China's Latent Economic Crisis and Potential Risks

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Since the beginning of broad ranging economic reform [in 1978], China's economy has been growing at a pace that commands the world's admiration. Entering the 1990s, however, the high-speed growth of the virtual economy has produced a large number of bubbles. Arguably, the major factor contributing to the dramatic growth of our country's economy in the past twenty years has been rapid investment. However, the quality of economic growth produced by this "investment, investment and more investment" model has been relatively mediocre. In recent years, the bubbles accumulated through sustained, ineffective supply have become a cause for concern that further development might be accompanied by potential risks.

Before the breakout of the Asian financial crisis, Western scholars La Roche and EIR issued an alert. La Roche's analysis is based on a material economy. He notes that there are two aspects of an economic process: (1) operation of financial currency and (2) production, distribution, and consumption of material products. He thinks that today's world economic system and vast wealth assume the form of an upside-down pyramid, at the bottom of which are material products. Above these products are services as well as commerce and trade; further above are bonds, stocks, currencies, commodity futures, etc. Sitting atop the pyramid are derivatives and other forms of virtual capital. La Roche argues that in any economic system, if the balance between physical assets and financial assets is tipped, an economic crisis will occur. It seems that among the variety of methods employed in analyzing the Asian financial crisis, the one used by La Roche and EIR has been relatively effective. Therefore, in this article the author will borrow their method to analyze the physical and financial dimensions of China's economy so as to reveal its real conditions.

1. <u>Potential Risks associated with a Latent Economic Crisis</u>

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In recent years, China's financial conditions have remained a topic of discussion both inside and outside China. This author once pointed out: there exist in China serious risks associated with a latent financial crisis, which may be a combination of all the features of the financial crises that struck several different countries, namely South Korea, Mexico, and Thailand.[2] What are the differences of the financial crises of the three countries? Why is a possible financial crisis in China likely to combine the features of the crises in all three countries?

The so-called "South Korean style crisis" refers to financial crises resulting from the long-standing relationship characterized by non-performing loans (NPLs) between industrial conglomerates and banks, as was typified by the situation in South Korea. Such a relationship is very similar to the vast debt chain between China's state-owned enterprises (SOEs) and domestic banks. If calculated pursuant to the newly issued accounting and auditing principles, a substantial portion of SOE debt takes the form of loans from state-owned commercial banks and thus the creditors are the same type of institutions as the debtors. The average ratio of indebtedness of all SOEs is over 83% and many loans are unlikely to be paid back.[3] At present, a considerable portion of individual and institutional borrowings from banks falls into the category of "ill-intended loans," which means the borrower never intended to pay back the loans. In June 1998, Guangzhou Intermediate People's Court published for the first time a list of "deliberately-insolvent tycoons," many of whom had the ability but no intention to pay back their debt.[4] According to statistics released by the People's Bank, as of the end of 1994, the four major specialty banks alone posted a total of 532.3 billion *yuan* (Renminbi) NPLs, which had increased to 1,000 billion *yuan* by the end of 1996, contributing to an average NPL ratio of nearly 30% for the whole system of state-owned banks. This number is four times more than their assets. The high NPL ratio has greatly reduced liquidity and solvency of banks and other financial institutions, planting the seeds of insolvency and a possible run on the banks. At present, the loss ratio of SOEs continues to climb. In 1997, the total amount of operating loss reached 130-140 billion *yuan*, leading to the deterioration of the NPLs between SOEs and banks. Since the banks were forced to use their own assets to make up for the losses, the capital adequacy ratio of state-owned banks continued to decline. By the end of 1996, it had already dropped to about 3%, 5 percentage points lower than the 8% level required by "the Basel Accord." In June 1998, Hainan Development Bank terminated its operation, the main reason being excessive losses caused by an overwhelming load of NPLs.[5]

In the past several years, China has maintained the operation of its financial system mainly by issuing an excessive amount of currency through the central bank and increasing the loan limits of state-owned commercial banks so as to avoid insolvency that may result from NPLs and the vast debt chain. However, there is a limit to such an approach. Since the claim on loans provided by banks to businesses constitutes "soft assets," banks have to take a loss whenever there is a case of insolvency. On the other hand, the citizens' deposits constitute the "hard debt" of banks. The imbalance between such "soft assets" and "hard debts" can cause the payment chain of the financial system to break at any time. If this trend is allowed to continue, commerce and bank credit may experience a sudden collapse, giving rise to social upheavals and devastating recessions. By last year, a common understanding had been reached in China that non-performing assets of banks were indeed the most likely trigger of a financial crisis. To date, however, banks are yet to come up with effective means to get rid of non-performing assets.

