
10. China's macroeconomics in the 40 years of reform

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China set out on the road of reform in 1978 and was gradually transformed from a centrally planned to a market economy. In the 40 years between 1978 and 2017, the economy maintained an average annual growth rate of 9.6 per cent. Per capita gross domestic product (GDP) increased from US\$490 to US\$7,795 in 2009 constant dollars.¹

What led to the rapid economic growth in the past 40 years? What problems arose, and why? What will be the future trend of growth? This chapter will attempt to provide brief answers to these questions.

Why China embarked on the road to reform

By 1978, China's centrally planned economy had reached a dead end. After the devastating impact of the Cultural Revolution, the economy was on the brink of collapse.

China established a planned economy in the 1950s with reference to the Soviet model. Almost all enterprises were state-owned, producing goods according to the central plan. All profits were turned over to the government. Collectivisation took place in agriculture and the government purchased products at below-market prices.

At the beginning of the state-owned economy (1953–57, the first five-year plan period), there was strong momentum in development. The annual growth rate of GDP was 9.2 per cent and the growth rate of residents' per capita consumption was 4.5 per cent. However, in this period, the centrally planned economy was not fully formed. Private industry and commerce coexisted with the state-owned economy before 1956 and the free market had not been banned.

Comprehensive nationalisation took place in 1956. The private economy disappeared. Subsequently, the Great Leap Forward and communalisation, launched by Mao Zedong in 1958, and the Cultural Revolution, launched in 1966, led to

1 All data in this chapter are from the National Bureau of Statistics (NBS) unless otherwise indicated.

sharp economic contraction. GDP fell by 32 per cent between 1960 and 1962 and by 10 per cent during 1967–68. Growth was restored afterwards, although the energy has weakened significantly.

In the 25 years (1953–77) prior to reform, GDP grew at an average annual rate of 5.9 per cent—slightly higher than the global average over the same period. According to Angus Maddison's (2001) purchasing power parity (PPP) measure, China's average growth rate was 5 per cent during the period 1950–73, which was not significantly different from the global average of 4.9 per cent during the same period. During the subsequent four years, China's official GDP growth rate was only 4.2 per cent.

In the 25 years of the centrally planned economy, the government mobilised the country's resources for industrialisation, substantially boosted the investment rate and enabled preliminary industrialisation. From 1952 to 1977, the rate of capital formation increased from 22.2 per cent to 34.7 per cent and the rate of consumption dropped from 78.9 per cent to 65 per cent (both as a share of GDP). During this period, industrial value added increased by 11.3 per cent annually—much faster than GDP. The industrial share in GDP rose from 17 per cent to 43 per cent. There was considerable production capacity in various industrial sectors.

The whole society paid a huge price for the rapid industrialisation during this period. The development of agriculture and service sectors was slow and people's income and consumption growth was even slower. The government forced the acquisition of agricultural products at low prices to ensure urban supply and low industrial costs. Business profits were entirely turned over to the state—mainly for government investment in industry—with almost no increase in wage levels. From 1952 to 1977, the real growth rate of per capita consumption of rural and urban residents was 1.7 per cent and 3 per cent, respectively. These statistics are likely overstated, although they are significantly lower than the 5.9 per cent GDP growth rate and 3.8 per cent per capita GDP growth rate.

In 1977, the last year before reform, 250 million of China's 780 million rural residents were living in abject poverty. The living conditions of urban residents were better, although there was a serious lack of consumer goods. Food, clothing and other basic consumer goods were subject to supply rationing. In 1977, the national average per capita savings deposit was just RMB19 (US\$11).

Industrialisation was accelerated at the expense of people's income and consumption, through administrative power and compulsion. Efficiency in this economic system gradually diminished—contrary to the original intention of catching up with developed countries. All economic activities were subject to government control, and people's enthusiasm for development and creativity were severely suppressed. Misallocation of resources and production inefficiencies were widespread. For the

period 1952–77, economists estimated total factor productivity (TFP) was between 0 per cent and –1 per cent (see, for example, Chow 1993; Wang 2006). Despite the rapid expansion of industrial capacity and a few extraordinary technological achievements, such as the development of nuclear power and missile technology, technological progress was in general very limited.

China's per capita GDP in 1973, measured by PPP, was \$839 (international dollars in 1990 prices)—only one-fifth of the global average at that time, less than half the average of 56 Asian countries and far below that of Japan, South Korea, Singapore, and China's Taiwan and Hong Kong (Maddison 2001). China's relative position in per capita GDP in the world was little changed from 1950. In this sense, China in the planned economy period failed to bring its people to prosperity or to narrow the huge gap with developed countries. Instead, growth gradually lost its energy in the long run.

