in any great detail. **DSGAsia** will be travelling to *Da Lu* early next month and meeting with companies and the usual suspects in the official sector. We will subsequently report back on our findings. Needless to say, we are not holding our breath that we will glean any great insights from official channels beyond GDP growing 7-8% this year but one never knows. Rather, we will concentrate on the more structural issue of growing regional disparities.

Foreign investors are correct to view great potential from the further liberalisation of the country's closed domestic markets. Whether they will make money remains a moot point

Regional disparity in the land of contrast

The premise that the whole of the Chinese economy has benefited from high aggregate income growth over the last decade ignores the problem of growing regional disparities in a land of stunning contrast. Far too often, investment bankers come back from a night out in the bars of Shanghai's Julu Lu and write breathlessly about China's inexorable march to becoming a developed market economy.¹ Such statements may be true to an extent when applied to Shanghai, Beijing, Guangzhou and a few other similar urban areas, and indeed these localities are in themselves bigger than many countries in the region, yet one needs to keep in perspective that Shanghai is

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¹ Similar sentiments can be applied to brokers' assessments of Japan after a session amongst the beautiful young things of Roppongi.



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no more the whole of China than Bangalore is the whole of India or Manhattan is the whole of the USA. And given that China's prime preoccupation over the past millennia has been in keeping the country together as a single sovereign entity, such sentiments are moreover dangerous in they underestimate or ignore the very real political, social and regulatory risks inherent in any investment decision.

Even a cursory glance at simple geography should make this phenomenon clear. China's land mass is more than half of Asia's combined, and its population almost threefold if India is excluded. According to State Statistics², Shanghai had the highest per capita income of over USD3400 in 1998 while Guizhou residents received less than one-tenth of this figure at USD280 per annum. Recent IMF estimates also show that FDI inflows to coastal region have averaged over 7% of regional GDP compared to just 1% in the western municipalities during 1993-1997³. In a similar vein, there are huge differences in consumption, saving, investment and income patterns across the different municipalities of the economy. As such, no single argument suffices to illustrate the complete situation of the whole economy. For instance, a consumption recovery argument could be well supported by the long queues seen in crowded supermarkets in Guangzhou but similarly undermined when observing rows of empty stores in cities such as Guizhou.

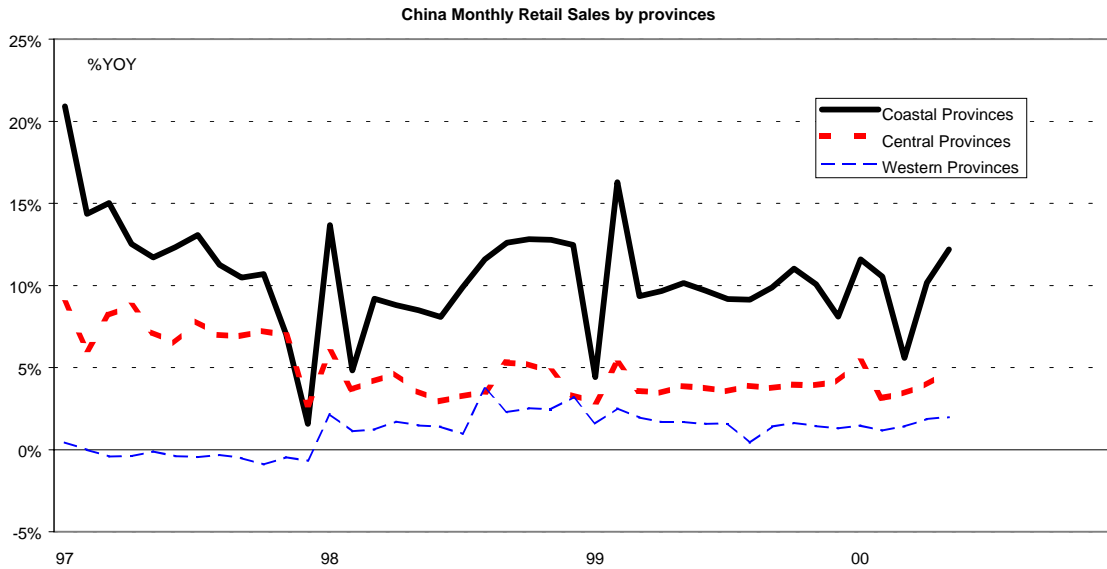
Shanghai is no more the whole of China than Bangalore is the whole of India or Manhattan is the whole of the USA

² All statistics and charts in the report are from the State Statistical Bureau unless otherwise stated.

³ Please see the IMF's May 2000 Working Paper 'Centripetal Forces in China's Economic Take-off' for further details.



