China's Economy
Reform and Perspectives

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It is now just over twenty years since China initiated its economic reform in 1978. Since then its average rate of growth of GDP has been a phenomenal 9.5 percent per year. This essay reviews the reform process, discusses the impact of the current Asian financial crisis, and attempts to assess the prospects of China's economy in the future.

The Reform Process

In 1978 Chinese leaders realized the weakness of Soviet-style planning and the need for reform but did not have a blueprint for change. They decided to experiment, adopting what was successful. Experimentation also helped in getting communist party support, as many party members were otherwise unwilling to accept and support the changes. Deng Xiaoping's slogan was "Seek truth from facts" — not from ideology.

The first successful reform occurred in the agricultural sector. It was initiated locally, when some commune leaders discovered that by assigning land to each farm household and allowing them to keep all the products in excess of the amount required by the procurement quota, rather than by practicing collective farming, the total output of the commune could be greatly increased. The success of this experimentation led the central leadership to adopt an agricultural responsibility system for the entire country. China thus changed its system in two or three years from collective farming to private farming, and market reform for the agricultural sector was essentially completed.

Reform for the industrial sector was much more difficult. Large state enterprises could not easily be divided into small production units, although an attempt was made to introduce the idea of the responsibility system into the industrial sector. Second, economic efficiency in an industrial enterprise depends not only on the incentive system inside the enterprise but also on the prices and supply conditions of inputs and prices and demand conditions of outputs, which were then subject to government control. Reform of the price system was therefore required. In the early 1980s, state enterprises were first given some autonomy in production, distribution, and investment decisions, and in the mid-1980s price controls and central allotment of inputs were gradually reduced. In the initial stage of price reform, there was a two-tier price system for products supplied by the state, the lower price available to state enterprises but at limited quantity of supply and the higher price that at which the needed product could be purchased on the market. The former amounted to a fixed subsidy to state enterprises and did not affect its marginal decisions, which were determined by the market price. Later, the two prices gradually converged.

In 1987, the contract responsibility system was introduced. Under this system an enterprise was leased to its management, and a fixed tax was collected, allowing the enterprise to keep all the remaining profits. According to statistical studies, productivity of state enterprises was increased in the 1980s but to a lesser extent than in the more dynamic township and village enterprises. The shortcomings of the state enterprises include inadequate training and experience of the management to deal with problems facing modern enterprises, inadequate compensation to the management (often only a third or less of the compensation in comparable township and village enterprises), excess supply and possibly low quality of existing labor force, and perhaps the governance system. (I say "perhaps" because there are many examples of efficient and profitable state enterprises under able management, which is a major factor in their performance.) Further reform of the state enterprises will be discussed later.

The third area of reform is the control of the macroeconomy. Since the early 1980s China has tried to establish a macro-control mechanism to exercise monetary and fiscal policies in lieu of central planning. Banking reform started in at least 1983, when the People's Bank was officially changed to a central bank. Until today it has not actually functioned as a central bank because there are no effectively functioning commercial banks in China. There were four specialized banks — the Industrial and Commercial Bank, the Agricultural Bank, the People's Construction Bank, and the Bank of China — which were converted to commercial banks in name but are entirely owned by the government and do not yet function as commercial banks in their credit policies. In March and May 1995, respectively, the People's Congress passed the Law on the People's Bank of China and the Commercial Bank Law. Both measures are modern in content, very similar to the laws governing the Federal Reserve System and the commercial banks in the United States, except that the Bank of China has less autonomy and is under the control of the State Council. In practice, however, commercial banks do not function effectively because of political interference, lack of trained personnel, the control of interest rates for loans and deposits, and insufficient incentives.

Government ownership of these commercial banks has one advantage. It makes a banking crisis in China unlikely, even under the present circumstances, when some 20 to 25 percent of loans are bad mainly as a result of past obligations to extend loans to state enterprises. The government has set up for each of the large commercial banks an asset management company to take over the non-performing loans. China has a high savings rate (over 30 percent), and the Chinese people keep most of their savings as bank deposits as they have a limited number of alternatives. They assume that their deposits are guaranteed by the government and are safe, so there is no reason for a bank run. Macroeconomic control has been exercised mainly through fixing the amount of credit which commercial banks in different regions are allowed to extend and the quantity of currency in circulation.