These failures motivated China—after a decade of retrogression during the Cultural Revolution—to start the transition from a centrally planned to a market economy.

Economic growth accelerated rapidly from the beginning of the reform period, and has stayed high for nearly 40 years. Real GDP in 2017 was 39 times that of 1977, surpassing Russia, Canada, Italy, France, the United Kingdom, Germany and Japan to become the second-largest economy in the world.

During the 40 years of reform, urban and rural real income per capita increased annually by 7.3 per cent and 7.6 per cent, respectively. Per capita consumption of urban and rural residents increased annually by 6.4 per cent and 7.2 per cent, respectively—both of which were lower than the 8.5 per cent growth rate of per capita GDP, but much higher than in the pre-reform period. Measured by the official poverty line of RMB2,300 per annum (2010 constant price), the incidence of rural poverty fell from 97.5 per cent in 1978 to 7.4 per cent in 2016.

However, there have also been serious economic challenges. Income inequality widened, particularly in the past two decades. There has been serious corruption inside the Communist Party and the government. There is serious overinvestment and waste of public resources. The economic structure is imbalanced and TFP has been decreasing in recent years. There is excessive intervention by the government in the business sector, and the speed of economic growth is diminishing.

Initial battles to break the old system: 1978–84

In December 1978, the third plenum of the eleventh Central Committee of the Communist Party of China (CPC) repudiated the Cultural Revolution and decided to reform the economic administrative system. The plenum also decided to

substantially increase the purchase prices for agricultural products (grain purchase prices were increased by 20–80 per cent). This meeting marks the beginning of the reform period.

Agricultural reform that feeds farmers

The first change was in the rural economy. The pre-reform system of people's communes had very low productivity and farmers generally remained poor. Mass production and an egalitarian system of income distribution, which replaced household production and household ownership, were economically inefficient. The government purchased grain at far below market prices and severely restricted farmers from selling products through the market. These arrangements dampened the production enthusiasm of farmers. In 1977, China's national grain output was 283 million tonnes and the average yield only 2,600 kg/ha of raw grain. After fulfilling the state requisition, many farmers were left hungry.

In 1978, farmers in Anhui and some other areas began a 'household contract system' to allow household production, in violation of official rules. This stimulated farmers' enthusiasm for production and significantly increased output. Some prefecture and provincial party and government leaders supported the change, which caused fierce ideological debate among senior leaders about socialism and capitalism, but eventually the reformers won. From 1979, the government allowed farmers to experiment with various modes of production and gradually liberalised the restriction on the household contract system (HCS). By 1984, the HCS (also known as the household responsibility system, or HRS) had spread throughout the country and the people's communes were abolished. Farmers were allowed to sell their products through the market.

From 1977 to 1984, national grain output rose from 283 million to 407 million tonnes. Output of cotton, oilseeds, fruits and some other agricultural products increased even more rapidly. The persistent problem of food shortage had been resolved. Substantial increases in output, increases in state purchase prices and the liberalisation of the agricultural product market together led to a 15.7 per cent real annual increase in farmers' incomes from 1978 to 1984. In the same period, agricultural value added grew at an annual rate of 6.8 per cent—up from 2 per cent in the period 1952–77. This lifted total annual real GDP growth by 1.5 percentage points over this period.

TVE development: Providing 50 million jobs

Agricultural reform raised labour productivity. With limited arable land, about half of China's rural labourers were no longer needed. Following the easing of policy restrictions, township and village enterprises (TVEs, formerly known as commune

and brigade enterprises) that engaged in nonagricultural production developed rapidly in rural areas, and became important in accelerating economic growth. Urban reform had not yet started. State-owned enterprises (SOEs) were still chronically inefficient. TVE production responded to market demand, quickly making effective use of labour resources. TVEs became the frontline force in market-oriented reform.

TVE employment increased from 23 million in 1977 to 52 million (11 per cent of total Chinese employment) in 1984, and to 106 million in 1992. Initially, the government strictly limited the business scope of TVEs to farm machinery and tools and the processing of agricultural products. These restrictions were later relaxed and TVEs were allowed to enter most production fields. The ownership structure of TVEs also evolved, gradually expanding from collective enterprises to individuals and other forms of private enterprise. The share of nonagricultural TVEs in total national gross output value increased from 6.3 per cent in 1978 to 14.5 per cent in 1984. A rough estimate suggests that the annual growth rate of TVE value added at constant prices during this period was between 19 and 20 per cent, lifting the GDP growth rate by 1.2 percentage points (calculated from data in Ministry of Agriculture, Animal Husbandry and Fisheries 1986; NBS various years).