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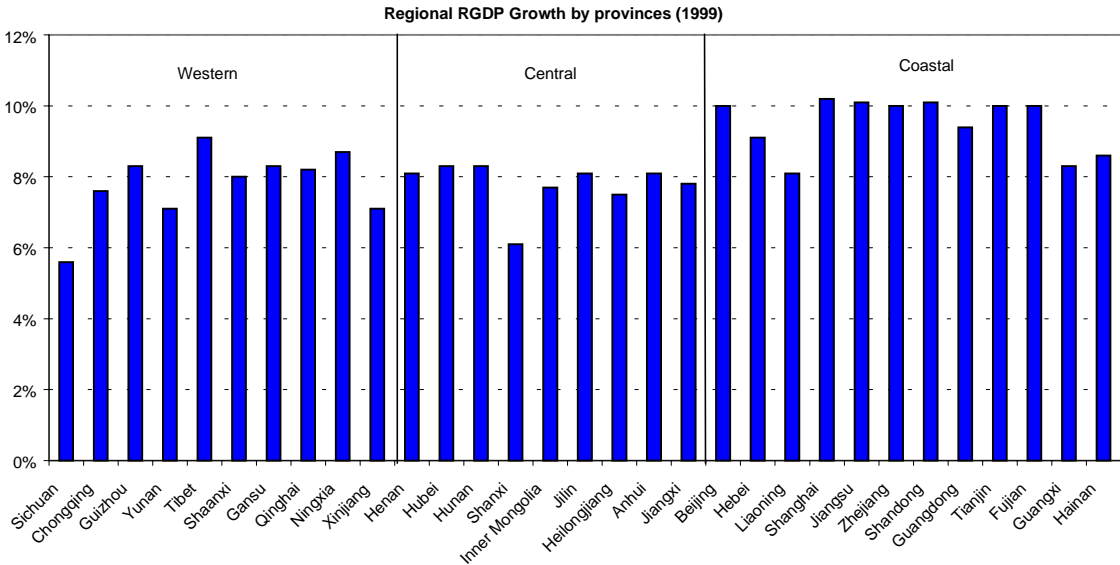
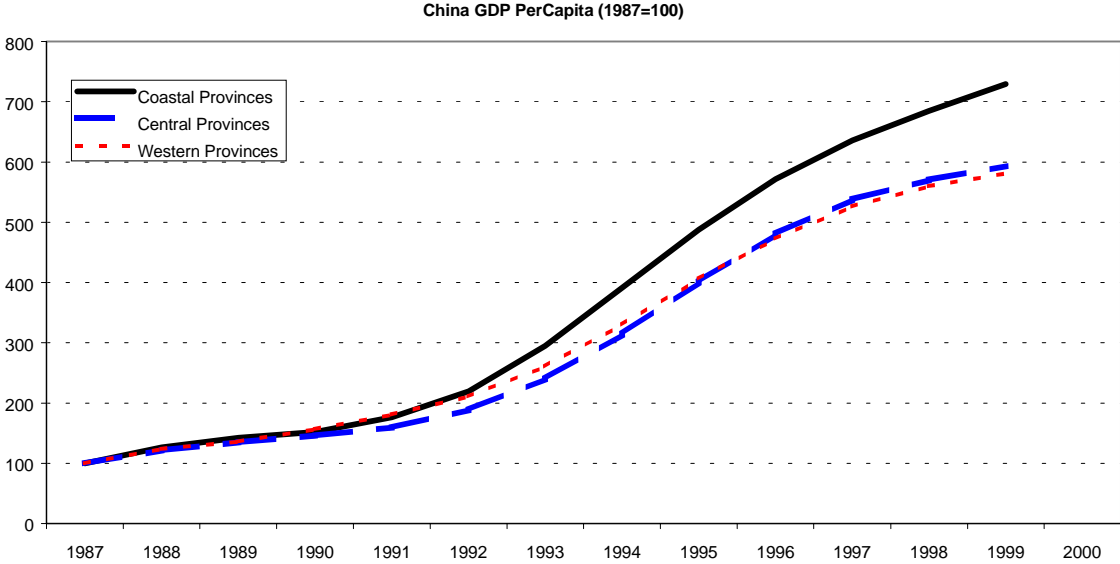


None of the above is to say that there has been no progress in even the poorest areas since the advent of the open door policy over 20 years ago. However, poverty is ultimately a relative not an absolute concept and social discontent stems from knowing about such disparities. Two decades ago, farmers in Shaanxi province were dirt poor but did not have a clue as to how their compatriots in Shanghai lived, let alone the lot of their ethnic brethren struggling under the yoke of colonialism in Hong Kong. These days, even the smallest villages have TV sets and the one of the curses of modern society, the mobile phone, is becoming increasingly ubiquitous.⁴ Greater information about inequality potentially breeds greater discontent and the over reaching goal of the authorities remains to keep such discontent in check.

