When the East Asian financial crisis ran rampant in the region and the world financial market suffered turbulence in 1998, China adopted appropriate policies to maintain the stable trend of economic development. It is estimated that the overall world economic environment is unlikely to make a big positive turn in 1999, in which case it will pose a grim challenge for China's economy. The issue of common concern is what policy to adopt to ensure that China's economy continues to grow at an appropriate rate.

The major problems facing China's economy are a slowing growth rate, insufficient demand and deflation. This situation began in mid-1997 and became apparent in the fourth quarter (Graphs 1 and 2). In October 1997, the price level began to fall continuously.

During the first half of 1998 the situation became worse. The underlying reasons were as follows:
1. The aftermath of the policies aimed at controlling the severe inflation during 1992–94 (Graphs 3 and 4).
The breaking of the “Iron Bowl” and the housing and health care reform have brought increasing uncertainty to households. Thus the propensity to save has been rising (Graph 6).

2. The reform of the state-owned enterprises has reached a critical moment, with millions of state-owned enterprise workers having to leave their jobs each year starting from 1997 (Graph 5).

4. The lingering effects of the East Asian crisis resulted in lower exports (Graph 7).

Graph 5
Unemployed state-owned enterprises workers
In millions

Graph 6
Propensity to save and to spend
Annual percentage changes

Graph 7
Export growth in 1998
Year-on-year percentage changes
Facing such a situation, the Chinese Government, together with macroeconomic authorities, adopted policies to increase domestic demand and stimulate economic growth in 1998.

The policies took effect on both the supply and demand sides.

With regard to demand, the macroeconomic authorities took a more aggressive fiscal and accommodative monetary policy stance. On the one hand, a RMB 100 billion Treasury bond was issued. The receipts were invested in infrastructure construction. On the other hand, the central bank lowered interest rates three times.

With regard to the supply side, starting from mid-1998 the Chinese Government began:
1. to implement the policy adopted by the 15th Communist Party Congress held in September 1997, which encourages development of various kinds of ownership of business and requires the Government to eliminate the prejudice against the development of private business;
2. to establish specific government institutions for small and medium businesses (establishing the Small and Medium Business Department in the State Economic and Trade Commission);
3. to require the banking system to take measures to increase loans to small and medium businesses; and
4. to lower the tax rates applied to small and medium businesses. In addition, some provincial governments have increased their support for these businesses.

Therefore, the growth rate of small and medium businesses began to pick up in the second half of 1998. For the whole year, the industrial output of township enterprises increased by 17.5% (Graph 8). For enterprises with sales revenues higher than RMB 5 million, the growth rate of value added increased by an average of 8.8% annually, of which that for state enterprises was 4.9%, collective enterprises 8.7%, shareholding companies 11.9%, foreign funded enterprises 12.7% and private businesses 19.6%.

The effects of the above stimulatory policies became apparent after September 1998 with all the macroeconomic indicators ceasing to fall and the national economy showing a positive turn (Graph 9).

Economic prospects in 1999

However, such a benign turn was unstable because, first, the growth of investment was mostly from state sources, with almost no increase from the private sector and a decrease of 3.5% in the collective ownership
sector. Investment from state sources rose by 19.6%, while the increase for society as a whole was only 14.1%, lower than the targeted minimum at the beginning of the year; second, consumption was not stimulated, with relatively higher growth in stocks.

Since the East Asian economies cannot recover very quickly, also considering the uncertainty in the economies of Europe and the United States, economic stability in China in 1999 relies mainly on increasing domestic demand. However, fiscal investment in infrastructure should not be used as a major policy measure to stimulate domestic demand. Therefore, we must find a new growth engine to realise the objective, and thus to ensure that the economy continues to improve and gradually enters a stage of stabilised growth.

Faced with such a situation, practitioners and academics have suggested the following (demand stimulating) policy options:
1. to continue to apply expansionary fiscal policy;
2. to apply expansionary monetary policy in a more manifest manner; and
3. to activate the consumption market, including the vast rural market.

The Government must adopt strong supply-side policies to reinforce the micro foundation of growth through reform. In the light of international experience and China's own national situation, it is very difficult for macroeconomic policy that aims to stimulate growth through increasing demand to be effective without vitality on the supply side and microeconomic reform. For example, to activate investments from the private sector relies not only on developing new financing channels and improving the financing mechanism, but also on fostering the growth of private businesses and their willingness to invest. A major obstacle to activating the rural market is the slow growth of rural income: this can only be increased through the development of small and medium enterprises, which may create more jobs to which the excessive rural labour force can transfer.

Providing the necessary stimulus requires three major steps.

The first is that the development of small and medium private businesses must be encouraged. Over the past 20 years of reform and opening to the world, these enterprises have had some development. Since 1998, the Chinese Government has made it a national policy to foster the development of small enterprises. But due to the predicament in ideology and the legacy of the planned economy, there were all kinds of obstacles in the way of small business development. In 1997, the CPC Party Congress established that private businesses are an integral part of the socialist market economy. This notion will be added to the Constitution some time this year. At present, various levels of government are making efforts to eliminate the prejudice toward these businesses and to provide more services to them in accordance with the government policy of fostering the development of small enterprises. Now China has millions of non-state small businesses. We will improve their operational environment and tap their full potential.

Second, action is needed to address the lack of development and systemic weakness of the financial system. The financial system is as important a framework as the circulatory system of the human body in that its soundness is a matter of life and death. There are the number of serious weaknesses in the financial system, especially the large amount of non-performing assets left over after the financial bubbles burst. The accumulation of years of non-performing loans is eroding people's confidence in China's financial system and the prospect of economic development and is forming a hidden risk of a financial crisis. The work to solve these problems started in 1998, and should be further enhanced in 1999. In 1998 the Chinese Government issued a RMB 270 billion Treasury Bond for the recapitalisation of the four state-owned banks so that their capital adequacy reaches 8%, the ratio required by the Basel Accord. The authorities are strengthening supervision of the financial market and financial institutions. The authorities have ordered banks to make plans for restructuring their non-performing assets. The insolvent businesses and financial institutions will be restructured or liquidated.

The third necessary policy is the reform of the state-owned enterprises and restructuring of the state-owned economy. The Chinese Government has decided to restructure the big state-owned enterprises into modern corporations. In 1997 the Government reordered the ownership structure, reducing the scope of the state-owned economy and promoting a multiple ownership structure in accordance with Deng Xiaoping's principle of forming an ownership structure conducive to increasing productivity, enhancing national strength and increasing people's living standards. In recent years, the Government has made some useful experiments and gained valuable experience. Now both the Government and people in the industries are discussing how to quicken the reform in restructuring the state-owned enterprises in the near
future, in order to revitalise the large industrial enterprises, commercial businesses, foreign trade companies and financial institutions.

The proper execution of the above measures will facilitate the stable growth of China’s economy in 1999. If things go smoothly, China will enter a new era of growth in late 1999.