The fourth area of reform was the "open door policy." The volume of foreign trade has increased, from just below 10 percent of GDP in 1978, to over 35 percent in 1996. Following the development experience of Taiwan and South Korea, exports were promoted. Trade deficits in the 1970s and 1980s were transformed to trade surpluses in the 1990s. Control of foreign exchange was gradually liberalized. With successive devaluation of the Chinese currency from 1.7 yuan to one U.S. dollar in 1980, to 8.6 yuan in 1994, the exchange rate was made equal to the market rate and the Chinese currency became convertible as far as trade transactions were concerned. From 1995 to the present, the exchange rate has remained approximately 8.3 yuan to the dollar.

The encouragement of foreign investment is the second component of the open door policy. Direct foreign investment increased from a meager $1.8 billion in 1984 to $41.7 billion in 1996, mostly coming from Hong Kong. Although foreign investment is a small fraction of GDP, it accounts for over 60 percent of China's exports. It is extremely important for China's development as it helps to transfer technology, managerial skill, and modern business practice to China as well as providing competition for state enterprises, forcing them to be more efficient.

The fifth area of reform has been encouraging the development of non-state sectors of the economy. By the early 1980s, the agricultural sector was almost entirely privatized. By 1996, state-owned enterprises accounted for only 28 percent of gross industrial output. Collectively owned, individually owned, and other types of enterprises accounted for 39, 16, and 17 percent, respectively (*China Statistical Yearbook 1997*, p.415). The dramatic growth of the collectively owned township and village enterprises is a fascinating story. These enterprises were built by the political and economic resources of the township and village governments to increase revenue. They are subject to market competition and employ the skills of competitively selected and highly paid managers, utilizing the high-quality labor force available in the countryside. These economically efficient enterprises are publicly owned and operate without a modern legal framework. The non-state sectors have grown to such an extent that, even if the minor state sector grows slowly, economic progress in China can continue.

The sixth area of reform concerns institutional infrastructure, including in particular the legal and educational systems. Reform of the legal system has been a slow process but is continuing. Many formal aspects of a modern legal system are now in place, including laws governing business conduct and bankruptcy, and courts to enforce them. In practice, disputes are still settled partly by political influence, personal relationships, and bribery, making it difficult to do business in China. The educational system has also been greatly improved. Modern economics and management education have been introduced into university curricula. Special training programs have been provided to government officials in charge of banking, financial, and fiscal affairs. Much remains to be done, simply because of the sheer size of the Chinese population.

Impact of the Asian Financial Crisis

While progress was being made in the above reforms, the Asian financial crisis came unexpectedly. China had a much sounder economic foundation than the Asian countries hit by the crisis. Its currency was not overvalued. For four years, up to the end of 1997, the Chinese currency had been freely traded at the official rate. Inflation was low in China, at 0.8 percent in 1997 and -0.3 percent in 1998. China had 140 billion in foreign reserves in 1997, a trade surplus, and a continued flow of foreign investment, and there were not a large number of short-term foreign debts or financial investments which could be suddenly withdrawn when foreign creditors or investors lost confidence. China was affected during the crisis mainly because devaluation of the currencies of neighboring countries reduced the competitiveness of its exports. For the first time in over two decades, total value of exports decreased in 1998, but China still maintained a trade surplus and a substantial amount of foreign investment.

The policies to deal with the impact of the Asian financial crisis consist mainly of increasing government expenditures in infrastructure building and modifying the speed of reforms in both the industrial and financial sectors. To maintain aggregate demand when exports were reduced, the government tried to build more railways, highways, agricultural land and water conservancy facilities, municipal facilities, and environmental protection facilities. Broadly defined, government investment of US $1.2 trillion was planned for the three years 1998 through 2000. As a result, the rate of growth of real GDP in 1998 was 7.8 percent, as compared with 8.9 percent in the previous year. One cannot tell to what extent the rapid increase in government investment was achieved at the expense of lowering efficiency and the quality of the real output. It is somewhat surprising that a more expansionary monetary policy was not pursued in 1998 to increase aggregate demand and to finance some of the government investment, as the country was experiencing a deflation in prices and stagnant private demand. In the first quarter of 1999, real GDP grew at an annual rate of 8.3 percent, a sign that the economy was performing better than in 1998.