The characteristics of the so-called "Thai style crisis" are undue dependence on foreign capital and misguidance of investment. The international community has long since determined that one of the factors that caused the Thai financial crisis was over-investment in real estate properties. Similar problems were identified in China as early as 1993 when China set about cleaning up the finance of "special economic zones." However, because the kickback in commercial home construction projects was on average over 10-15% of the total budget of related projects and individual members of the management team were able to pocket sizable gains, many new commercial building projects continued to be launched despite the fact that large numbers of completed buildings were hard to sell. As a result, the market suffered indigestion and the number of unsold commercial homes increased dramatically (see Table 1).

Table 1. Accumulation of Unsold Commercial Homes

Year	Accumulation (Square Meter)	Annual Increase (Square Meter)	Rate of Increase
1994	32,890,000		
1995	50,310,000	17,420,000	52.96%
1996	62,030,000	11,720,000	23.30%
1997	71,350,000	9,320,000	15.02%

Source: "A Diagnosis of Unsold Commercial Homes," Real Estate Page, *China Industrial and Commercial Time*, July 30th, 1998.

Half of these unsold commercial homes are concentrated in developed areas, of which Guangdong, Shanghai, Zhejiang, Jiangsu, and Liaoning make up respectively 19.8%, 13.6%, 9.1%, 8.9%, and 6.0% of the nation's total. The main reason for the low occupancy rate is that prices are too high, even higher than developed countries (see Table 2). The majority of people belong to the low-income or medium-income categories and it is impossible for them to afford such expensive homes. Since there are not many buyers at the market, a huge gap exists between supply and demand. Such a gap reduces the effectiveness of the policy aimed at stimulating economic growth with real estate development. It is unbelievable that home prices in a developing country are much higher than those in developed countries. At the same time, the state does not benefit from giving away land use rights. The essential factor contributing to such a phenomenon lies in the fact that numerous corrupt government officials at various levels have turned real estate development into a grand "banquet" of pocket lining.

Table 2. Ratio Between Home Price and Annual Family Income for Selected Countries

U.S.	Canada	U.K.	Brazil	Australia	Sweden	China
2.8:1	4.8:1	3.7:1	5.7:1	4:1	1.8:1	12:1

Like Thailand, China attracted a large amount of foreign capital before setting up adequate financial control mechanisms. In the past four years, China has topped the list of developing countries in capital inflow. Worldwide, it comes next only to the United States. China has always stressed the uniqueness of its domestic conditions and rejected using prevailing international standards to calculate foreign exchange reserve surplus, but quite a few indicators in Table 3 are significantly different from normal standards, which implies that if nothing else, China's pace of foreign exchange increase should slow down. Although the Bank of China has used part of the reserves to purchase foreign debt securities, thus earning some income, such measures have incurred relatively high opportunity costs, for that portion of the reserves has not been used as production-related investment, thus limiting technological progress and economic growth. This is particularly true of developing countries like China.