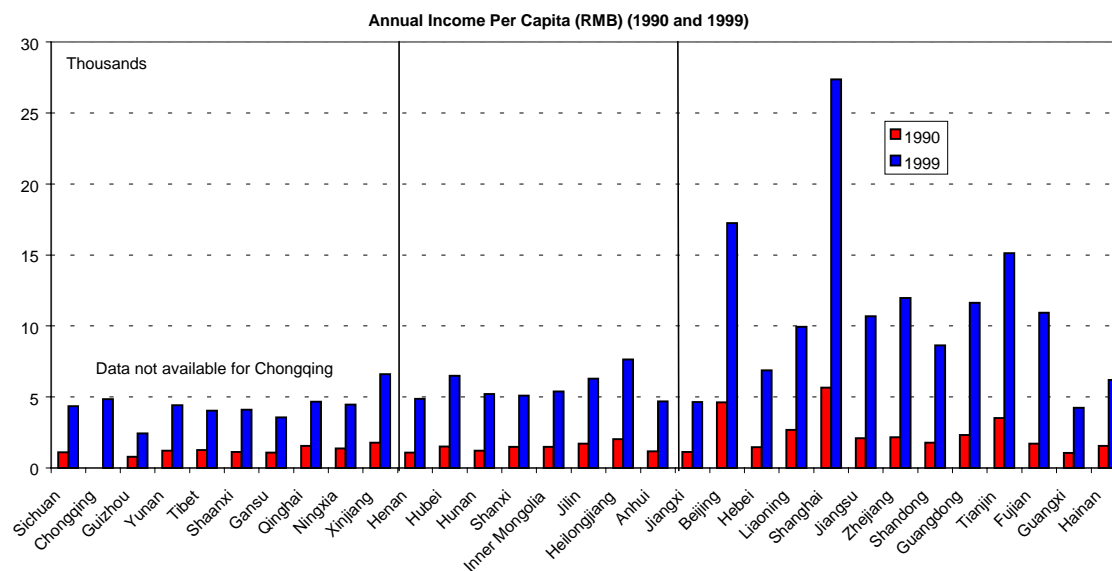
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⁴ As is another, the home Karaoke machine

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China is patently therefore *not* one big single economy. Although the entire country has enjoyed an unprecedented headline growth expansion, many areas – particular the inner provinces and the rustbelt of the SOE-dominated, industrial northeast – have seen little in the way of foreign trade, investment and capital and have lagged accordingly. Three factors have underscored this growing inequality. First slowing agriculture growth (after the initial surge in productivity that followed de-collectivisation) has resulted in a much lower levels of income in the western part of the country. Second the coast has geographical comparative advantages both in terms of consumer demographics and outward processing. Third the scale of economic reform in southeast China has created a favourable environment for many successful manufacturing and export companies. This in turn has boosted demand for sophisticated products and higher levels of service and there is little to suggest that such demand will not remain exceptionally strong for many years to come.

China is patently *not* one big single economy

Regional differences in the pattern of fiscal balances are even more pronounced. In general, coastal governments tends to run larger and better managed budgetary accounts while by contrast, public revenues tend to fall short of the rising costs of providing social services in the interior provinces. This is due in the latter case to generally higher unemployment levels and rising subsidies (on and off balance sheet) as SOEs have often been unable to come to terms with even the mild reforms introduced over

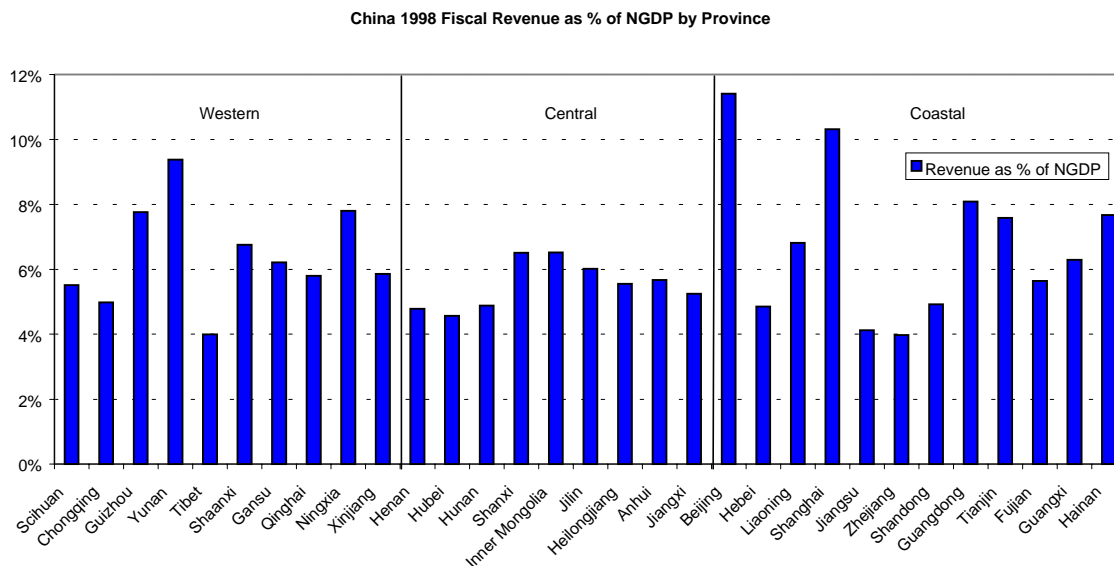
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recent years. Moreover, the quality of governance and the appreciation of market mechanisms often tend to be lacking while resource wealth remains largely untapped or grossly mismanaged. Government expenditure runs at around 200% of budget revenues in the west compared to about 130-150% in the central and the eastern regions (figures are before central government allocations are accounted for).