With respect to the reform of state enterprises, General Secretary Jiang Zemin announced in his report to the Fifteenth Congress of the Communist Party in September 1997, "We should support, encourage and help diverse forms in our collective economy. Public ownership can and should take multiple forms." The essence of the policy is to change state enterprises to share-holding companies. This is the first time reform of state enterprises has reached the level of what might be called privatization, even though such a word is not used. For the small- and medium-sized enterprises, restructuring has already taken place, whereby managers and workers may purchase shares according to their wages. Members of boards of directors were elected by the shareholders. For example, if the monthly wage of a worker is 600 yuan, he may pay 2,000 yuan for his shares, while a high-level manager may pay 5,000 to 10,000 yuan for her shares. The shares can be traded internally but not publicly. For large state enterprises, restructuring takes a variety of forms, but most become modern corporations in which shares may be purchased by outsiders. Companies which are qualified according to their financial performance can have their shares traded on the Shenzhen, Shanghai, Hong Kong, or even the New York stock exchanges. The State Economic and Trade Commission and its branches at provincial, city, and county levels have direct responsibility for the restructuring of the state enterprises under their jurisdiction. The restructuring process is effectively administered through central directions given in Beijing at meetings involving party and government leaders from all provinces. These officials in turn transmit the directives to lower levels in all parts of China. The personnel are competent.

During such a restructuring process, workers may get laid off, leading to unemployment, and some have had their wages reduced, sometimes by as much as 50 percent, or even more. Some workers have not received their regular salaries. These problems are concentrated in provinces with a large number of state enterprises, especially in the northeast. For the country as a whole, the recorded unemployment rate (excluding those laid-off workers receiving partial compensation) increased from 3.2 percent in 1996 to 4.0 percent in 1997, but it was reduced to 3.2 percent in October 1998. The unemployment problem is expected to be controlled for three reasons: First, the government is monitoring the level of unemployment to prevent massive social unrest. This is slowing down somewhat the process of restructuring state enterprises. Second, the Chinese people are resourceful. Many laid-off workers have found work in the market, especially in the service sector. Third, the government is stimulating the economy through infrastructure building, which absorbs some workers. It also helps retrain them and place them into new jobs.

On the reform of the financial system, the current crisis appears to be speeding up the enforcement of transparent financial reporting and the supervision of financial institutions by the People's Bank. Several investment trusts — notably the Guangdong Investment Trust and Investment Company (GITIC) — which were financed by government capital went bankrupt in late 1998 and early 1999. Foreign banks and investors considered their money to be protected by the government when they put it in these trusts, which is not legally the case. The fact that some of the trusts were allowed to go into bankruptcy has led investors to revise their expectations, making them more realistic in future investing. In February 1999 the government of China decided to close down five state investment trusts which were subsidiaries of the major commercial banks engaged in risky investments. Supervision of financial institutions has now become more strict in China.

The open-door policy or globalization of the Chinese economy was slowed down by the Asian financial crisis. Chinese leaders must have observed that opening the Chinese financial markets to short-term foreign investment and allowing free capital flows are hazardous. They were aware of the risk when they divided the shares in the Shenzhen and Shanghai stock exchanges into A and B shares, allowing foreign investors to buy only B shares. Thus, fluctuations in prices of the B shares affect the fortunes of foreign investors only. China was in the process of gradually making its currency convertible for capital transactions, but the crisis has caused it to impose restrictions on transactions even in the current accounts.

This is related to the issue of whether China will, or should, devalue its currency. The advantage of devaluation is to make China's exports perhaps more competitive, provided that it does not lead to another round of devaluation by its neighbors. There are many more reasons not to devalue. From the viewpoint of purchasing power parity, China had a zero and a negative inflation rate in 1997 and 1998, respectively. It has over $145 billion in reserves, which are increasing because of a trade surplus and an inflow of foreign investment. The economy is growing at a rapid rate and does not require increasing exports to stimulate it in the short run. In the long run, if the trade surplus and the flow of foreign investment continue, the supply of foreign exchange will exceed demand, leading naturally to an appreciation of the Chinese currency. Chinese leaders have stated repeatedly that there will be no devaluation in the short term. Keeping this promise ensures their credibility and the role of China as a stabilizing force in the current financial crisis. The advantages of maintaining the existing exchange rate appear to far outweigh the possible gain of devaluation.

