

DEPARTMENT OF NATIONAL DEFENCE  
MINISTÈRE DE LA DÉFENSE NATIONALE

China: Economic Difficulties  
Lead To Project Cancellations.  
IAC Special Assessment, 4/81

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COPY NO./EXEMPLAIRE NO. 7  
DATE/DATE 12 February 1981  
ISSUE/DOCUMENT SA 4/81

**REPORT BY THE  
INTELLIGENCE ADVISORY COMMITTEE**  
**RAPPORT PUBLIÉ PAR  
LE COMITÉ CONSULTATIF  
DES RENSEIGNEMENTS**

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1150-110/J6 (DGIS)

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IAC Special Assessment 4/81  
Approved: 12 February 1981

CHINA: Economic Difficulties Lead to Project Cancellations

Summary and Conclusions

1. Economic difficulties are forcing Chinese authorities to issue orders to scale down construction of the planned US \$5 billion Baoshan steel complex, resulting in the cancellation and suspension of contracts with foreign companies. A number of other industrial projects involving foreign participation have also recently been suspended or cancelled. Concern at senior policy-making levels in China regarding control over state budget deficits and other major state financial outlays appears to be the key specific reason for the move. Shortages of experienced and reliable financial administrators, and local pressures on regional authorities for increased employment, are among the important factors operating to frustrate adequate central government management of limited state funds. Some lack of sympathy with present national policies exists at regional levels and may be contributing to central government financial problems. The decision to reduce the commitment to the Baoshan project underlines the serious and far-reaching deficiencies in all of the construction/design capabilities currently at the disposal of the central government, particularly with respect to large-scale economic programs and plans. It will be some time before China can correct these deficiencies. This latest Chinese decision regarding Baoshan should lead Western firms currently contemplating any major technical and financial involvement in China to proceed with caution.

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Rapport d'évaluation spéciale du CCR 4/81

Date d'approbation: le 12 février 1981

CHINE: Des difficultés économiques entraînent l'annulation  
de projets

Résumé et conclusions

1. En raison de difficultés d'ordre économique, les autorités chinoises sont obligées d'ordonner que soient réduits les plans de construction du complexe pour la fabrication et le traitement de l'acier à Baoshan, dont le coût avait été évalué à \$5 milliards E-U., ce qui entraîne l'annulation et la suspension de contrats conclus avec des sociétés étrangères. Un certain nombre d'autres projets industriels auxquels devaient participer des entreprises étrangères ont aussi été suspendus ou annulés récemment. Cette mesure découlerait surtout, semble-t-il, de l'inquiétude des échelons supérieurs du gouvernement chinois devant le peu de contrôle exercé sur les déficits budgétaires et autres grandes dépenses de l'Etat. La pénurie d'administrateurs des finances expérimentés et honnêtes, ainsi que les pressions que font les localités sur les autorités régionales pour obtenir plus d'emplois, sont au nombre des facteurs qui contribuent le plus à empêcher une saine gestion, par le gouvernement central, des fonds publics assez limités. Les régions n'approuvent pas entièrement les politiques nationales actuelles, ce qui aggrave peut-être les problèmes financiers du gouvernement central. La décision de réduire les plans de construction de l'énorme projet de Baoshan fait ressortir les lacunes sérieuses et profondes que comportent toutes les compétences en matière de construction et de design dont dispose actuellement le gouvernement central, surtout lorsqu'il s'agit de programmes et de projets économiques de grande envergure. Il faudra du temps à la Chine pour combler ces lacunes. Cette décision récente concernant Baoshan devrait inciter les sociétés occidentales qui envisagent actuellement de grands projets techniques et financiers en Chine à agir avec prudence. (CONFIDENTIEL)

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Discussion

2. The Chinese Government, under the pressure of serious economic problems, has decided to suspend construction of large portions of the Baoshan steel complex near Shanghai and to prolong the completion date of major components of the complex now under construction. In addition, a number of other industrial projects in petrochemicals, mining and non-ferrous metals involving foreign participation have recently been cancelled or suspended. Baoshan is the largest industrial complex now being built in China with foreign assistance. The value of the basic steelmaking and ancillary plant complex has been placed at some US \$5 billion, although Chinese officials have concluded that the ultimate cost could be two to three times higher once expenditures on all infrastructure support facilities have been included. The Chinese decision to curtail radically construction of the Baoshan complex places immediately at risk Japanese and West German contracts worth some US \$1.85 billion (including second-phase capacity expansion of the basic steel mill plus hot strip and cold rolling mills). Chinese officials have indicated that their decision on Baoshan reflects difficulties with the present national economic policy of readjustment and the attendant financial problems. (CONFIDENTIAL)