Table 3. China's International Balance of Payment

	China	International Alert Level/ International Standard	Notes
Ratio Between Foreign Exchange Reserve and Short-Term Debt	617%	80%	Indonesia 73%, Malaysia 186%, the Philippines 84%, South Korea 147%, Thailand 109%
Foreign Exchange Reserve Capable of Import Support	7 months	3-4 months	
External Debt and GDP Ratio	15.5%	50%	External Debt Outstanding as of 1995: 106.5 Billion US Dollars; Capital Inflow of 1979-1995: 229.1 Billion US Dollars
Current Account Deficit and GDP Ratio	-2.5%		Past experience indicates that a ratio between 0-5% is conducive to economic growth, greater than 5% or smaller than 0% is harmful to economic growth.
Foreign Exchange Increase Rate and GDP Growth Ratio	2 Times	0.3-1.2	Applies to developing countries only.
(Foreign Direct Investment + Current Account Deficit) /GDP	5.7%	2.5%	

Source: "A Macro-Analysis of China's Economy: 1997," National Economy Research Institute (Beijing)

An excessive surplus of foreign exchange reserve may also generate inflationary pressure and reduce the effect of government policies intended to reduce inflation. According to the current regulations on foreign exchange transactions, the central bank has to buy all the foreign exchange inflow. If the central bank wants to exercise strict control over the total amount of credit extended, it will have to take into account money used to purchase foreign exchange. As a result, it has to strictly control loans not related to foreign exchange transactions. In this way, institutions or enterprises without access to foreign exchange find it so difficult to obtain loans that they have to limit or even halt production. In addition, based upon information disclosed in the past two years or so by banks in Shenzhen and other places, there have been instances in which large amounts of external short-term funds have flowed in for "ill-intentioned" arbitrage. International financial speculator George Soros has "sincerely advised" various governments that "it is the fault of the government to leave room for speculation in the marketplace." As long as the government leaves room for speculation in the marketplace, some people are bound to engage in speculation. Therefore, the government should be on high alert.

The so-called "Mexican style of crisis" refers to financial crises caused by substantial capital outflow. Some researchers in our country have conducted comprehensive and systematic analyses, which conclude that since 1985 China's capital outflow has made up as much as 52.3% of the foreign debt increase, a ratio surpassing the average capital outflow ratio of the world's 15 most-indebted countries in the 1980s. Entering the 1990s, China's capital outflow approached or even surpassed annual newly incurred foreign debt, taking fourth place in terms of capital outflow, after only to Venezuela, Mexico, and Argentina.[6] In other words, while the Chinese government borrows extensively abroad, about half of the capital secured is lost through various channels, and part of it may have “disappeared” for good.

In a report submitted to the OECD, a consultant at London Royal Institute of International Studies pointed out: from 1989 to 1995, the total outflow of China's long-term capital may have exceeded 100 billion US dollars and about half of this amount was not been approved by the Chinese government. The report stated: "Not all the long-term capital outflow has been approved by the government. Most of it found its way out of China through illegal channels, as is reflected in the numerous ‘errors and loopholes’ in the capital account of international balance of payments. Such outflow has climbed from 330 million US dollars in 1989 to 17.8 billion US dollars in 1995 (including direct investment and investment in securities)." The report also pointed out: up to 1994, most of China's external investment was concentrated in Hong Kong, Australia, Canada, and the United States. China's illegal capital outflow constituted an important source of funds that contributed to the prosperity of the real estate and financial markets in Hong Kong and other areas. By 1995, Chinese businesses and individuals had invested a total of 30-40 billion US dollars abroad.[7] At the same time, in Vancouver, Los Angeles, and other cities, the number of real estate properties and stores purchased by immigrants from Mainland China increased dramatically, indicating an on-going capital outflow from China.