Initial SOE reform attempts and the SEZ experiment to embrace the market

During the same period, reform began in SOEs in the industrial and service sectors. In 1978, Sichuan province took the lead with an experiment to allow pilot SOEs to sell any production over the state quota through the market, and to retain a proportion of their profit to pay bonuses and employee benefits. This was the first attempt to introduce SOEs to market mechanisms, providing initial incentives in production and efficiency improvement. The experiment was a success, and the central government then extended the reform to the entire country in 1980, and SOEs began to partially participate in market competition.

Two other important reforms took place in 1979 and 1980. In the first, special economic zones (SEZs) were established in Shenzhen, Xiamen, Zhuhai and Shantou. Free-trade and preferential foreign investment policies were implemented in the SEZs. The second was preliminary fiscal reform. In 1980, the 'eating from separate kitchens' reform of the government budgetary system was introduced to give more autonomy to local governments to spur better local development. In 1983 and 1984, a two-stage taxation reform was introduced to replace the profit turnover system with an internationally common tax system. These steps established the necessary conditions for transition to a market economy.

What led to accelerated growth?

The reforms in 1978–84 mentioned above were not built on an explicit commitment to a market economy because there was huge resistance from those holding to traditional ideology, although all the reform measures were market-oriented.

During this period, the HCS and other agricultural reform and market-oriented TVEs provided initial impetus to the acceleration of economic growth. Introduction of market mechanisms into the SOE sector, establishment of SEZs and decentralisation of the fiscal system also contributed to growth. The GDP growth rate increased from an average of 5.9 per cent in the pre-reform period to an average of 9.6 per cent (Table 10.1).

Table 10.1 Contributing factors to growth acceleration, 1978–84

	Contribution to growth acceleration (percentage points)
GDP growth rate higher than pre-reform period	3.6
Contribution of agricultural reform	1.5
Contribution of TVEs	1.2
Initial SOE reform, SEZs and fiscal reform	0.9

Source: Author's calculations based on data from NBS (various years).

Moves towards the market: 1985–92

In October 1984, after clashes between reformists and conservative forces, the CPC Central Committee issued its 'Decisions on Economic System Reform', formally proposing to establish 'a commodity economy with plan'. At that time, the notion of a 'market economy' still had some negative connotations in mainstream ideology, while 'commodity economy' was considered a neutral alternative term for the market economy. This was an iconic shift from the planned economy assisted by market adjustment at the very beginning of reform to a market economy, although 'with plan' was not forgotten. Since then, reform has gradually expanded to all spheres of the Chinese economy.

The 1987 report of the thirteenth National Congress of the CPC set out clearly that reform was aiming to establish a 'socialist market economy'.

Through a 'double-track price system' to the market

Before the reform, the government purchased all enterprise products at fixed prices. The government set output levels, this resulted in serious shortages in some products, whereas others were in surplus. This rigid system made it impossible to bridge the

gap between supply and demand, as prices could not be raised and production could not increase without changes in the central plan. Waste and shortages persisted for long periods.

The shift towards market prices was realised through the double-track price system reform. The experiment carried out by Sichuan province in 1978 to expand the autonomy of SOEs allowed the coexistence of planned and market prices. The experiment was later extended nationwide. In 1984, the Meganshan Young Economist Symposium put forward the idea of a combination of price adjustment and easing, which was adopted by the central government and later helped create a more complete 'double-track price' mentality. It meant that the planned price system remained in the short term to avoid major shocks, while prices were partially and gradually liberalised towards a market price system.

In practice, market prices emerged in the rapidly developing TVE and urban private enterprise sectors as well as partially in SOEs. TVEs and urban private enterprises had not been restricted by planned prices from the early stage of reform, which made market prices more widespread.

In 1988, the Chinese Government decided to conduct a 'price storm' to change to a market price system, but this failed because the time was not ripe. However, the price transition continued with the rapid development of the private economy. By the mid-1990s, market prices had gradually taken the place of planned prices. The double-track price system provided a path for smooth transition to a market economy. In contrast, Russia's 'shock therapy' price and other reforms triggered hyperinflation, major dislocation and loss of production.

Opening of coastal cities: Foreign investors

Following the establishment of four SEZs in 1979, the State Council decided in 1984 to extend the opening-up policy to 14 coastal cities, including Shanghai, Tianjin, Qingdao, Dalian and Guangzhou. This attracted a large number of foreign businesses and businesses from Hong Kong, Macau and Taiwan to invest in China's coastal areas, promoting trade growth. From 1984 to 1992, foreign direct investment (FDI) in China rose rapidly, from US\$2.9 billion to US\$58.1 billion. The total value of imports and exports rose from US\$63.6 billion to US\$165.5 billion. The ratio of total import and export value to GDP rose from 17 per cent to 34 per cent. A trade deficit of US\$1.3 billion was replaced with a surplus of US\$4.4 billion.

