6. China's economic transformation[1]

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Why economic reform started in 1978

Deng Xiaoping took over control of the Communist Party of China (CPC) in 1978. He was responsible for initiating reform of the planned economy to move towards a more market-oriented economy. In a sense, the change in policy can be interpreted partially as a continuation of the 'four modernisations' (of agriculture, industry, defence, and science and technology) announced by premier Zhou Enlai in 1964, but interrupted by the Cultural Revolution. This explanation was suggested to me by a former vice-premier of the People's Republic of China (PRC). On the other hand, a former premier once told me: 'The Cultural Revolution did great harm to China, but it freed us from certain ideological constraints.' These statements indicate that the Cultural Revolution did affect the thinking of top party leaders and thus the course of China's economic development. Taking these statements into account, together with other considerations, I offer the following explanation for the initiation of economic reform.

There were four reasons the time was ripe for reform. First, the Cultural Revolution was very unpopular, and the party and the government had to distance themselves from the old regime and make changes to win the support of the people. Second, after years of experience in economic planning, government officials understood the shortcomings of the planned system and the need for change. Third, successful economic development in other parts of Asia—including Taiwan, Hong Kong, Singapore and South Korea, known as the 'Four Tigers'—demonstrated to Chinese government officials and the Chinese people that a market economy works better than a planned one. This lesson was reinforced by the different rates of economic development in North and South Korea, and among countries in Eastern and Western Europe. Fourth, for the reasons stated above, the Chinese people were ready for, and ready to support, economic reform.

Given these four reasons, was economic reform in 1978 inevitable? My answer is yes. The first two reasons alone were sufficient to motivate the government to initiate reform. The urgency of the case was such that it had to occur as soon as the political leadership was ready after Chairman Mao Zedong's death. The Chinese

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economic reforms of 1978 are an instance of the possibility of predicting major social change by examining the prevailing conditions. As an introduction to our discussion of economic reform, it is useful to point out that the reform process has been spurred by a combination of the efforts of the central government and the natural desire of the Chinese people and lower-level government units to improve economic institutions for their own benefit. The role of the central government has been a gradual and experimental one and has proceeded in steps. It will be useful to keep this general picture in mind when studying China's reform process.

Agriculture

Reform of Chinese agriculture under the commune system initially occurred in 1978 and 1979, when commune leaders in some regions discovered through examples initiated by farmers that they could fulfil their output quotas by reorganising the commune internally. In essence, each farm household was assigned a piece of land and was held responsible for delivering a given quantity of a specified product so the commune could satisfy its procurement requirement. After fulfilling the delivery quota, the farm household was free to keep the remaining output for its own consumption or for sale in the market. This 'household responsibility system' (HRS) has the economic characteristics of private farming in a market economy. It amounted to each farm household leasing a piece of land and paying a fixed rent in the form of the output quota. The Fourth Plenum of the Eleventh Central Committee of the Communist Party (CCCP) officially adopted the HRS in September 1979. The subsequent rapid increases in agricultural output and farmers' incomes provided support for this system.

After 1978, rural markets began to reopen. Farmers were allowed to raise pigs, chickens and ducks, the farming of which had been banned during the Cultural Revolution as capitalist activities. They also engaged in sideline activities such as handicraft production that were previously the preserve of the communes. China's farm economy in essence returned to the private economy that had existed in the early 1950s before the organisation of cooperatives and the establishment of communes. One difference pertained to the ownership of land. Strictly speaking, ownership of land was and still is collective; it belongs to the commune or the village. The right of use belongs to the farmer who is assigned the land. Eventually, the right to use assigned land was guaranteed on a permanent basis and became transferable—hence, the difference between this right to use and ownership is moot. Reform therefore succeeded in allowing private farming to return to the agricultural sector.

During the first six years of reform (1978–84), the annual growth rate of the gross value of agricultural output nearly tripled, to 7.1 per cent. The HRS deals only with the production component of the market. Market reform in agriculture includes four other components, as pointed out by Huang and Rozelle (2014), on which much of the discussion in this section is based.

The second component is marketing and distribution. After the output is produced, it can be sold to government procurement agencies. Allowing the products to be sold in local markets is the second component of market institutions. Although agricultural commodity markets were allowed to emerge during the 1980s, their number and size were small. In 1984, the state procurement network still purchased more than 95 per cent of marketed grain and more than 99 per cent of marketed cotton. Later extension of the market included the sale of products abroad through private export companies. In the past decade, food exports have been growing faster than imports, but, in 2010, China was still largely self-sufficient (97 per cent) in food (including processed food).

The third component is the pricing of products. Instead of the government determining the prices of agricultural products, a market institution requires that the forces of demand and supply determine prices. Price changes had a positive impact on output during the first years of transition. This simply reflected the increase in supply as prices increased.

The fourth component is the development of financial institutions to support the development of agriculture. Credit institutions allowed farmers to borrow money to finance production and investment. Most farmers were able to carry on their production with little outside financing, as China's agricultural output and input markets were dominated by cash transactions. Where it was needed, liquidity was supplied by off-farm remittances and zero-interest loans. Insurance was provided by diversification, multiple cropping, high levels of irrigation and off-farm earnings.

The fifth component is the role of the government. First, there has been little effort by the government to organise small farms into larger cooperative organisations. Only about 20 per cent of China's villages had farmers professional associations (FPAs) in 2008 and only 10 per cent of farmers belonged to one—far below the levels in almost all other East Asian nations and many Western nations. Second, the government has provided research and development (R&D) in agriculture by developing technology for farmers. Such efforts have been controlled by the state agricultural research system, mainly to produce higher yields, and, after 2000, to improve quality. Only a small share of agricultural R&D in China is performed by the private sector, partly due to a 'crowding out' effect from the government programs.