No doubt, large capital outflow has had a significant negative effect on China's economy. On one hand, the state pays a high price to obtain external debt; on the other hand, substantial funds flow out and disappear forever. Some researchers hold that since China's capital inflow is greater than outflow, the outflow has not led to decrease of capital formation or recession. The author cannot agree with such a view. In any country, capital outflow would constitute a great loss; it may even cause the economy of a country to collapse. Prolonged capital outflow may eventually diminish a country's foreign exchange reserve, lead to a credit freeze, and prevent it from securing loans from abroad. If the government tries to stop the outflow by raising interest rates, it may lead to a reduction in supplies, causing wages and prices to spiral up, thus destabilizing the economy and speeding up the outflow by aggravating the worries and concerns of foreign investors. Therefore, large capital outflow is likely to trigger an all-out financial crisis and political unrest. In addition, the country's creditworthiness will be greatly reduced in the international market for many years to come, such as in the case of Mexico. When the Mexican financial crisis broke out in 1994, the initial analysis by some institutions indicated that the crisis was caused by political instability, which gave rise to the dumping of the peso. Later on, the investigative report published by the IMF pointed out: the real trigger of the crisis was that a large amount of capital controlled by domestic investors flowed out. From 1976 through 1994, Mexico's capital outflow made up as much as 64.8% of foreign debt increase, ranking second in the world. The lesson from the Mexican financial crisis is China's simply cannot overlook the potential danger from consistent and increasing capital outflow. The above analysis shows that China is indeed faced with risks of a possible financial crisis. Such risks were highlighted with the closedown of quasi-bank corporations like China Agricultural Trust and Investment Co., China New Technology Investment Co. and other non-bank financial institutions.[8] If the Southeast Asian financial crisis was caused by a break in the chain of payment to the outside world, then China is likely to be hit by a financial crisis caused by a break in the chain of domestic payment. Once China's latent financial crisis comes to the surface, it will cause greater damage to the economy than the Southeast Asian crisis and will be more difficult to deal with.

The growth of financial assets marks a transition from the economic growth (increasing wealth through labor) phase to the wealth distribution (or outright robbing) phase. The latter requires a relatively high social productivity and a certain level of average income reached by members of the society. Evidently, China has not met such requirements. China's latent financial crisis is inseparable from the sophistication of financial speculation and such sophistication cannot be compared directly with developed countries. In developed countries, the overall economy can contain a certain percentage of bubbles without triggering a financial crisis, but it would be inappropriate to conclude that China can afford further expansion of financial speculation on the grounds that the above-mentioned percentage has not been reached. When judging whether a country's financial activities are above or below the desirable level, one must consider whether this country's economic development is commensurate with financial development. If we conduct such a comparison in the case of China, we will find that China's financial development is "early-maturing," particularly in regard to financial instruments (such as stocks, bonds, and futures). In recent years, China's material production sectors have suffered from low profit margins, but immense wealth can be accumulated through financial transactions. Such a pattern of wealth distribution cannot be explained with theories about the division of labor and specialization: judging from the overall wealth of a society, physical wealth has to be created through labor instead of multiplication (or even explosive growth) of financial transactions. The essence of excessive financial activities is to redistribute the material wealth of society through paper money.

In recent years, China has experienced an explosive growth of financial instruments, which is in essence speculation rather than "modernization" of the financial system. This type of speculation has produced a huge gap between China's physical assets and financial assets and caused certain layers of the financial pyramid to break. The speculation has led to another consequence: the proportions made up by the primary and secondary industries in the total economy are declining too fast and too early, while the living standards of the people have not reached a relatively high level, and the society has yet to achieve high-speed wealth creation by means of technology. On the surface, the financial market is prosperous, but in reality further development of the national economy lacks a solid foundation.

2. The "Fault" between Material Production and Consumption

Since macro-adjustment measures were taken in 1993, lack of effective demand has become a challenge that prevents further economic development. In recent years, the government has tried to stimulate demand through various channels, such as encouraging real estate development and private ownership of automobiles, but without much success. Such a situation is related not only to the above-described deterioration of the financial conditions, but, more deeply, to the serious imbalance between physical assets and financial assets. On one hand, due to an irrational economic structure, much of the supply is ineffective; on the other hand, due to unfair social distribution, people at low-income and medium-income levels, who make up the majority of the population, do not possess adequate means of consumption. Since 1998, the slowdown of China's economy has been increasingly apparent and all sorts of problems resulting from the irrational economic structure have been revealed.