Foreign investment and trade expansion obviously contributed to economic growth. According to data from China's national industrial censuses, industrial enterprises invested in by foreign, Hong Kong, Macau and Taiwan businesses had a share of only 0.4 per cent of gross industrial output (GIO) in 1985, but this had risen to 13 per cent by 1995.

Development of nonstate enterprises

Before the reform, the industrial and service industries were dominated by SOEs. In 1977, SOEs had a 77 per cent share of GIO, with the remainder contributed by collectively owned enterprises, most of which were subordinate to local governments. After several years of vigorous development of TVEs and foreign-funded enterprises, the share of non-SOEs rose to 31 per cent, in 1984, and that of SOEs dropped to 69 per cent due to their slower growth.

After 1984, market-oriented TVEs continued to grow rapidly, while a large number of individual and private enterprises also emerged. Conservatives at the decision-making level repeatedly proposed a ban on private enterprises, but were not supported by the central government. In 1987, the thirteenth National Congress of CPC officially affirmed the positive role of the private economy. In 1988, the government promulgated provisional regulations for private enterprises and established their legal status. The development of TVEs and private enterprises was suspended as policies were tightened in 1989–91; however, it accelerated again from 1992 (see Garnaut et al. 2001). It is estimated that, during the period 1985–92, industrial output grew at an annual rate of 10.1 per cent in SOEs—up from the level in the initial stage of reform—and 17.3 per cent in non-SOEs (private, individual, collective and foreign-funded enterprises). The share of nonstate enterprises in GIO rose from 31 per cent in 1984 to 44 per cent in 1992.

Progress and stagnation of reform

Reform brought rapid economic growth in China, but a number of economic imbalances emerged. One was poor control over money and credit supply, which led to an inflation rate of 18 per cent in 1988–89. A second was rapidly expanding income inequality, caused by faster economic development in urban than in rural areas, in the eastern coastal than in the central and western areas and in social strata other than ordinary workers. A third imbalance arose because of ineffective monitoring of government power, leading to serious corruption and distortion of income distribution. These sparked strong dissatisfaction among the common people, leading to what was later known as the ‘1989 political disturbance’.

Generally speaking, this was caused by imbalances across various aspects of reform. First, the regulatory mechanism of the central bank was incomplete and could not effectively control money and credit supply. Second, there was a lag in establishing comprehensive social security and income redistribution systems along with the progress of marketisation to prevent excessive widening of imbalances in income distribution. Third—and even more crucially—political reform did not advance and there were inadequate supervisory and restraint mechanisms on government power, exacerbating corruption.

The need for reform in response to these problems was urgent, but policymakers were slow to act or in retreat. GDP growth fell to 4.2 per cent in 1989 and 3.9 per cent in 1990. Private sector development paused, and some reforms came to a standstill. There was an attempt to recentralise the authority that had been transferred to localities and enterprises. Some conservatives tried to reverse the direction of market-oriented reforms and return to the traditional centrally planned system. This generated widespread public dissatisfaction and boycotts by government officials at various levels in support of reform. Deng Xiaoping then turned the tide and delivered a warning speech during his 1992 tour of southern China, saying 'whoever wants to change the line, principles, and policies since the Third Plenary Session will be defeated by the people who do not agree' (Deng 1992). China returned to its reform path. In 1992, development of the nonstate sector accelerated and GDP growth returned to double-digit levels (Garnaut et al. 2001).

Who contributes the most to accelerated growth?

During the period 1985–92, GDP maintained a high annual growth rate of 9.6 per cent. Table 10.2 estimates the respective contributions to accelerated economic growth of the market-oriented non-SOE sector, the partially market-oriented SOE sector and the household-based agricultural sector. Nonstate enterprises enjoyed vigorous levels of development and were the major contributors to high economic growth during this period. The efficiency of SOEs rose, but institutional problems remained.

Table 10.2 Factors contributing to accelerated growth, 1984–92

	Growth rate (%)	Contribution to growth acceleration (percentage point)
GDP	9.6	3.6
Nonstate sector	17.3	2.2
SOEs	10.1	0.4
Agriculture	3.7	0.5
Other factors		0.5

Note: Due to lack of data for the service industry, we use the growth rates of industrial value added and the relative shares of SOEs and nonstate enterprises in industry to calculate their respective growth rates, and to approximate growth rates and the relative shares of the entire nonstate and SOE sectors, and their contribution to the acceleration of GDP growth. The contribution of agriculture is based on the extent to which its growth rate surpasses that of the pre-reform average of 2 per cent, weighted by its share of GDP.

Source: Author's calculations based on data from NBS (various years).