Given the above market institutions, there is strong competition among millions of small farmers and traders, the levels of which have produced agricultural commodity markets that are highly integrated and efficient. Unlike the incomplete market reform in Chinese industry, agricultural market reform is almost complete. When we measure the extent to which China has become a market economy by the percentage of national output produced by financially independent and profit-motivated production units, we can include almost all agricultural output in this percentage.

While market reform of the agricultural sector has been successful, agricultural productivity and incomes did not increase as rapidly as in the early 1980s, creating serious problems of rural poverty. This problem will be discussed in terms of three components.

The first is the income gap between urban and rural residents. Rural poverty is not a result of the low income levels of the rural population. It is true that the gap in per capita income between urban and rural residents has widened, but the rate of increase for the latter has been so rapid that the rural population, on average, is much better off economically than before (see Chow 2000). If one insists on using income as the chief measure of rural poverty, the problem has to be viewed as either: 1) the deterioration of the relative income of rural residents in spite of the rapid increase in absolute income; or 2) discontent among the rural population created by the improvement in income itself (i.e. increasing expectations). Since neither of these two interpretations appears to be sufficient to explain the seriousness of the current problem, one has to seek other explanations.

The second component is the central government's unfavourable treatment of rural residents compared with urban residents. It has spent less on infrastructure investment in rural areas than in urban areas, and only a limited amount to improve agricultural productivity. It has provided fewer welfare benefits, including healthcare and education subsidies, to rural residents and, although labour mobility allowed farmers to move to urban areas to find work, those migrating workers did not have residence permits in the cities and could not receive services such as health care and schooling for their children. Although the commune system was abolished, procurement of farm products by government agencies has continued, but the procurement prices are often set below market prices. In addition, farmers were not allowed to sell their products to private traders, as private trading and transportation of grain were prohibited. The market economy therefore does not function for the benefit of farmers in the distribution and pricing of grain.

The third—and perhaps most important—component of the rural poverty problem is that farmers' rights can be violated by the illegal activities of local government officials. The most disconcerting example is the confiscation of land from farmers for urban development, for which farmers receive arbitrary compensation well below the market price. Many farmers and other rural residents are not paid what they are entitled for public work or for teaching in public schools. Farmers are also subject to illegal levies, including taxes on acreage that is not actually used, a special tax for growing commercial crops rather than grain and livestock, and fees for schools, road construction and other services provided by local governments. Through much of Chinese history, local government officials have considered themselves privileged, with the authority to rule over peasants. The abuse of power under the PRC is worse than previously because officials are given greater levels of power. Well-publicised stories of the abuse of power by local party and government officials are documented in Chen and Wu (2005). The abuse of power by local officials is known to be fairly widespread, as evidenced by the large number of protests by farmers reported in the media (see Han 2003; Zhang 2006: 19–20).

Enterprises

Enterprises are the second important production unit. The Chinese People's Congress adopted elements of reform for state enterprises in September 1980. At the opening of that session, vice-premier Yao Yilin, chairman of the State Planning Commission, announced that experiments giving state enterprises more autonomy and market competition would be greatly expanded. Industrial reform began in late 1978 with six pilot enterprises in Sichuan province; by the end of 1981, some 80 per cent of state-owned industrial enterprises were involved in the reform experiment. The major elements of industrial reform in the early years included some autonomy regarding the use of retained profits, production planning, sales of output, experimentation with new products and capital investment; adoption of an 'economic responsibility system' by assigning identifiable tasks to low-level units within an enterprise and paying them according to productivity; increasing the role of markets; streamlining the administrative system at the local level for state enterprises under local control; and encouragement of collectively owned enterprises.

The main difference between the reform of state-owned industrial enterprises and that of agriculture is that privatisation was not adopted for state-owned enterprises. Reform of state-owned enterprises turned out to be more difficult than that for agricultural production. In ideological terms, members of the Communist Party believed in the ownership and control of the major means of production by the state. Politically, government bureaucrats were unwilling to give up their power and vested interests by allowing state enterprises to operate independently. Economically, unlike small farms that are self-sufficient, large industrial enterprises were dependent on factors outside their control, including the supply of equipment and material inputs produced by other enterprises. In administrative terms, most state-owned enterprise managers did not have sufficient knowledge and experience to run a modern enterprise as an independent entity because they had been trained to obey production targets. Even with additional training, managers were reluctant to give up their old habits of dependence on the economic ministries.

Observing the limited success of the reform of state enterprises and the need to overhaul the entire economic system, the twelfth CCCP adopted a major decision relating to economic reform, on 20 October 1984. Individual state enterprises would be given autonomy in decisions regarding production, supply, marketing, pricing, investment and personnel to function as profit-seeking economic units. The scope of central planning was reduced—except in the case of certain major products—and the method changed from mandatory to guidance planning. Market forces rather than central control determined the prices of more products, while a macroeconomic control mechanism was developed through the use of taxes, interest rates and monetary policy under an improved banking and financial system. Various forms of economic responsibility systems were established within individual enterprises to promote efficiency, with differential wage rates instituted for different kinds of work and levels of productivity. The development of individual and collective enterprises was fostered to supplement state enterprises; foreign trade and investment were expanded and technological exchanges with foreign countries promoted. These steps were revolutionary, given the institutional and ideological tradition up to that point, but were limited in scope, because it was not possible to go further at that time.

In 1987, the 'contract responsibility system' was introduced to all state enterprises, with each signing a contract with the level of government that had control over it. Under the contract, the enterprise committed itself to pay the government a fixed annual tax and could retain any remaining profit. In practice, it was up to the enterprise to distribute any profit to workers and managers as bonuses, but managers' compensation was limited by social pressure. The incentive for management to improve efficiency and take risks was therefore limited. Profits were distributed to workers mainly to increase the popularity of and support for management. A second reason for the limited success of the contract responsibility system was that, in practice, when the profit of a state enterprise increased, its supervisory government authority demanded a higher tax than originally agreed on. In reality, the tax depended on profit and no longer had the desired incentive effects of a fixed levy.