3. The most apparent economic problem currently faced by the Chinese central government is the further budgetary deficit in 1981, following heavy deficits in 1979 and 1980. Recent large, new state programs aimed at improving the incomes of farm and industrial workers have boosted state expenditures well beyond the state's capacity to generate budget revenues. Budget revenues actually fell in 1979 and 1980, largely as a result of decisions which allow firms throughout the country to retain a larger portion of their

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income by reducing the quantities of tax monies that normally go to the central government budget. We consider that the dimension of current imbalances in budget revenues and expenditures could not have been predicted by the Chinese Government because central authorities did not have the planning capacity nor control over regional activities to be able to foresee or measure the mix and size of the administrative and operational problems that would be encountered in the period 1979-81. (CONFIDENTIAL)

4. The collection of taxes by the central government has proved to be more difficult than might have been anticipated. The problems appear to relate to a combination of central and regional administrative inexperience, incompetence and skullduggery. Critical national shortages of professionally trained and experienced accountants are evidently bedevilling central and regional attempts to implement new financial procedures. Adding to the confusion are apparently widespread arbitrary reductions in the remission of taxes as well as deceptive and illegal evasion of taxes by various regional authorities.

(CONFIDENTIAL)

5. The problems with budget expenditure are at least as great as those experienced on the revenue side. We assume that Chinese officials made some attempt to forecast the amount of budget funds which could be saved through implementing readjustment policies. Those forecasts were evidently far too optimistic, judging by the criticisms in the official press regarding capital program implementation. The biggest difficulty has been a failure to reduce effectively expenditure for new investment, which is a large portion of total budget expenditures. This has been one of the most important factors contributing to the wide gap between budget revenues and expenditures.

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6. In a drastic move last year, the central government cut by one-third the quantity of funds to be allocated by the state budget for total capital construction investment in 1980. To the dismay of the Government, the total of state budget plus non-budget funds spent for investment in 1980 increased by a large margin over 1979. Therefore, far from being able to reduce total capital spending, the Government lacks the power to stop it from rising. Funds released by the central government to the regions, and intended to increase the productivity of industries producing such things as consumer goods, are being diverted into regionally inspired new investment projects. The bulk of these investments will probably never produce a pay-back equal to their costs and are therefore inefficient outlays. They do not have the favourable economic effects of outlays used to boost pay packets when workers produce more goods which people want. The ultimate loser in this case is the state budget. Inefficient investments in new enterprises never produce effective taxes, but highly profitable consumer goods firms do and, most importantly, more or less immediately.

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7. The central government does not have enough able financial personnel and other specialists to enable it to tighten its control of national financial flows. Even if such personnel were available, this alone would not necessarily cure all current problems. Strong pressures at the regional level make it difficult for local officials to withstand popular calls for increased local employment and new industries to improve the local standard of living. It is also possible that some of the central government's problem is derived from a regional conviction that the centre does not really take its own policies too seriously.

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The Baoshan steel works is a case in point. From a regional standpoint, the project has probably appeared to contradict the central government's claim that it wanted a cutback in inefficient, poorly planned, large-scale, heavy industrial undertakings. In this regard, while a portion of the cost of the multibillion dollar project is known, the final costs are in fact indeterminate because some large expenditures lie well out in the future. It is also probably generally known in regional official circles in China that no adequate engineering feasibility study and cost-benefit analysis appear to have been undertaken either by the Chinese Government or the participating Japanese companies before the Baoshan project was commenced. The Chinese authorities did not carry out the studies, apparently because they are desperately short of experienced architectural-engineering and economic personnel. The Japanese companies were eager to undertake this project and probably assumed from the specifications given them by the Chinese Government that adequate basic engineering and economic studies in support of the project had been undertaken. Some grounds therefore seem to exist for regional concerns that the centre either has not taken itself seriously or that it has been operating one policy for itself and a different one for the regions.

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8. Although it is likely that financial considerations regarding both the domestic and foreign currency costs of Baoshan are at the root of the central government's decision to curtail the project, the move cannot help but aid the centre to impress on the regions the seriousness of the former's readjustment aims. From a domestic standpoint, the cutbacks therefore have several real immediate advantages. Externally, however, China is likely to find that such cutbacks bear a high cost. The Japanese Government may reduce its aid commitments to China, and

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Japanese firms may prove reluctant to commit themselves to any similar large-scale project in the near future.

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9. While Japanese organizations will have to shoulder some of the blame for their present contractual and financial problems at Baoshan, their experience is a salutary lesson for the Western business community with existing or pending interests in the Chinese economy and market. As a result of shortages of technical experts and funds, the Government of China is currently incapable of competently participating in the designing, planning, managing and funding of large-scale industrial projects. It will be some time before China can train sufficient numbers of personnel to undertake these projects. Therefore, any Western firm intending to help develop a large-scale complex in China may have to consider insisting on having virtual control of all construction/design responsibilities and on having iron-clad guarantees regarding payment for goods and services.

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