Promoting and complementing the market: 1993–2002

After 1992, in the new wave of reform and development following Deng's tour of southern China and the reaffirmation of the reform orientation by the fourteenth National Congress, the market-oriented nonstate sector continued to grow and flourish, with the total economy also growing rapidly. In addition, due to aggravation of some structural imbalances in the economy, several reforms were advanced.

Tax-sharing reform: Balancing distribution of government resources

In the initial stage of reform, the control of public resources was decentralised. Local governments and enterprises had autonomy over and incentives for using economic resources and promoting economic growth. However, the proportion of government revenue in GDP was decreasing year by year and the central government budget was increasingly hard-pressed. From 1978 to 1994, the ratio of budgetary revenue to GDP dropped from 31.1 per cent to 10.8 per cent. Total government revenue (including extra-budgetary revenue) declined from 40.6 per cent to 16.7 per cent of GDP. It was a challenge to fund the necessary public service functions of government. Moreover, central budgetary revenue in 1993 accounted for only 22 per cent of total government revenue and only 2.7 per cent of GDP.

In response, the so-called tax-sharing reform was carried out in 1994. The collection of central and local taxes was separated, to enable each tier of government to manage taxes in its own sphere. In addition, provision was made for the central government to transfer funds to the localities. This change caused central government revenue to rise substantially. The share of budgetary revenue in GDP rose year by year, to 15.7 per cent in 2002, while the share of total government revenue reached 24.8 per cent in that year. The central government's financing problem was solved.

However, a new problem emerged. The ratios of budgetary and total government revenue to GDP have continued to rise. By 2016, they reached 21.4 per cent and 35.2 per cent, respectively—close to the pre-reform levels. This increased the burden on business. In addition, public resources were increasingly concentrated with the central government and local government revenue declined. In some areas, public servants' salaries were not paid on time and expenditure on public services was affected. As compensation, the central government allowed local governments to charge land transfer fees. These fees were raised higher and higher, pushing up housing prices, especially in large cities.

SOE restructuring

Although a principle of SOEs having sole responsibility for profit and losses, based on market rules, has been applied for many years, there were problems in the operational mechanism. In practice, SOEs enjoy their profits but are seldom held responsible for their losses. Governments have sometimes intervened too much, draining enterprises of vitality, and sometimes too little, allowing managers to squander or steal public assets. This caused SOEs' losses to increase rapidly. However, some leaders bound by traditional ideology had been reluctant to push forward with further SOE reforms.

In 1995, most small and medium SOEs in industry suffered losses, and only large SOEs remained profitable. This encouraged the central government to adopt a policy known as 'grasp the large, let go of the small'. Most large SOEs were corporatised, while small ones were subject to restructuring, including through mergers, leases of assets, bankruptcy and sale.

This reform has led many poorly managed small SOEs into bankruptcy or privatisation. The number of SOEs and state-controlled shareholding companies (together called state-controlled enterprises, or SCEs) in the industrial sector decreased sharply, from 118,000 in 1995 to 41,000 in 2002. However, the total profit of these SCEs rose from RMB67 billion to RMB263 billion and the profit-cost ratio rose from 3 per cent to 7 per cent during the same period. Surveys found that many privatised former SOEs turned from loss to profit, and efficiency improved significantly.

SOE reform in the 1990s was generally successful. Without such drastic reforms, many badly managed SOEs would have become a heavy burden on development. However, there were problems. There was insufficient preparation for restructuring. Sometimes a lack of transparency led to loss of public assets and improper enrichment of a small number of people. Tardiness in establishing a social security system caused many laid-off workers to endure difficulties, despite an emergency relief payment.

One lesson from this is that future structural reforms will require adequate preparation and thoughtful programming to ensure a transparent process and fair results. Another is that a flexible labour market requires a sound social security system to protect workers.

Establishing a social security system

Social security in the centrally planned period was only available for public servants and SOE workers. Employment in the public sector was secured and payments to retirees and employees' medical expenses were borne by their employers.

Other urban and rural workers and residents had no such insurance. During the reform period, the lack of social security became an increasing problem and further increased income inequality.

The pace of establishing a social security system accelerated from the mid-1990s. In 1997–98, the State Council decided to establish the urban employees' basic pension insurance and basic medical insurance systems. In 1999, the unemployment insurance regulations were promulgated and coverage was expanded to the urban nonstate sectors. By 2002, 147 million urban workers (58 per cent of total urban workers) were covered by basic pension insurance, 102 million (40 per cent) were covered by unemployment insurance, 94 million (37 per cent) by basic medical insurance, 44 million (17 per cent) by injury insurance and 35 million (14 per cent) by maternity insurance. This was an important step forward, although coverage remains far from complete.