While the reform of state enterprises was not entirely successful, the collective and private sectors were dynamic and expanding. As well as state enterprises, there are three other types of enterprise in China: collective, individual and overseas-funded—the last established under the country's open-door policy.

Township and village enterprises were established as rural collective enterprises with the support of local governments wanting to increase revenue. Unemployed labour could be used for nonagricultural production. Local governments had the land, capital and human resources to establish these enterprises, and they had the connections to cut through the red tape required to set up and run them. The ownership rights of these enterprises were often unclear, and yet they seemed to function well and were profitable. Their success provides a puzzle for economists.

The collective and private sectors grew much more rapidly than the state sector. From Table 6.1, we can see that, in 1978, individual and other types of industrial enterprises were nonexistent and state enterprises produced 77.6 per cent of total gross industrial output value. This was reduced to only 28 per cent in 1996, compared with the 39 per cent contributed by collective enterprises. One important conclusion to be drawn from these data is that even if state enterprises are not increasing their productivity, China's economy can continue to grow rapidly if the nonstate sectors remain vibrant, because the state sector accounts for only a small share of total output.

Table 6.1 China: Gross industrial output value by ownership (RMB billion in current prices)

	State-owned	Collective-owned	Individually owned	Other types	Total
1978	328.9	94.8			423.7
1985	630.2	311.7	18.0	11.7	971.6
1996	2,836.1	3,923.2	1,542.0	1,658.2	9,959.5

Source: NBS (1997: 413).

The inefficiency of state enterprises has been considered a major problem in the Chinese economy, but the seriousness of this is exaggerated on two counts. First, the productivity of state enterprises has been steadily increasing in the past two decades, although at a slower rate than that of the collective and private sectors. Second, the relative importance of state enterprises has been declining and the effect of the state sector's performance on the growth of the entire economy is less important than before. State enterprises remain, however, a significant burden for the government and the economy. They require government subsidies, while the entitlements of workers are a drain on government budgets and economic resources. In addition, such entitlements include more than just wages; the entire support system—including schools for their children, health care for their families and retirement benefits—is very costly. Reducing the size of enterprises creates an unemployment problem.

Several factors affect the economic efficiency of state-owned enterprises. There is a shortage of competent and well-trained managers and staff to operate a modern enterprise, along with a tendency to make management decisions based on personal relations and for personal gain at the expense of the enterprise. The system does not provide managers with appropriate incentives to work for the benefit of the enterprise; they are on a much lower pay scale than managers in similar collective enterprises. Nor is there a suitable governance system. Many workers still subscribe to the concept of the 'iron rice bowl'—that is, relying on the state to guarantee their job security. In addition, the equipment and technology of some state enterprises need to be updated. One important condition favourable to the reform of state enterprises is the high degree of competition from collective and foreign enterprises in both domestic and foreign markets.

The main avenue for continued reform of state enterprises is to restructure them to shareholding companies. In late 1998, when the East Asian Financial Crisis was affecting the Chinese economy, the privatisation of state enterprises was slowed for fear that sale prices might dip too low, to the benefit of corrupt officials under insufficient government supervision. In March 1998, premier Zhu Rongji announced that state enterprise restructuring should be completed in three years. His main objectives were to make profitable the majority of the 50 largest state enterprises, which were operating at a loss, and to restructure most small and medium-sized state enterprises into shareholding companies. The government reported that two-thirds of the 6,600 largest state-owned enterprises had surrendered to the state net profits in the year 2000 totalling RMB230 billion, although some might have falsified their accounts under pressure, as the government acknowledged.

To appraise the prospects of success of state enterprise restructuring in China, the following observations can be made. First, restructuring efforts in the early 2000s were a continuation of a series of attempts beginning in 1979 to reform state enterprises and make them financially independent, efficient and profitable. This is an evolutionary process, so dramatic results should not be expected in a short time. Second, there is a tendency for managers of state-owned enterprises to hold on to their power and resist change. Third, the success of an enterprise depends on many more factors than just the ownership and governance structure. Other important factors are the ability and resourcefulness of its managers and workers, the particular industry it is in, the degree of competition and so on. Fourth, on the positive side, the problems with state enterprises are not so urgent that they require immediate solutions. The government is proceeding at a deliberate speed. It is making sure not too many workers are laid off in any period. Fifth, and also on the positive side, with the introduction of foreign capital, management and technology through joint ventures and even buyouts of failing state enterprises, the performance of many has been and will be improved.

Price reform

An important component of the CCCP's October 1984 decision on economic reform was reform of the price system. The main objective was to decontrol administratively determined prices gradually, and allow prices to be determined by market forces, which would help state enterprises receive the correct signals for their economic calculations in the choice of inputs and the planning of outputs.

However, administered prices cannot be decontrolled immediately. First, there is the problem of equity. Allowing the prices of basic consumer goods to increase would affect the welfare of consumers, who have been subsidised. Second, production in the state-owned enterprises—which were supplied with low-priced inputs under the planned economy—would be disrupted. A compromise solution was to introduce a two-tier price system: one set of prices remained the same as before, while the market determined a second set for the same goods. State enterprises could still purchase their allotted amounts of inputs and sell given amounts of outputs at the administered prices. In addition, each enterprise could purchase additional inputs and sell above-quota outputs at prices determined by the market.

The two-tier price system provides incentives for enterprises to economise on inputs and increase outputs for profit. As practised in China in the 1980s, this system was therefore an economically efficient one. A possible economic inefficiency could result—in terms of the functioning of a market economy—if certain enterprises are operating at a loss without government subsidies and discontinue operation. As time went on, administered prices were gradually changed to match market prices and, by the 1990s, when the majority of products in China were sold at market prices, the two-tier price system was no longer needed.