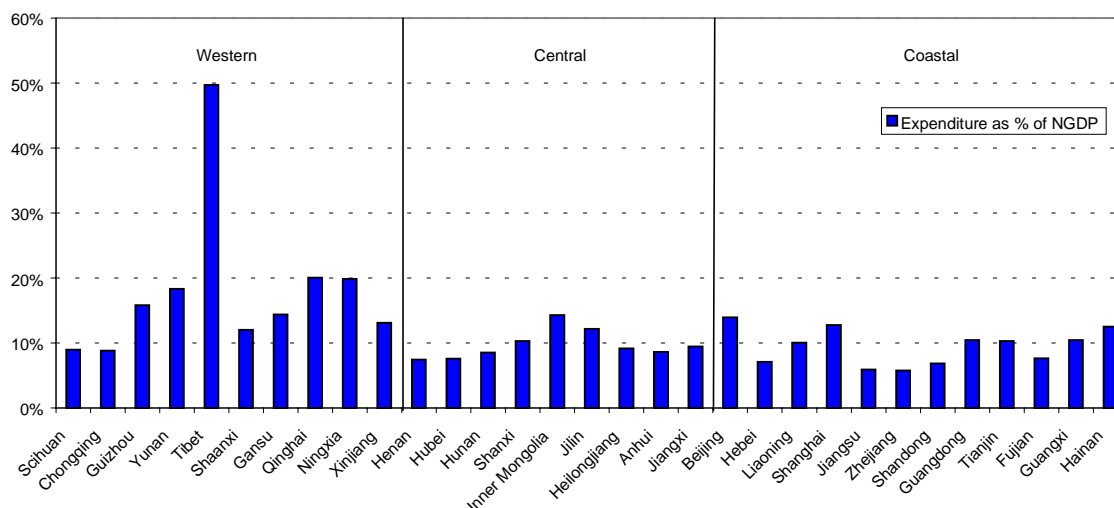
In part to ensure more equitable fund distribution and resource allocation, China has taken a number of steps to strengthen the central government's control over tax revenues. For example, in the future, all government income will accrue to the national treasury instead of local municipalities or other state accounts. However, it remains to be seen whether the government will be successful in its aims since the richer provinces seem loath to cede control over their own revenue raising and collection powers, and are also balking at increasing *de facto* subsidies to their poorer cousins. The aim of broadening the benefits of growth throughout the country is both desirable from a social stability perspective as well as an economic one. China's full economic potential cannot be achieved when so many of its human and natural resources remain under-exploited while the risk of social explosions poses a broader threat to the whole country's progress.

However, the richer provinces seem loath to increase subsidies to their poorer cousins



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China 1998 Fiscal Expenditure as % of NGDP by Province



A Chinese proverb says *kong qu dong nan fei* or *falcons fly to the southeast*. Failure to create at least basic economic anchors for the interior working population risks an additional and perhaps uncontrollable tide of internal migration to the more prosperous coastal regions. This phenomenon is already clearly illustrated by the growing numbers of workers queuing for seats back home during the Chinese Lunar New Year period. Of course this is not to argue against internal (or external for that matter) migration since China's game plan over the past decades has been to use new industries such as exports and services to absorb surplus labour squeezed out of the state sector. And over the medium term this remains an extremely sensible and potentially successful policy framework to pursue; one that has resonance in the experience of many other countries, notably America's shift westwards.

Failure to create at least basic economic anchors for the interior working population carries myriad risks

Nevertheless, it can be argued that the reforms of the recent past have been the easiest to implement since these have mainly involved creating new industries rather than dismantling old, entrenched fiefdoms. By contrast, reforms China is now embarking on – legal, bureaucratic, state-enterprise, WTO-related – cut right into the interests of those who have most to lose from the dismantling of the state's patronage, output and distribution machinery, and of those in the interior who are least prepared to face the chill winds of a competitive market system. These two groups will likely find it tactically astute to create an unholy, if unlikely, alliance to challenge

The reforms of the recent past have been the easiest to implement – the next wave will be met with greater resistance

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the dictates of the centre, and hence the risk is that implementation of further reforms will be volatile and will only progress slowly.