Accession to the WTO

China's accession to the World Trade Organization (WTO) in 2001 allowed it to become an equal participant in international trade. The process of accession involved domestic reform. Many existing domestic laws, regulations and traditional management methods were in conflict with international rules and had to be changed, which contributed to improvements in the business environment. After accession, China's export processing industry expanded rapidly. Abundant domestic labour resources were effectively utilised; employment opportunities and labourers' incomes increased rapidly. In 2001, the total volume of imports and exports was equivalent to 38.5 per cent of GDP, and reached a high of 64.2 per cent in 2006. This played a crucial role in promoting subsequent economic growth.

Further development of the private economy

From 1992 to 2002, non-SOEs maintained annual growth of 16.9 per cent—significantly higher than the annual growth rate of SOEs (and later SCEs) of 8.6 per cent in the same period. Nonstate enterprises' share in total sales revenue in the industrial sector increased from 44 per cent to 60.2 per cent during this period, surpassing that of SCEs. Of sales by nonstate enterprises, private firms contributed two-thirds, with the rest contributed by nonstate-dominated shareholding companies and limited liability companies, foreign funded enterprises and those from Hong Kong, Macau and Taiwan as well as collective and cooperative enterprises. Collective enterprises' share decreased to about 3 per cent of nonstate industrial sales by 2002. From that time, the nonstate enterprise sector can be regarded as the private sector.

During this period, private enterprise continued to lead China's rapid economic growth. Annual economic growth of 9.8 per cent was 3.9 percentage points higher than the average in the planned economy period. The private nonagricultural sector contributed 3.3 percentage points of the total, while the SCE sector made a negative contribution of -0.3 percentage points of the total.

In 1992, China's per capita GDP was only US\$423 (converted at the going exchange rate). It reached US\$1,148 in 2002. In 1998, China moved from a low to a middle-income country according to the World Bank's classification.

Market reform advances and political reform lags

During the period 1993–2002, tax reform and the establishment of a social security system provided the basic conditions for a modern market economy, while SOE reform and accession to the WTO promoted further marketisation. The great defect was that reform of the political system had been indefinitely delayed. In addition, the previously proposed reforms to separate the functions of government from those of the party, and to separate enterprise management from government administration were not followed through. Leaders at different levels of the CPC had monopoly power and were not open to public scrutiny. Some evolved into undisciplined overlords and became seriously corrupt. This was the main cause of the deterioration of government administration and market distortion.

A decade of hope and fear: 2003–12

After China's accession to the WTO, the economy became more outward-oriented. Its export-processing industry enjoyed rapid growth, with substantial increases in imports and exports. There was rapid urbanisation and economic growth; improvements in public services, social security and income redistribution systems; and major infrastructure developments. The first two advances were a result of increased marketisation. In the last two areas, the government played a positive and complementary role to the market in sustaining economic growth.

There were also serious negative changes: the first was the continued widening of income inequality; and the second was unprecedented corruption in the public sector. Macroeconomic policies also had excessively short horizons. Excessive government intervention in investment, land allocation and enterprise operation disrupted the role of markets in optimising resource allocation and led to structural imbalances.

Outward orientation, urbanisation and private sector growth

After China's WTO accession in 2001, trade and export-oriented processing industries flourished. In 2007, before the Global Financial Crisis (GFC), the share of import and export value in GDP reached 62 per cent—20 percentage points higher than in 2002. It decreased after the GFC, to 45 per cent in 2012.

During the period 2002–12, urbanisation accelerated for three reasons. First, exports supported a large number of new jobs in urban areas, attracting many rural–urban migrant workers to cities. Second, in 2001, the State Council revised urbanisation policy from 'strict controls on the scale of large cities and active development of small cities and towns' to a policy of 'coordinately developing large, medium and small cities and towns' in line with market trends. Third, the Sun Zhigang incident in 2003—in which migrant worker Sun Zhigang died in Guangzhou as a result of physical abuse he suffered while being detained under the custody and repatriation system—triggered a strong expression of public opinion, resulting in the State Council's abolition of restrictive and discriminative policy measures against rural migrant workers and liberalisation of the movement of people between urban and rural areas.

During the period 2003–12, the urbanisation rate increased from 39 per cent to 53 per cent, with an annual increase of 1.4 percentage points, which significantly exceeded previous periods.

The private sector continued to grow substantially faster than the SCE sector. Private enterprises' share in industrial output increased from 60 per cent to 76 per cent, and continued a 3.3 percentage point contribution to economic growth.

During this period, China rose from a lower–middle to upper–middle-income country according to the World Bank's classification. Together with RMB appreciation, GDP per capita at the exchange rate rose from US\$1,148 in 2002 to US\$6,338 in 2012.