Price reform was a gradual process beginning in the mid-1980s. How rapidly prices should be decontrolled was an important issue discussed at the top level of the Commission for Reconstructing the Economic System. The major concern with rapid deregulation was the adjustment producers and consumers would have to absorb. Once the government provided subsidies to producers in the form of low input prices and monopolistically protected output prices—and to consumers in the form of low prices for food, clothing and housing—an attitude of entitlement was formed. It would be politically difficult to change this without social protest. In the case of producers, the two-tier price system enabled them to keep their entitlements while allowing market incentives to operate at the margin. In the case of consumers, the prices of food items did not increase rapidly after decontrol because of the rapid increase in food supply resulting from the successful reforms in agriculture.

The banking system

To exercise macroeconomic control as practised in a market economy in lieu of central planning, a modern banking system had to be established. The People's Bank of China (PBC) was a mono-bank that had branches to accept deposits from the public. Its other functions were to issue currency and to extend loans to state enterprises according to the need specified by the planning authority. The PBC had no authority to decide on these loans. Commercial banks did not exist in the sense of being able to extend credit to enterprises according to the criterion of profitability. Reform of the banking system to serve the market economy progressed gradually in the late 1980s and early 1990s. In 1983, the PBC was nominally transformed into a central bank. Specialised banks—including the Industrial and Commercial Bank of China, the Agricultural Bank of China (ABC) and the People's Construction Bank of China—were established and given some autonomy to extend credit to state enterprises, but were also subject to central government direction. They were under local political pressure to extend credit for regional economic development. As a result, excessive expansion of credit led to inflation in 1985, 1988 and 1993. The chief tool to stop credit expansion was the imposition of credit quotas. In November 1993, the third plenum of the fourteenth CCCP decided to accelerate reform of the financial sector by giving more independence to the PBC as a central bank and transforming the specialised banks into commercial banks. In 1995, the People's Congress passed the Law on the PBC and the Commercial Bank Law, modernising the PBC as a central bank and the specialised banks as commercial banks—in principle, though not in practice.

To relieve the four state banks (including the PBC) of political pressure to extend credit, three 'policy banks' were created in 1994 to provide loans to state enterprises for the purpose of carrying out particular economic development policies: the State Development Bank, the Agricultural Development Bank and the Import and Export Bank. By early 1998, these policy banks accounted for only about 6 per cent of the loans of the big four banks. Since the early 1990s, new commercial banks have also appeared on the scene, taking the form of corporations with shareholders and boards of directors. In the late 1990s, these banks accounted for 15–20 per cent of loans and 8–10 per cent of deposits. These new banks have greater flexibility in decision-making and function slightly more like modern commercial banks. Their ownership structure has prevented them from operating more efficiently, and bank managers still behave like bureaucrats, holding on to their economic power. There is still political pressure and economic temptation to extend credit to state-owned enterprises at higher risk than cost–benefit calculations warrant. Managers and staff need more training and experience before they can operate as modern commercial bankers.

Furthermore, of their loan totals, the four state banks are coping with 20–25 per cent nonperforming loans—some US$200 billion out of a total of nearly US$1 trillion—as a result of past obligations to finance state enterprises. About 80 per cent of all the loans of the four state banks consist of loans to state enterprises. To solve these problems, a number of measures were taken in the late 1990s. Local bank managers were appointed by the bank's headquarters—rather than being subject to local government approval—freeing the four state banks from local government interference in their credit policy. The PBC was required to behave like the US Federal Reserve system, providing closer supervision of the behaviour of the commercial banks.

Is the Chinese banking system in crisis? The answer appears to be no, in spite of these shortcomings. In a market economy with a modern banking system, a banking crisis occurs when many loans become nonperforming. This was an essential characteristic of the finance sectors of the countries that experienced the 1997–99 East Asian Financial Crisis. The Chinese situation, however, is different. First, speculative investments in China—though they exist in the real estate market and in the production of consumer goods—are less serious and are subject to strict government supervision. In countries such as Thailand, Malaysia and Indonesia, much larger percentages of foreign investment were portfolio or financial in nature; foreign investors could, and did, withdraw their money quickly when investment opportunities appeared unfavourable. Second, governments in Thailand and Indonesia maintained exchange rates that overvalued their own currencies before the crisis occurred. The central bank of Thailand covered up the loss of a large amount of foreign reserves to support the Thai currency by selling dollars in the futures market. Once investors recognised the loss of foreign reserves and the overvaluation of the Thai baht, the risk to their investments became apparent and they withdrew their money swiftly, leading to a sharp devaluation of the baht. The Chinese currency was not overvalued. More importantly, people have confidence in the value of their deposits in the banks because they believe that the government owns the banks and implicitly guarantees their deposits. The fact that 20–25 per cent of total bank loans are bad has not affected this confidence and is not likely to lead to large withdrawals of deposits. Given the high savings rate of the Chinese people and the limited alternatives for their savings, in the 1990s, the ratio of savings deposits to gross domestic product (GDP) in China was rising.

To deal with the large amounts of bad debt on the balance sheets of the four large state-owned commercial banks, the Chinese Government in 1999 set up four asset management companies, each serving to restructure the bad debts of one large bank. The method of restructuring is for the asset management company to take over the bad debts of the bank it serves in exchange for its own debt, to strengthen the structure of the bank's balance sheet. The asset management company in turn tries to collect from the state enterprises part or all of the debt in its possession. It has the power to supervise and monitor the financial position of the state enterprises as their creditor. It can also sell the debts in the market, possibly at a price below book value. As long as the bad debts do not increase rapidly and Chinese people keep making deposits, the commercial banks will continue to function.