The irrationality of the economic structure is highlighted by excessive production capacity and a distorted industrial structure. In the past 20 years, China basically took the path of high investment, high inflation, high employment and high growth. Although the high-speed increase of investment stimulated economic growth and to some extent loosened up energy, transportation, and other "bottlenecks," it also led to excessive production capacity. Accompanying this problem is distortion of industrial structure. On the one hand, there exists a surplus of low-quality and outdated products, such as steel, petrochemicals, and machinery; on the other hand, products which have a high technology content, such as specialty steel, precision digital-control machinery, and potent compound fertilizer, have not been able to meet demands. Moreover, there has been a great deal of redundancy across different sectors and regions both in traditional and emerging industries. For example, almost all the economic sectors have built up their own machinery-making capacity. Another example is that not only enterprises in light industries are engaged in food processing, but trade organizations or even military facilities also make investments in this area. During "the ninth 5-year plan" period, 22 provinces and independent municipalities gave priority to development of an automobile industry and 24 provinces and independent municipalities also listed electronics as one of their "pillar industries." This type of investment is bound to end up with an industrial structure characterized by low quality products, small and scattered production facilities, and high cost. Because of various constraints, it is difficult to achieve industry consolidation and form large, competitive enterprise groups. For instance, there are over 1,700 steel companies in China, twice as many as the total of all other countries combined. In developed countries, the average annual output of a steel company is 10 million metric tons, whereas ours is only 54,000 metric tons. The cause for such a distorted industrial structure lies in slow progress in economic reform. China is still at the "simulated market economy" phase, with economic resources controlled by the administrative power rather than distributed through "the invisible hand" of the market.[9]

Given the distorted industrial structure and excessive surplus of goods, the vicious competition within sectors has entered a phase of mutual destruction. For instance, this year competition in shipping containers, air-conditioners, VCDs, and three-wheeled farming vehicles has become so intense that the prices of many products have fallen below their cost.[10] Some companies are even engaged in unlawful activities, such as distributing anonymous letters aimed at stigmatizing the competition or soliciting the help of the gangsters to drive the competition out of one's "turf." A good example was last year's beer battle in Qionglai County, Sichuan Province. The local beer factory resorted to connections with both the "black" (gangsters) and the "white" (government) to drive Blue Sword and Red Sword (both brands produced by a non-local company) out of the local market. Surprisingly, the local government supported such hooligan means of "competition" and declared that the action was to "protect Qionglai's economy" and that "Qionglai has its beer factory;

if it can't pay the workers, then the workers won't be fed."[11] At present, the central government does not have any effective methods to solve such problems and the only thing it could do is to request that "as for product areas where excessive production capacity exists and where supply exceeds demand, resolute measures must be taken to limit output, compress inventory, and strengthen sales so as to maintain reasonable price levels." Such requirements, which are aimed at setting the minimum price and limiting price wars, can only alleviate the symptoms, but will not cure the "disease."

After the "four little dragons" or "four little tigers" emerged in East Asia, China's southern and southeastern regions have also embarked on a path of export-oriented development. However, the key to the success of this model lies in the ability to upgrade products. If it takes too long to improve the technology content and quality of products, the products will not be able to compete in the international market. Over the years, most export products have been low-end processed products, from "bits and ends" in early years to "yarn and cloth" in recent years. Although by now industrial products have climbed to about 85% of the total value of export, labor-intensive and half-finished low-end products still make up over 70%. In the wake of the Asian financial crisis, China's labor-intensive and half-finished products obviously faced tougher hurdles. According to Xu Fuxing, head of the Technology Development and Technology Export and Import Department of the Ministry of External Economic Cooperation and Trade, China's foreign trade cannot stay at the level of "trading one aircraft for tens of thousands of tons of pork;" instead, transition to technology-intensive products must be effected, otherwise there will be no way out.

In the past four years, China's technology exports have increased an average of 43.5% annually, twice as much as total exports increased, which was 20%. For the first half of last year, the total value of technology export contracts still reached 2.54 billion US dollars. Major export projects like a Thai refinery, a Sri Lankan cement production line, an Indian heat-engine power plant, a Burmese shipping yard, and a Macedonian power plant were each around 100 million US dollars for technology and equipment. However, the technology content accounted for only 5% of the total export value, which is very low indeed. Although the government has issued a series of support measures, there is still a long way to go before China significantly increases the proportion of technology exports.