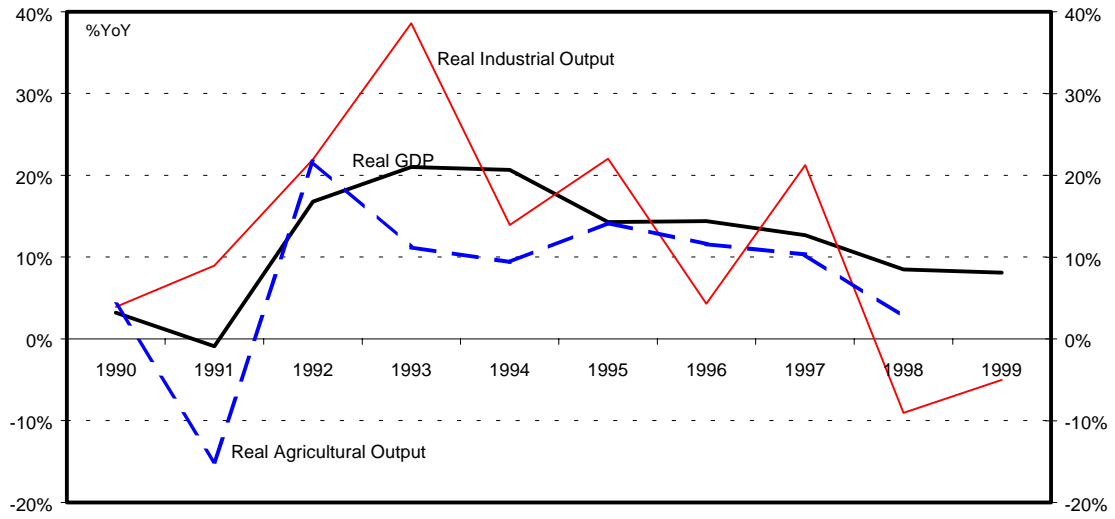
Moreover, there is growing evidence that voluntary assimilation by the coastal regions of those displaced in the interior is already hitting its limits. Delve a little deeper into the provincial statistics beyond the, surprise, surprise 7-8% growth rates reported in recent years, and rather less comforting figures emerge. Industrial and agricultural output numbers significantly lag the headline GDP numbers reported while shifts in the labour market have been seismic. Heilongjiang, in the industrial northeast provides a salient illustration. Between 1995 and 1999, urban employment fell from 70% of the provincial population to 55%; yet over the same period there was virtually increase in agricultural output despite the influx of displaced urban workers returning to their natural rural habitat. Add to this other demographic imbalances such as a lack of marriageable age females as a result of the distorting influence of China's one child policy (a trend that is further exacerbated by disproportional female migration south to work in the factories that support the export industries), and the spectre of large groups of unskilled, unemployed, bored, impoverished and unmarried men is not a pleasant one. Such conditions do not augur well for political and social stability – risks that the central authorities are acutely aware of.

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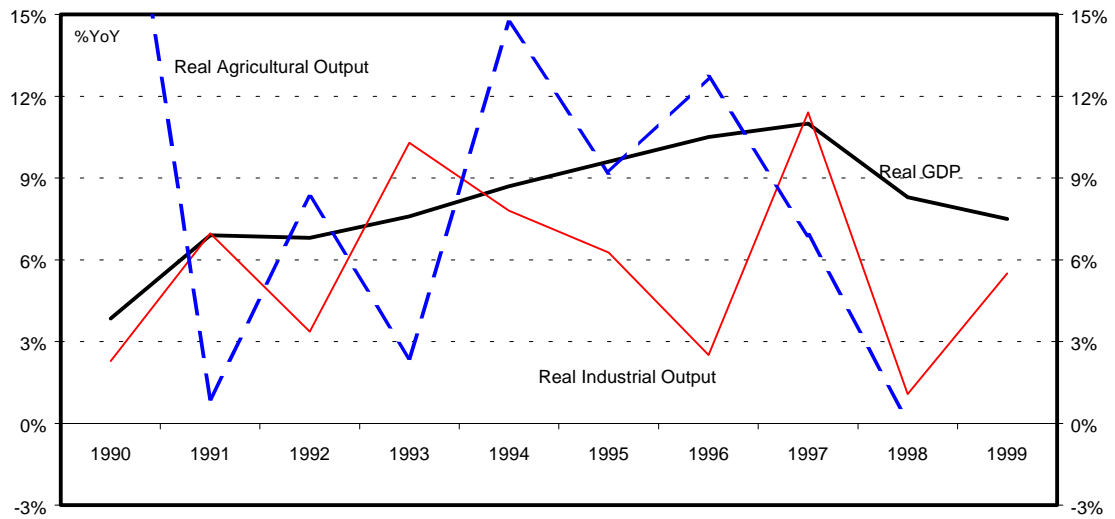