Banking reform is only one aspect of the reform process and shares some of the characteristics of reform in other state sectors. In spite of its present shortcomings, the Chinese banking system appears to be serving some basic functions of financial intermediation, although not efficiently. The banking system can be expected to improve in time, but only slowly.

Foreign trade and investment

China's economy was essentially a closed one before its economic reform. In 1978, the total volume of its foreign trade—or the sum of the values of its exports and imports—amounted to only 7 per cent of its national income. Deng Xiaoping's open-door policy encouraged the opening of China to foreign imports and the promotion of exports. By 1987, the volume of foreign trade had increased to 25 per cent of GDP and, by 1998, to 37 per cent. As a component of aggregate demand, exports weakened as a result of the currency devaluations in, and the reduced demand from, several Asian countries including Japan during the East Asian Financial Crisis. While some of the state-owned companies engaged in foreign trade were not doing well, private and foreign companies were taking an active role in promoting Chinese exports of a variety of consumer goods to the world market. Even when the rate of increase in the volume of exports was smaller in 1998, the rate of growth in GDP was affected only moderately because exports account for only 20 per cent of GDP. (Note that in 1996, China's GDP grew by 9.6 per cent while its exports grew by only 1.5 per cent.) In the meantime, the government adopted a variety of measures to stimulate exports, including the lowering of export duties and refunding taxes on raw materials used to produce exports.

Foreign investment—the second component of the open-door policy—was promoted through the opening of different regions of China. In 1982, the now well-known Shenzhen economic zone bordering Hong Kong was created. Foreign investors could set up factories there to take advantage of inexpensive skilled labour and pay them at market-determined wage rates, unlike the rates prevailing in other parts of China. Investors also received special tax breaks. In less than a decade, Shenzhen developed from a piece of farmland to a modern city. Soon other economic zones and special areas were created for the convenience of foreign investors. Foreign investment increased from an annual rate of less than US$1 billion in 1978 to nearly US$30 billion in 1998.

In 1997, the flow of foreign direct investment (FDI) continued to be strong—10.1 per cent higher than in 1996. In the first five months of 1998, FDI fell by 1.49 per cent compared with the same period in 1997. The trade surplus and the surplus in the capital account helped increase the amount of foreign reserves in China, from US$2.3 billion in 1977 to US$142.8 billion by the end of 1997. As China continued to record a trade surplus during the first few months of 1998, and foreign investment continued to flow in (although at a slower rate), foreign exchange reserves should have been accumulating accordingly; in fact, they increased much more slowly.

As well as the inflow of foreign reserves from a trade surplus and foreign investment, the value of the Chinese currency was supported by large foreign reserves and by its strong purchasing power. China's currency was strong compared with the US dollar, at an exchange rate of RMB8.3 per dollar, because China had a lower inflation rate than the United States. Retail prices in China in March 1998 were 1.2 per cent lower than in the same period in 1997, and remained nearly constant until the middle of 1998. These factors provided strong fundamentals for the value of the Chinese currency and made devaluation unnecessary. Even if the trade surplus had fallen because of competition in world markets from Asian countries, which had devalued their currencies, the economic fundamentals and the political will of the Chinese leadership were strong enough to prevent a devaluation of the Chinese currency. If neighbouring countries had retaliated by further devaluing their currencies, this would have diminished any possible gain from a Chinese devaluation. From a political perspective, the government tried to maintain the value of the renminbi because it was attempting to play a positive role in contributing to the stability of Asian financial markets.

Institutional infrastructure

Since the beginning of its economic reform, China's education system has been improving and returning to its pre–Cultural Revolution state. Universities were opened, and students were given opportunities to take examinations to enter universities and graduate schools. Intellectuals who had been criticised and mistreated were restored to their previous status and given due respect. The population as a whole wanted to absorb new ideas and knowledge from other countries, having been deprived of such knowledge when China was closed to the outside world. From 1985 to 1998, the Ministry of Education sponsored cooperative programs with foreign educational institutions to improve education in China. At the same time, individual universities were given the freedom to invite foreign scholars to lecture. Students were permitted to go abroad to study. Modern textbooks were adopted in university courses. As time went on, skills in modern languages, especially English, improved rapidly, and texts in English began to be adopted. Privately initiated and funded educational institutions were encouraged in the late 1990s and have since flourished. Schools from the primary level to colleges and professional schools have received support from overseas Chinese.

The government has made a serious effort to modernise the legal system, motivated by the overarching national modernisation agenda and the need to engage with the international business community, especially foreign investors. The Ministry of Education in the early 1980s began to set up programs for legal education, training many lawyers. There was also a need to set a modern legal framework for domestic social order. The People's Congress has created many laws governing individual and corporate behaviour, with a system of courts set up to enforce them. On paper, today's Chinese laws are comprehensive and modern in content, but their enactment has not greatly changed the behaviour of the Chinese people.

Reform policies similar to those of Taiwan

It is interesting to note that several economic policies adopted by the leadership of mainland China during its reform process are similar to those adopted by the Government of Taiwan more than two decades earlier.

The growth of both economies is the result of a reduction in government intervention and the encouragement of private initiative. In both economies, to initiate the development process, the government had a set of general policy guidelines; and, in each case, the government reduced its intervention and allowed more private initiatives. Essentially, by providing citizens with freedom and economic opportunities—however incomplete—both governments succeeded in developing their economies. The second common feature is the importance of the agricultural sector in the early stage of growth. In both Taiwan and mainland China, the increase in agricultural productivity was achieved mainly by redistributing land to farmers. Third, the promotion of exports is an important component of both countries' development strategy, with the prosperity of the export sector a major source of rapid economic growth. The fourth commonality is the government emphasis on the stability of the general price level. Both governments learned from the bitter experience of hyperinflation in China before the establishment of the People's Republic in 1949. The fifth common element is the gradual lifting of restrictions on imports and the setting of an official exchange rate close to the free-market level.