When both investment and exports face challenges, domestic consumption becomes particularly important. Looking back upon various hot consumption areas since 1980s, we can see that although the nation-wide savings has reached over 5,000 billion *yuan*, nearly half of the financial assets are in the hands of the richest 10% of the population, while the majority of the people belong to the low-income and medium-income category. An urban family with median income is still limited in its consumption potentials. Having cleared the threshold of 1,000 *yuan* consumption level (capable of purchasing big-ticket home appliances) in 1980s and early 1990s, these families now need to buy their own homes, but commercial homes are out of their reach. At the same time, farmers, who make up the majority of the nation's population, do not have adequate consumption capacity. Of the total retails sales, less than half is accounted for by rural residents. There are other reasons for the lack of vigor in the vast rural market, including structural inconsistency between supply and demand, an outdated wholesale and retail infrastructure, constraints on commodity flow, etc., none of which can be solved within a short period of time.

Low consumption is also related to the poor quality of industrial products. While consumers increasingly demand good quality, factories continue to put out large quantities of shoddy products, which can only increase the inventory level. Over the years, poor quality has been hampering the development of China's market economy. It has also been a hot subject of consumer complaints. To improve product quality, the State Bureau of Technology Supervision (SBTS) has, starting from the second half of 1995, been conducting quality surveys for selected new products, with 129 types of important products covered. Thanks to these surveys, product quality has improved appreciably. However, based on the findings of the survey conducted in the second quarter of 1998, the situation still warrants concern: of the 53 types of products from 1,904 companies, the average pass rate was only 77.8%. Of the different types of companies surveyed, large SOEs in the "pillar industries" of the national economy enjoyed a pass rate of 95.4%, but the pass rates for small collective enterprises, private enterprises, and individual entrepreneurs were respectively 69.8%, 59.7% and 50%. Special area surveys revealed that in low-tech products such as baby formulas and home gas cookers, both small collective enterprises and private enterprises had a pass rate of 0%.[12]

Based on the above analysis, we can see that there exists a gigantic "fault" between China's market supply and demand, which explains why various stimulus measures taken in recent years have not been effective and constitutes a new "bottleneck" in economic development. When there is one fault line between physical assets and financial assets and another fault line between production and consumption, stimulation of consumption will not be effective unless the fundamental problems are solved first.

3. Modernization of Business Enterprises: A Strategy for In-Depth Reform and Crisis Prevention

To eradicate the root causes of economic crisis, China must first address problems in material production, namely, to carry out in-depth enterprise reform and improve the "system environment" in which enterprises operate.

Enterprise development in the past 20 years can be divided into three periods. The first period started in 1978 and ended in 1993. During this period, thanks to better circulation of commodities brought about by market liberalization, commercial entities were presented with opportunities to make huge profits; the industrial entities, too, also attached great importance to commercial transactions, including raw material purchases and product marketing. Areas with high concentration of energy and raw materials, taking advantage of the differences between state-stipulated prices and market prices, witnessed rapid accumulation of wealth. In 1993, the government started a macro-adjustment process and business enterprises entered the second period of development, which was dominated by industrial capital. The average profit margin of commercial entities declined while that of the industrial entities rose. During this second period, areas with a solid industrial base, such as Guangdong, Zhejiang, and South Jiangsu, achieved remarkable growth. On the other hand, areas depending mainly on production of energy and raw materials gradually lagged behind. As a result, regional differences became more apparent. The year 1997 began with a new round of changes and business enterprises entered the third period of development. After 20 years of rapid development, the speed of growth declined, the overheated market began to cool down, and the imbalances within the economic structure became more pronounced. There emerged not only a fault between supply and demand, but also a fault between physical assets and financial assets. The chain of domestic payment in the financial system was likely to break at any moment. All these problems presented business enterprises with serious tests and challenges. More and more enterprises, besieged by a host of problems including reduction of workforce, placement of displaced workers, and digestion of non-performing assets, were under tremendous pressure to survive. As a result, enterprises had to devote their full attention to short-term problems, with little energy left to explore ways of further development.