Rural livelihoods, social security and infrastructure

Rural reforms in the 1980s played a crucial role in improving the agricultural sector. After several years' rapid growth, the energy released by reform was exhausted and agricultural production entered a period of slower growth. The income gap between urban and rural areas expanded again. The agricultural tax coupled with the local collection of miscellaneous fees imposed a big burden on farmers. In 2006, the State Council formally abolished the agricultural tax and related fees.

Important achievements between 2003 and 2012 included major increases in the coverage rate of basic social insurance for urban employees, from 37 per cent to 71 per cent. A basic pension insurance system for urban and rural nonworking residents and a basic medical insurance system for urban nonworking residents were established, covering 484 million and 272 million people, respectively, by 2012. In rural areas, the new rural cooperative medical system and the rural minimum living allowance system achieved full coverage.

During this period, infrastructure construction progressed rapidly. The total length of expressways increased from 25,100 km to 96,200 km. Railways increased from 71,900 km to 97,600 km, of which high-speed rail contributed 9,356 km by the end of 2012. Cargo volumes increased from 507 million tonne-kilometres to 1.738 billion tkm, while passenger turnover increased from 141 million to 334 million passenger kilometres.

Income disparity and corruption

Between 2003 and 2012, the income disparity of Chinese citizens expanded significantly. The Gini coefficient of income increased from 0.433 in 2002 to the highest on record of 0.491 in 2008. It then began to ease, to 0.474 in 2012. Widening income inequality as measured in official data relates to the urban–rural wage gap and regional disparities. However, a major part of widening income disparity in reality is caused by corruption and improper use of public resources and is missing from the official data.

The author's previous studies show that some urban residents in the past had large amounts of 'grey' income (income without a proven legitimate source) that was not included in official income statistics, and was concentrated mainly to the top 10 per cent of urban households. Grey income was estimated to be RMB2.4 trillion in 2005, RMB4.6 trillion in 2008 and RMB6.2 trillion in 2011—roughly equivalent to 12 per cent of GDP in 2011 (Wang and Woo 2011; Wang 2013). Grey income is mainly a result of corruption and institutional defects, including poor management of public funds in government investment, improper distribution of public resources and monopolistic benefits, lack of monitoring of government authorities, bureaucracy and corruption in the public services sector. These phenomena were found to be intensifying and seriously threatening social fairness and long-term economic development.

Macropolicy, government intervention and structural imbalance

Between 2003 and 2012, monetary policy continued to be loose. Growth of money supply (M2) in most years exceeded 16 per cent, significantly exceeding the rate of GDP growth. In 2009, in response to the GFC, it reached a high of 28 per cent. This led to severe bubbles in the capital and real estate markets, and the stock market indices plunged as the bubbles burst. Housing price increases in megacities such as Beijing, Shanghai and Shenzhen reached hundreds of times the annual income of wage earners, which seriously impacted ordinary workers.

During this period, the scale of government and SCE investment expanded considerably, with its share of GDP growing from 18.9 per cent in 2002 to 24.8 per cent in 2009, before decreasing slightly to 23.1 per cent in 2012. Beyond necessary investment in infrastructure and urban development, inefficient government investment is widespread. Investments by various levels of government were often associated with the pursuit of improper interests and it became common for officials with power over government investments to accept bribes.

In recent years, large-scale government investment and easy money supply have no longer generated high economic growth. From 2002 to 2012, the consumption rate dropped from 60.6 per cent to 50.1 per cent of GDP and the capital formation rate increased from 36.9 per cent to 47.2 per cent of GDP. Excessive capital formation led to severe overcapacity in industry and housing and a sharp decline in the rate of return on capital.

During the period 2003–12, the growth rate of the SCE industrial sector dropped to 6.9 per cent from 8.6 per cent in the previous period, reflecting a marked decline in productivity growth. However, private enterprise continued to maintain a high growth rate, at 14.4 per cent. As a result, its share in industry increased from 60.2 per cent to 76 per cent.

Government intervention in business has expanded with controlling power over resource allocation. The Index of Marketisation of China's provinces developed by the National Economic Research Institute (NERI) shows a significant deterioration in the period 2008–10 in the 'relationship between the government and the market' as well as in 'development of factor markets' (Wang et al. 2016).

It is crucial for future economic development to clarify the relationship between the government and the market.

Looking forward to continuing reform: 2013–17

After the eighteenth National Congress of the CPC in 2012, China's reform program took a new turn. The party engaged in a desperate fight against corruption and also sought to deal with the imbalances in economic structure and to revitalise the economy. In particular, it committed to continuing institutional reform.