There are also differences in the degrees to which market forces are allowed to operate in the two economies. Suffice to say the bureaucratic behaviour of mainland China's economic officials interferes with the working of free enterprise to a larger extent than that of their counterparts in Taiwan. In the 1960s and 1970s, foreign investors in Taiwan also experienced corruption, but not to the extent that occurred in mainland China in the 1980s and 1990s. The reason is China's planned economy and the Cultural Revolution had made its bureaucrats very hungry for money. As economic conditions and government administration improve, corruption and disruptive bureaucratic behaviour will decrease. Another difference between the two countries is the role of state enterprises, which have more influence in mainland China, with its socialist economy. Nevertheless, there are certain instances in which the mainland Chinese Government is more open to the outside world, including permitting foreign investors to participate in the building of economic infrastructure, such as superhighways, and permitting imports of foreign automobiles—neither of which was allowed in Taiwan. One common policy has been to restrict foreign commercial banks from entering the domestic market to compete with domestic banks.

Reasons for the success of China's economic reform

Since economic reform started, China's real output as measured by GDP in constant prices has grown at a remarkable average rate of 9.6 per cent per annum. There is no question that China has experienced a rapid rate of economic development, but what explains the success of its reforms?

First, Chinese leaders are pragmatic and not subject to ideological restraints. Of course, some policies were not proposed because Communist Party members were not ready to accept them at the time. On the subject of pragmatism, Deng Xiaoping said that one should not care whether a cat is black or white as long as it catches mice.

Second, there was no blueprint for the economic institutions and policies that were adopted through experimentation. This is a process of learning by doing or, as Deng put it, of 'crossing the river while feeling the stones'. There are two advantages of such experiments: they identify what works and, when successful, they introduce the old guard to new ways, convincing them to give their support to the reform program. This process has been characterised as 'gradualism', in contrast with the 'shock therapy' adopted by some Eastern European countries, which attempted to change to a market economy almost immediately.

Third, the reforms had the support of the Chinese people and government officials who had experienced the failure of the planned economy. They desired a new system after the excesses of the Cultural Revolution.

Fourth, there was political stability while the reforms took place; the Communist Party remained in power and was able to exercise leadership.

Fifth, much credit must be given to the Chinese leaders themselves. Deng, in particular, should be given most of the credit for working behind the scenes to oversee the general direction of the reforms. He advocated pragmatism and experimentation. Some top leaders were not willing to let China deviate from its traditional course, and there was a difficult political balancing act at the top level of the Communist Party. Zhao Ziyang was a brilliant economic thinker who served as premier and later party general secretary, and who designed and carried out economic reform; and Hu Yaobang was the humane and highly respected party secretary. The subsequent premier, Zhu Rongji, was also very skilful in managing the economy, while general secretary Jiang Zemin kept the country and the party in order. There have been numerous capable officials in the Chinese Government whose contributions cannot be enumerated here.

Given the pragmatic attitude and the ability of Chinese leaders and government officials, as well as the willingness to experiment and the support of the people, there was no way China's move towards a market economy could fail—unless a market economy does not work better than a planned economy (which no economist believes). Why did almost no one in 1979 forecast the rapid transformation and growth of the Chinese economy that was to come? Very few people at the time understood that there were sufficient conditions for the success of the economic reforms. The high degree of success of the reform process was partly due to the accompanying rapid growth of GDP, to which able Chinese labourers and entrepreneurs contributed. At a given stage of reform, the human capital of the Chinese people (though this is difficult to measure) allowed the economy to grow rapidly, and the rapid growth itself pushed the reforms forward. In addition to domestic human capital, both human capital and financial capital were supplied by thousands of overseas Chinese—in Hong Kong and elsewhere—and by foreign investors. Not many people in 1979 recognised the quality of China's human capital and its role in promoting economic reform indirectly through increasing China's national output. Without high-quality human capital, economic institutions and market incentives alone cannot produce rapid economic growth.

The above positive features of China's economic reform process need to be balanced with some qualifications. Political stability and the government's ability to manage the economy were not perfect. Inflation and corruption in the late 1980s created much discontent among the urban population. Student demonstrations started in April 1989 at the memorial of the death of party secretary Hu Yaobang and lasted until June. Failing to end the demonstration by other means, Deng Xiaoping sent in tanks to disperse the protesting students in Tiananmen Square. Hundreds of people were killed, including citizens of Beijing who tried to stop the tanks and members of the Chinese Red Army.

All over the world, there was an immediate critical reaction to this incident—to an extent probably unexpected by Deng. Government officials and businesspeople from many foreign countries refused to go to China. Foreign investment and tourism declined. The government suffered a big shock from internal disagreements about how to handle the demonstrations, and from the negative reaction in many parts of the world. However, the reform policy continued—contrary to the expectations of some foreign observers. In February 1992, during his visit to Shenzhen, Deng took the opportunity to reaffirm and, in fact to further push, domestic economic liberalisation and the open-door policy. Later that year, the party congress declared China's economy a socialist market economy. By the end of 1992, China had resumed its rapid growth path after the disruption of the Tiananmen incident. The incident served as a test of the stability of China's political system and the able leadership of Deng, who managed to regain support after so much external and internal criticism.

The degree of institutional reform achieved can be measured by the contributions of the market institutions to national output at the beginning of the twenty-first century. The *China Statistical Yearbook* (NBS 1997: 42) provides the following breakdown of GDP from 1996 of RMB6,859.4 billion: primary industry, RMB1,388.4 billion; secondary industry, RMB3,361.3 billion; and tertiary industry, RMB2,109.7 billion. If all primary industries (namely, agriculture), 75 per cent of secondary industry (since state enterprises account for less than 30 per cent of gross industrial output and some are profit-oriented) and 50 per cent of tertiary industry (since much retail trade is private) are considered as the output of profit-maximising producers, a total of RMB4,964.3 billion of the GDP of RMB6,859.4 billion is so produced. This amounts to 72.4 per cent of the Chinese economy being market-driven, and is a good indicator of the stage reached by market economic reforms. This 72 per cent of market-driven GDP happens to coincide with the 28 per cent of gross industrial output value produced by state-owned enterprises, reported at the end of section three of this chapter.