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Anhui Province



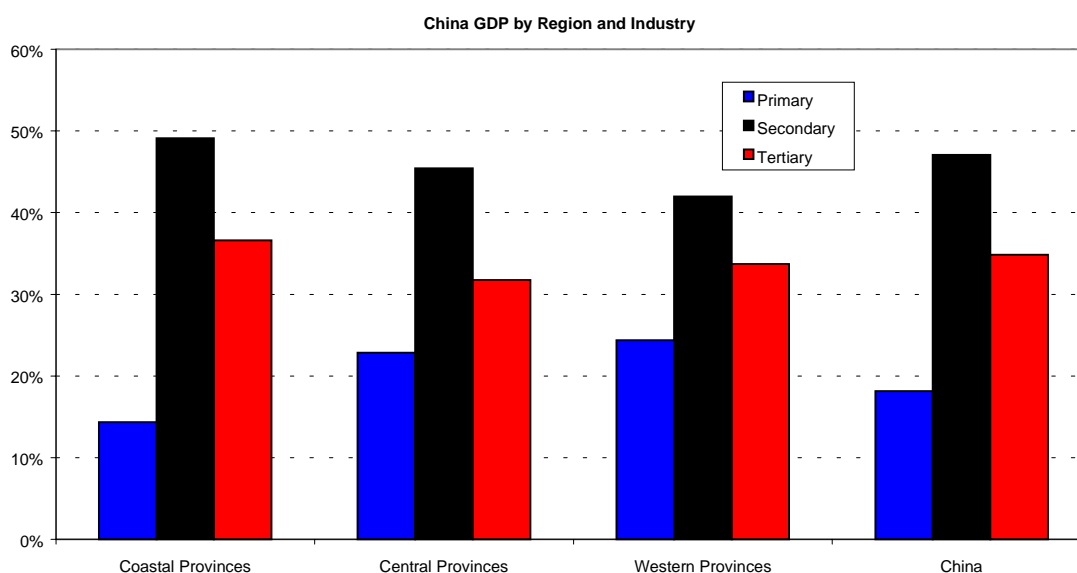
Heilongjiang Province



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The natural retort to all of this is that economic development is often accompanied by rising inequality⁵ (at least in the initial stage), and that the ongoing demographic shift will continue to provide an additional supply of cheap labour for secondary and tertiary industry development in the coastal provinces and major cities. Those who are well trained and educated are also likely to continue to be drawn to the coastal cities in anticipation of greater income prospects and opportunities. This is all fine news for foreign investors trying to set up a low-cost, quality representative office in Pudong. However, it also implies even greater divergence in income and is why the authorities have started to pursue a policy of large-scale investment in the west aimed at re-balancing this skewed distribution.

The authorities recognise all of the above and have started to pursue a policy of large-scale investment in the west aimed at re-balancing this skewed distribution



In early 2000, the National People's Congress (NPC) approved the implementation of huge infrastructure projects, as part of a policy of broader fiscal stimulus to boost domestic demand and employment, including an allocation of RMB33 billion of physical investments in the country's west. Under this 'Look West' policy, the State Development Planning Commission, which supervises foreign and other preferential investment

The result is the 'Look West' policy

⁵ True though one of East Asia's great achievements has been to stimulate economic development while ensuring that the benefits accrue to a broad spectrum of the population.

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policies, also introduced broad measures to encourage employment opportunities in the west. These policies contains several elements:

- **Infrastructure development:** This is a continuation of the state policy of boosting fixed asset investments implemented in 1998. The frenzy of construction, including new highways, bridges, tunnels, dams and high-rises has been pretty apparent in cities like Chengdu or Chongqing and the aim is now to extend this more to the interior. Although question marks remain over whether the funds are being spent efficiently or being siphoned off into the pockets of local cadres, the overall macro impact of such fiscal stimulus should remain fairly positive over the medium term given that China – unlike Japan – does require basic infrastructure for future economic development.
- **Tourism:** China's western regions are rich in natural scenery and historical relics and for years tourism revenue has brought in a considerable income for the local governments. More funds for preserving and upgrading ancient sites, and for the construction of hotels and other tourist facilities, are to be welcomed. However, the authorities will need to be vigilant to prevent the sort of excessive, inappropriate and tacky investments that have ruined many another holiday destination in the past.
- **Environmental improvement:** Arguably by improving environmental conditions, it will be possible to attract more foreign investment, technological and managerial expertise.⁶

Whether foreign companies will be eager to bring in the same amounts of capital (and enthusiasm), after their somewhat chequered record of returns in ostensibly far more attractive locations over recent decades, remains a moot point. Moreover, those most successful of 'foreign' investors, the Hong Kongers and Taiwanese, have tended to make their money by investing in and around the areas of their antecedence and have tended to fare somewhat less well when straying beyond their own clan territories. The Hong Kong businessmen who are summoned to Beijing from time to time are being seen to be doing their national service in return for continued (relative) autonomy on their home turf. However, there is little evidence that

Whether foreign companies will come in numbers remains a moot point

⁶ This is also applicable to Hong Kong, where the air quality is only slightly better than that in Chongqing