Anticorruption measures and improved income distribution

According to incomplete statistics, from 2013 to 2017, more than 190 senior officials at the provincial governor and ministerial level, and many more at lower levels, were punished for corruption. The anticorruption campaign has had a strong deterrent effect on corrupt officials and applied a brake to the spread of corruption.

The anticorruption campaign reduced losses and improper distribution of public resources and improved income distribution. The official Gini coefficient decreased from 0.474 in 2012 to 0.465 in 2016—but this did not include grey income in either year. The decline in real inequality was probably greater than that indicated in the official data. Improvements in income distribution also raise household consumption, indirectly supporting economic growth.

Fighting corruption through judicial and administrative means may have only a short-run effect. Reform of the political and administrative systems is necessary for a fundamental solution.

Reform and structural rebalancing

The Chinese economy has encountered problems of structural imbalance in recent years. Industrial sectors suffered from serious overcapacity due to overinvestment. Nationwide, the leverage ratio reached 250 per cent—indicating high financial risks. GDP growth continued below 7 per cent after 2015, for the first time since 1978. TFP significantly decreased. Slower export growth in recent years has made a negative contribution to economic growth, although plenty of evidence indicates that major causes of this were accumulated problems due market interference such as continuing heavy government investment and loose monetary policy.

The eighteenth CPC Central Committee made a decision in 2013 to allow the market to play a decisive role in resource allocation, but, in practice, few major changes have been seen. The government's short-run priority is structural rebalancing. In the past year or two, there have been some achievements in this regard, as well as negative effects due to intensive use of administrative measures. For example,

administrative measures to reduce excess capacity resulted in a sharp rebound of energy and raw materials prices, while many loss-making SOEs were still protected by local governments. There has been little improvement in productivity.

The macrolevel leverage ratio (the ratio of nonfinancial enterprises, government and household debt to GDP) has been increasing, although the growth rate of M2 slowed to 8.2 per cent in 2017 from 11–14 per cent in previous years. The leverage ratio may decline in the coming two or three years, although this is uncertain.

Getting rid of structural imbalances and reviving the economy depend on reform of the system. Of particular importance are the following measures.

First, government reform is needed to transform its functions from a focus on GDP to a focus on public services and maintaining a good market environment, so as to reduce its intervention in the economy.

Second, the government needs to promote fiscal and taxation reforms to improve the distribution and use of public resources, to reduce inefficient government investment and waste and to further strengthen education, medical services and the social security system. The household registration system needs reform to enable more than 200 million rural–urban migrants to settle in cities and enjoy equal access to social benefits.

Third, land reform and opening the land market is needed for better allocation of resources and to suppress real estate bubbles.

Fourth, it should maintain a neutral monetary policy to bring down the high leverage rate in the next few years for economic stability.

Most of these reform items have been included in the official reform plan, although implementation has been slow. A lesson may be learnt from previous reforms: reform is a need of the general public and cannot be achieved only by efforts at the decision-making level. Public support and participation are the key elements for success.

Economic growth

The average GDP growth rate in 2015–17 was 6.8 per cent—significantly lower than the average of 9.6 per cent during the past 40 years. The Chinese Government and most economists have accepted that the period of high growth has ended and future growth will be in a higher-medium range—likely meaning between 5 per cent and 7 per cent. However, slower growth is mainly the result of institutional problems, which will either become more serious or will be solved through reforms and policy adjustments. The future is therefore uncertain, but there is still great potential for future growth.

First, urbanisation has remained the engine of economic growth in past decades, with the urbanisation rate reaching only 58.5 per cent—significantly lower than that of developed countries. There is plenty of room for further urbanisation to drive economic growth, although some urbanisation policies and related institutional arrangements need adjustment, such as the urban household registration system.

Second, in the process of moving from a middle-income to high-income country, China's growth in household consumption will play a crucial role in sustaining economic growth. The current rate of consumption in China is too low (53.6 per cent in 2016). Adjustment of government policy to improve public services and social security could improve income distribution and household consumption.

Third, experience indicates that huge impetus for growth and technical innovation is stored in the private enterprise sector. The key to releasing this potential is to maintain a good business environment for fair market competition and the rule of law—in particular, reducing government intervention on markets, restricting monopolistic power and improving legal protection of intellectual property rights.

Analysis shows that, with the implementation of the reforms and policy adjustments mentioned above, future economic growth could be restored to above 7 per cent, and China could join the high-income-country club before 2030 (see Wang and Zhou 2016).

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This text is taken from *China's 40 Years of Reform and Development: 1978–2018*,
edited by Ross Garnaut, Ligang Song and Cai Fang, published 2018 by
ANU Press, The Australian National University, Canberra, Australia.

doi.org/10.22459/CYRD.07.2018.10