The impact of WTO membership

At the turn of the twenty-first century, China was in the process of joining the World Trade Organization (WTO). To meet the conditions to enter the WTO, China agreed to gradually lower its tariffs on agricultural and industrial products and open its service and manufacturing industries. The lowering of tariffs would lead to an increase in imports of both agricultural and industrial products for consumers. The prices of these products were expected to decline and the quality of the products would improve—both to the benefit of Chinese consumers. Foreign manufacturers operating in China would also provide competition, with China's low-cost labour and savings on the cost of transporting final products into the country. Financial and telecommunication firms in China would have to upgrade their products to survive foreign competition.

WTO membership will also affect China's economic structure. Structural changes include changes in the relative importance of different industrial sectors and of state versus nonstate sectors. Tertiary industry is expected to increase its share of GDP partly as a result of China's entry into the WTO. The stimulus to the domestic service industry provided by foreign competition and expected foreign investment will lead to more rapid growth than would otherwise have occurred. The high-technology component of the manufacturing sector will increase in importance partly because of the expected increase in foreign investment. The domestic manufacture of consumer durables—especially automobiles—will suffer from the increase in imports, while increased foreign investment in the automobile industry will help increase domestic production. The expected growth in both the service and the manufacturing sectors will lead to a further decline in the share of agriculture, but this would take place even without entry into the WTO. The relative decline in the agriculture sector will be hastened by foreign competition as a result of the lowering of tariffs on agricultural products. The total effect of WTO entry on China's industrial composition is, however, limited.

Premier Zhu Rongji's main motivation for promoting China's entry into the WTO was to use foreign competition to speed up economic reform in both the industrial and the service sectors. In the late 1990s, reform in both sectors was slow because of the vested interests of a group of managers appointed under a previous administration who were determined to hold on to their positions. Simply changing state enterprises to shareholding companies did not lead to the replacement of incumbent managers or to the adoption of new ways of doing things. Foreign competition provides a more powerful force to combat such inertia. How successful such outside pressure will be depends on how strong the inertia is. In addition, for fear of creating too much social instability, the government cannot and will not allow competition to come in too rapidly. The slow speed of entry to China's market is codified in a schedule that lowers tariffs gradually and permits foreign firms to enter the financial and telecommunications industries step by step. Informally, there is red tape and other means to delay foreign competition, which can be exercised by central, provincial and local government officials.

Li et al. (1999) applied a dynamic computational general equilibrium model of the Chinese economy to study the impact of WTO membership. Four aspects of WTO membership are discussed: 1) tariff reduction; 2) stepwise abolition of nontariff barriers to industrial products; 3) increased import quotas on agricultural products and eventual abolition of all import quotas; and 4) phasing out of quotas on China's exports of textiles and clothing to developed economies. The impact of WTO membership on economic growth comes from two sources: specialisation through international trade and an increase in efficiency within each industrial sector through competition. The study estimated that China's real GDP in 2005 would be 1.5 per cent higher from the first source due to the above policies. This increase is derived from increased specialisation in trade according to China's comparative advantage, as WTO entry allows more agricultural imports and textile and clothing exports, in particular. If the gain in total factor productivity is incorporated, the average annual growth rate in GDP from 1997 to 2010 will be 1 per cent higher after entry into the WTO. Bear in mind that the annual growth rate projected for this period is approximately 7.5 per cent; I believe it might serve as an upper bound on the effect of WTO entry. There will be inertia to inhibit the forces that promote both sources of output growth. In fact, these forces were already operating in the 1990s, and are expected to continue even without WTO membership.

One should also consider the impact of WTO membership in hastening the modernisation of China's legal system as it is forced to deal with more and more foreign firms. The impact on legal institutions will include changes in formal institutions and laws and, to some extent, in the legal behaviour of the Chinese people. Since the mid-1990s, many new commercial laws have been enacted governing corporate behaviour, bankruptcy and the behaviour of banks and other financial institutions. Furthermore, the Chinese judicial system has been modernised and improved. The practice of litigation is now more widespread and the number of lawyers has increased dramatically. There were also signs at the beginning of the 2000s that, as the country becomes wealthier and the government makes greater efforts to enforce the law, Chinese citizens have tended to become more law-abiding. One important role of the WTO is to settle disputes on matters related to world trade between countries; this will help promote order in international business activities.

WTO membership will also have an effect on China's political system. Membership could increase both the demand for and the supply of democratic government. On the demand side, the further economic development and modernisation made possible under WTO membership will increase people's interest in democratic government and their ability to participate in it. On the supply side, the outlook of government leaders will become more global and modern. Such effects will be positive, but one cannot expect them to occur very rapidly. There are inhibitions derived from the historical, social and bureaucratic traditions of China.

In summary, I have suggested reasons WTO membership could have positive impacts on China's institutions. The impacts are small, because the provisions of membership are limited in scope. The effects are expected to be gradual, not only because the terms of membership are to be introduced in steps, but also because economic, legal and political institutions are difficult to change. In addition to the formal provisions to open China's economy gradually, the central government is monitoring the speed of changes to avoid social instability. At the same time, local governments and bureaucrats will seek to stall the changes with red tape if they find them too threatening to local economic institutions. Slow changes in China's institutions may be desirable. Some observers consider the social changes in China since 1978 have been as rapid as the Chinese people can absorb.