According to competitiveness reports published in 1996 by the World Economic Forum and Lausanne International Institute of Management and Development, of the 46 countries and areas surveyed, China ranked 28th in technology elements, 32nd in basic research, 39th in science and technology education, 3rd from the bottom in technology management, and second to the last in financial resources available for enterprise technology development.[13] In developed countries, the proportion of economic growth resulting from progress in science and technology has been on the rise, increasing from about 20% at the beginning of the 20th century to 60-70% in the 1970s-1980s and 90% in the 1990s. At present, the "knowledge-based economy" is becoming all the more important. However, besieged by problems accumulated over the years, such as excessive inventory, outdated equipment, continuous losses, reduction of work force, placement of displaced workers, and over indebtedness, Chinese enterprises are left with no resources to improve their competitiveness.

In enhancing the competitiveness of enterprises, it is far from enough to rely solely on changes of organizational structure and property ownership (e.g. mergers of strong partners), because enterprise competitiveness is built upon the social system, whose strength as well as the overall qualifications of the citizens will ultimately make a decisive difference. No matter how capable a business entity is of self-improvement, it cannot resist the system; on the contrary, to ensure its survival and development, it must comply with system requirements. For instance, if there is ample room for "rent-seeking," businesses will be induced to commit bribery so that contacts can be made with those powerful government officials in control of resource allocation and ready to exchange power for money; otherwise, businesses will not be able to survive. China's "system environment" generates a structural force which dictates the current trend of reform as well as behavior of government and business enterprises. China's financial institutions as well as business enterprises are well aware that the ultimate outcome may prove undesirable, but driven by such a structural force, they nevertheless flock towards it.

China should not go any further along the current reform path. In order to achieve modernization, China must allow business enterprises to modernize first. If business enterprises are allowed to drag on within the current system environment, China's modernization will lose its foundation. This is a real problem that cannot be solved by resorting to the new "religion" of nationalism and shouting "No." Under the current difficult situation, the only way out is to keep cool-headed and create a rational system environment for business enterprises as well as an effective legal framework for the market. Only by doing so can China reinvigorate its business enterprises and improve competitiveness so that the root causes for an economic crisis will be eradicated.

Notes:

[1] He Qinglian, The Financial Crisis That Faces China at the Turn of the Century, *21st Century*

(Hong Kong), December 1997.
[2] Speech by Chen Qingtai, Deputy Commissioner of State Economic and Trade Commission, at the "Conference on Cities Selected for Acquisition and Bankruptcy Pilot Program" in Taiyuan city, Shanxi Province, July 31, 1996. Taken from *Guangdong and Hong Kong Information Daily*, August 4, 1996. The SOE loss numbers quoted were for 1996. The 1999 numbers were much worse.
[3] *Guangdong and Hong Kong Information Daily*, June 16, 1998.
[4] *Guangdong and Hong Kong Information Daily*, June 23, 1998.
[5] Wang Jun, “China's Total Capital Outflow and Structural Analysis,” *Reform*, No. 5, 1996.
[6] “China Has Become An Important Source of World Capital,” *Financial Times* (U.K.), December 27, 1996. Taken from *Reference News*, January 8, 1997.
[7] “Can China's Financial Trust Industry Get out of the Trap*?” China Industrial and Commercial Time*, August 31, 1998.
[8] He Qinglian, “The Historical Orientation of China's Reform,” *Modern China Studies* (U.S.), No. 1, 1999 (Volume 64), pp. 47-48.
[9] “Mass Suicide of "Whales" of China's Shipping Container Industry,” *Investment Guardian*, July 6, 1998; *Guangdong and Hong Kong Information Daily*, August 25, 1998; “No Winner out of A Bloody Battle,” *China Industrial and Commercial Time*, July 7, 1998.
[10] “A Spear from the Front While An Arrow from Behind: A Sectoral War,” *Shenzhen Commercial Daily*, August 12, 1998.
[11] *Southern Weekend*, August 28, 1998.
[12] *China Market Economy Daily*, March 18, 1998.
[13] In this report, China ranked 6th in R&D resources thanks to its No. 2 position in total human capital and No. 4 position in total number of enterprise employees.