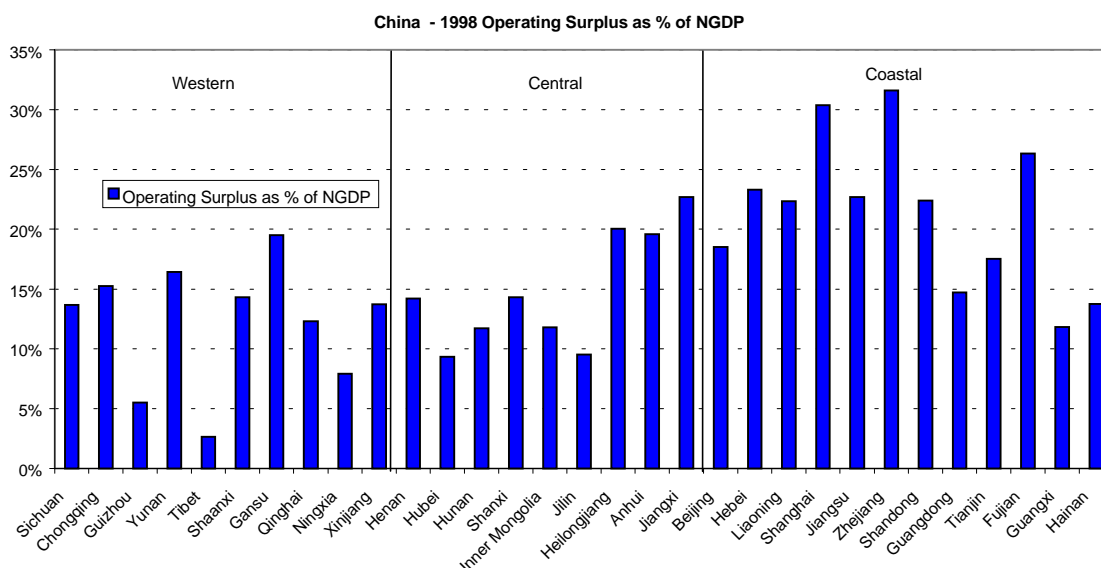


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they are voluntarily going to pour fortunes into parts of the country where they are viewed almost as much as foreigners as the *fan gweilos*.

The latter day Monkeys and Pigsies embarking on their journeys to the west will have to think carefully about prospective returns on capital. Even by China's undemanding hurdles, returns in the west are particularly poor as illustrated by official data on operating surpluses.⁷ Of course a lower starting point implies the potential for even greater upside. But investors may be wise not to hold their collective breath given the huge lack of managerial skills and institutional weaknesses of these regions.

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Opportunities doubtless exist. The industrial transformation whereby services output is gradually taking over from a falling secondary contribution in Shanghai or Guangdong should create opportunities for the interior to become one of the new cores of manufacturing production. The comparative advantages of cheaper labour costs and an abundance of raw materials near to production bases should be encouragement for investment in them selves. Set against these potentials though is an impediment of sheer

Opportunities doubtless exist due to the west's comparative advantages of cheaper labour costs and an abundance of raw materials

⁷ Operating surpluses are revenues after wages, tax and depreciation. They do not allow for interest costs nor for non-wage benefits and thus markedly overstate the true level of profitability.

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geographical distance from market compounded by still poor infrastructure links. Furthermore, the transformation in the mindset of the local population to one attuned to capitalistic notions such as quality and productivity, as opposed to sheer volume of output, may take many years. Unlike in Guangdong or Shanghai, the west had little broad experience of market mechanisms even before the revolution and institutions and attitudes may be slow to adapt to the changes demanded by such economic transformation.

So how does all of this impact on the potential returns available to participants in the securities markets? Directly, very little it might seem at first blush since most foreigners are far more involved in parts of the economy miles away (metaphorically and literally) from the wild, wild west. Nonetheless, we believe that such an attitude is somewhat naïve since it disregards the very real regulatory and policy risks that are entangled with all of the social imperatives driving the centre's wish to boost the interior. As we have already suggested, delivery on undertakings made as part of the WTO accession process will fall disproportionately on the parts of the economy that remain nonviable. Indeed, many of the well-managed SOEs in the coastal areas are going to have difficulty facing intensifying competition from foreign companies.

Unemployment concerns will make it difficult for China to live up fully to its commitments once admission is granted – at least at the pace that foreigners are currently pricing. Moreover, many of the senior bureaucrats, cadres and state managers have little interest in seeing China move to a more open, competitive system; rather they have every interest in pushing for a post Soviet Russia type outcome and diverting resources and monopoly power to themselves. This is not to say that the centre does not recognise this as a threat or is compliant in the process. We strongly believe that the coterie of functionaries around Zhu Rongji truly wishes to use WTO as a Trojan Horse for successfully reforming the SOEs and hence to cement the continued legitimacy of the Communist Party. However, what was promised without the advance knowledge of more reactionary forces cannot be as easily implemented without strong resistance. For the moment they are being kept relatively quiet as the country puts on a show of unity to ensure that the national prize if international acceptance is achieved. Nevertheless, once China is in the club, the real bargaining begins. Rumbblings from parties such as the telecommunications ministry could be a good portent of what to expect from others going forward.

Foreign investors need to be aware of the very real regulatory and policy risks that are entangled with all of the social imperatives driving the centre's wish to boost the interior

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From a near term perspective, China and Hong Kong (along with India) appear to be facing the lowest macro risks of any countries in the region. Although trade flows are likely to continue to moderate while the US adjusts to a slower pace of demand, WTO-inspired FDI flows should lead to China's overall balance of payments being better supported than most. Meanwhile a weaker USD and lower USD rates will help to keep monetary conditions on an easing path which should also help to underpin recovering, albeit patchily, domestic demand. The potential problem for foreign investors is that much of this has been priced for many months ago and this raises questions of valuation and also risks of disappointment on delivery relative to expectation. These will come about not because China wishes to disappoint. Rather because domestic social and political concerns will act as brakes on central action once WTO accession is finally done and dusted.