As well as the substantive provisions for entry, WTO membership has symbolic significance: China's position in the world economic community is recognised. The conditions for entry to the WTO will serve as a blueprint for China's institutional changes for at least a decade, even if the provisions agreed to do not take effect as early as the formal statements claim. In the meantime, helping Chinese leaders project a better image of themselves in the world community will improve their own confidence to govern and the confidence of the Chinese people in their leaders. The psychological effects of WTO membership may make Chinese leaders more willing to adopt democratic reforms and Chinese citizens more patient in following their leaders as they guide the gradual political change in China towards more democratic government. I make this positive concluding statement under two assumptions. First, the most important objective of all political leaders—including the Chinese—

is to secure their political power. Second, if their political power is assured—and notwithstanding the bureaucratic inertia underlying one-party rule in China—Chinese political leaders are likely to try their best to modernise China and fulfil the dream of generations of Chinese since the Opium War of 1840.

Prospects for reform

There are three sets of forces affecting the Chinese reform process in the early twenty-first century, which should be kept in mind when we examine the prospects for future evolution of China's economic institutions. First is the role of the government, which is by and large positive in initiating reform in various sectors. For economists who believe in limiting the role of government in a market economy, the experience in China confirms the important role of the government in carrying out institutional reform and implementing economic policies to deal with crisis situations—the latter in developed economies as well. To the extent that government actions are required, the competence of government officials is an important factor determining the success of economic reform and economic policies. China has selected some very competent people to serve as government officials, the prevalence of corruption notwithstanding. The Chinese Government also has the will to modernise the economy, as evidenced by its efforts at reform since 1978.

Second, there are market forces pushing reforms forward, two important components of which are private enterprise and foreign investment. Joining the WTO will add impetus in that direction. The third set of forces, however, is institutional inertia, which could slow the process, including government bureaucracy and vested interests in state enterprises and the banking system. There is a lack of trained and competent personnel to run modern enterprises and commercial banks, and the development of human capital is a time-consuming process.

For almost two decades, continued economic growth and reform have been the two most important characteristics of the Chinese economy. These characteristics persisted during the East Asian Financial Crisis and continued in the first decade of the twenty-first century. Reform of the banking system and of state enterprises remains one of the most important tasks facing the Chinese Government. The East Asian Financial Crisis had both positive and negative impacts on economic reform. On the negative side, the speed of reform was somewhat reduced, as evidenced by the introduction of restrictive policies on foreign exchange transactions and on the privatisation of state enterprises. On the positive side, the crisis provided new experience for policymakers, and new observations for economists, of the nature of desirable institutional changes. In any case, the East Asian Financial Crisis led to a reexamination of existing economic institutions and will benefit the outcome of reform in the long run. When the crisis receded, economic reform resumed its speed in China, as it had after the political shock of the events in Tiananmen Square in 1989. The Chinese Government seems determined.

I hope to have conveyed to the reader the following major characteristics of the Chinese economy.

First, although China was once a planned economy, by the turn of the century, it had become essentially a market economy. As a first approximation, one should treat China's economy as a market economy.

Second, and related to the first, is that the economic ideology of traditional communism has almost disappeared. To anticipate and assess the future economic policies of the Chinese Government, one should understand its officials as pragmatic and, by and large, intelligent decision-makers whose objective is to improve China's market economy. Such an understanding avoids the mistakes of many Western observers in predicting a return to central planning after the Tiananmen incident and in predicting a devaluation of the renminbi, a banking crisis and serious unemployment during the East Asian Financial Crisis.

Third, as a qualification of the first point, the Chinese market economy has many shortcomings and economic reforms are not complete. In spite of this, the economy has grown and will continue to grow rapidly in the next decade or two because of the resourcefulness of the Chinese people and because it is not necessary to have a perfect economic system to sustain a fairly high rate of growth.

Fourth, further reform of China's economic institutions will be a slow process because the institutional changes that could be made easily were made in the first two decades of reform, leaving the difficult ones still ahead. These characteristics of the Chinese economy should remain essentially valid for the first one or two decades of the twenty-first century.

Fifth, to understand the nature of the inertia preventing further reform, one must examine Chinese traditions before the establishment of the People's Republic. For example, tradition has led and will continue to lead to bureaucratic behaviour in the management of state enterprises and will restrict the freedom of private enterprise to enter the market and function as effectively as in an open market economy. Reform of formal legal institutions alone cannot change the legal and bureaucratic behaviour of the Chinese population.

Sixth, one can expect both the nationalism aroused after China's defeat in the Opium War of 1840 and the strong urge for modernisation and economic development to affect China's economic and diplomatic relations with other nations.

In summary, one might call the Chinese economy a 'bureaucratic market economy' (its official designation is 'socialist market economy'). It is bureaucratic in two senses. First, state-owned institutions, including the commercial banks and state enterprises, are controlled and run by bureaucrats. Second, nonstate enterprises—both domestic and foreign—have to deal with bureaucrats in the central government and sometimes also in the state sector to conduct their business. Both institutional characteristics hamper the growth of the Chinese economy and are unlikely to change in the near future.

The directions of economic reform have remained the same. According to an article in *The New York Times* on 25 May 2013, China's Prime Minister, Li Keqiang, announced that the central government would reduce the state's role in economic matters to unleash the creative energies of the nation. This includes giving private businesses a bigger role in investment decisions and setting prices. According to a directive issued on the Chinese Government's website, the broad proposals include taking gradual steps to allow market forces to determine bank interest rates and to promote the entry of private capital into finance, energy, railways, telecommunications and other areas. Foreign investors will be given more opportunities to invest in banking, finance, logistics, heath care and other sectors. Furthermore, the decision of the CCCP on economic reform released on 20 October 1984 already listed most of the directions for reform announced by Li Keqiang in 2013. Another important characteristic in the process of economic reform and policy formulation is that the implementation of an announced policy may be slow or may not even be completed as a result of various obstacles.

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