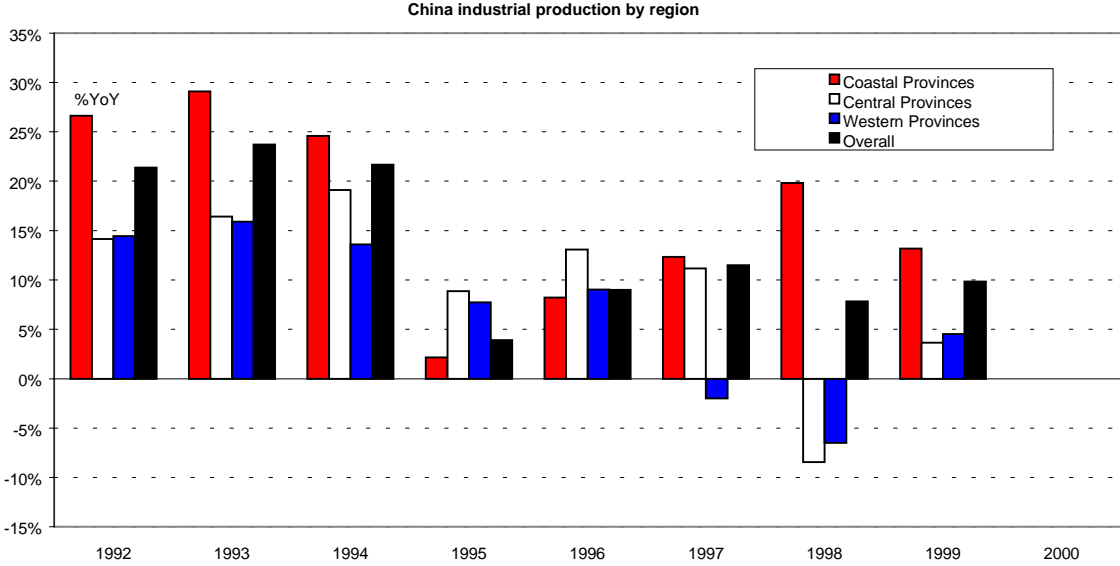
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Regional Per Capita Income Growth Rates					
% YoY	1978-82	1983-87	1988-92	1993-97	1978-97
North	5.6	9.4	5.9	11	8.3
Northeast	4.1	9.6	4.4	9.2	7.5
Coastal	8.8	12.3	8.3	13.5	10.5
Southeast	7.4	9.9	5.5	12.3	9
South	6.9	9.1	6.4	9.1	8.2
West	4.2	10.1	4.7	7.8	7.2
China	6	10.5	6.3	8.8	8.3

Sources: IMF



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Key economic indicators in respective Chinese provinces

Area	Coastal Provinces			Central Provinces			Western Provinces		
	Guangdong	Shanghai	Beijing	Jilin	Anhui	Jiangxi	Gansu	Chongqing	Sichuan
RGDP %YoY	9.4%	10.2%	10.0%	8.1%	8.1%	7.8%	8.3%	7.6%	8.3%
NGDP (1998, RMB bn)	791.91	368.82	201.13	155.78	280.55	185.92	86.98	142.93	358.03
Population (1999, mn)	72.70	14.70	12.60	26.60	62.40	42.30	25.43	30.75	37.10
Annual Income Per Capita 1999, RMB)	11636.2	27374.5	17253.0	6285.2	4690.1	4650.7	3577.7	4840.7	2445.6
Foreign Capital Actually Utilized (1999, USD mn)	12638.94	4601.94	1627.45	408.55	452.62	487.97	51.54	452.71	64.06
CPI (1998, %YoY)	-1.8%	0.0%	2.4%	-0.8%	0.0%	1.0%	-1.0%	-3.6%	-0.4%
RPI (1998, %YoY)	-3.0%	-4.9%	-1.7%	-2.1%	-1.9%	-1.2%	-1.9%	-5.5%	-2.3%
CPI in Services (1998, %YoY)	5.9%	14.4%	21.3%	7.9%	14.4%	12.2%	5.6%	4.8%	9.6%
Retail Sales (1999, RMB bn)	365.61	159.05	129.79	73.4	97.84	65.03	33.15	59.64	31.37
Retail Sales Growth %YoY (1999)	12.50%	8.20%	11.30%	9.50%	6.40%	8.80%	9.00%	-	8.20%
Industrial Production Growth (1999, %YoY)	48.80%	31.00%	10.50%	-1.50%	-30.10%	-16.20%	-7.20%	-	-13.70%
Exports (Latest Month, USD bn)	7459.32	2174.11	587.73	85.27	192.61	116.2	-	-	97.32
Illiteracy Ratio	9.25%	10.19%	6.51%	8.43%	20.53%	13.48%	28.65%	15.45%	15.70%
Total Investment (1998, RMB bn)	264.413	196.638	112.462	43.178	72.261	40.06	30.145	49.297	114.533



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