In spite of the strong economic fundamentals and political rationale supporting the existing exchange rate, many people inside and outside China still expected the yuan to decline against the dollar. Exporters and others decided to put some of their earnings in foreign currencies. In early fall 1998, China's foreign reserves remained at about $140 billion even though there was a trade surplus of $30 billion and foreign investment of $27 billion. The free market exchange rate for the yuan, as found in banks in Hong Kong, was about 8 percent lower than the official rate. The government decided to restrict the flow of currency out of China. Although it could claim that there was no change in exchange rate policy, in practice there were more forms to fill out and more delays in getting approval when one applied legally for foreign exchange.

In summary, China's reform process has been an experimental and gradual process. It was to be continued before the Asian financial crisis struck. State-enterprise reform, financial reform, and the opening of the Chinese economy have all been affected by the crisis, but there is no question that as soon as conditions allow, the reform process will resume, incorporating the lessons learned from the crisis. What are the trends and prospects?

Prospects

Consider the first area of reform, that in the agricultural sector. Privatization alone is recognized to be insufficient for future needs. One area requiring much attention is the introduction of modern technology to agriculture, including decentralized research to meet the needs of each locality to increase productivity. A second is the improvement in infrastructure, including transportation, communications, and electric power. A third is education, not only for the young but for the farming population, to learn new technology and management and marketing skills. So far the government has not encouraged the development of non-state distribution systems in agriculture, and marketing of grain still relies on procurement by the state.

Reform of state enterprises is likely to pick up speed as soon as the crisis is over. The government is very determined to proceed with reform as it cannot continue to subsidize the loss-making enterprises, which account for about half of the over 200,000 state enterprises. As these enterprises are producing less and less of China's total output and as some of them are becoming financially independent share-holding companies, they will become less of a burden to the economic growth of China.

The banking and financial sector has benefited from the experience of the crisis. More transparency in financial reporting and stricter supervision of financial institutions are taking place, but banking reform is expected to be slow. It takes time to train qualified modern bankers, to rid the banks of political influence, and to convert them to profit-making and risk-calculating enterprises. The government has not tried to restructure the banks to become share-holding companies open to private ownership, as in the case of state industrial enterprises, but rural cooperative funds have been allowed to sell shares and extend small loans to farmers as working capital. In recent years, commercial banks other than the big four have appeared. These banks are subject to less political influence and behave slightly more like modern commercial banks, but their shares are all held by government agencies. To reduce political influence on the banks by local governments, a new rule was instituted, and local bank managers are now appointed by the bank's headquarters and are not subject to the approval of the local government. The four state commercial banks would also be free from local government interference in their credit policy. Furthermore, there has been discussion about setting interest rates according to the market forces of demand and supply. All these reform measures will take time.

China's globalization has also been slowed down, including in particular making the Chinese currency convertible for capital account transactions. After the financial crisis, developing countries became more cautious in opening their capital markets to free short-term capital flows. China is no exception. In fact, China should be given credit for recognizing some of the pitfalls of entering a completely free global financial market without sufficient institutional preparation. China does wish to open its doors more widely to the outside world, as a means of gaining technology and providing foreign competition to its domestic industries, as evidenced by the concessions which it has been willing to make in order to enter the World Trade Organization. The concessions include opening the domestic markets to agricultural imports (citrus fruits and wheat); allowing foreign firms to engage in telecommunications, banking, entertaining and other areas; and lowering import duties at a faster rate.

The government faces several other important economic problems. One is the environment. In both rural and urban areas, the environment has deteriorated greatly as a result of years of neglect. Deforestation, floods, soil erosion, and polluted air are all very serious problems. Floods were extremely damaging in 1998. Of the ten most polluted cities in the world in 1999, nine were in China. Second is increased income inequality. Although all segments of the population and geographical areas of China have benefitted greatly from economic growth, disparity has widened between the rich coastal provinces and many provinces in the interior. Third, while the pre-reform system provided health care, retirement compensation, and employment security to members of the society, substitutes for these provisions have not been firmly established under the current market economy. Fourth, science/technology and education policies have to be improved to serve economic development needs. Fifth, highly subsidized urban public housing is being replaced by private ownership. In each of these five areas the government has recognized the importance of the issues and has devoted economic resources to deal with them, but the solutions are slow in coming for the first four.

I cannot end an essay on economic reform without commenting on political reform in China. This is not the place to debate whether political reform toward democracy is necessary for economic reform. All can agree that, as economic reform leads to improvement in the living standards of the citizens and gives them more economic power and freedom, they will demand more political power and freedom. In China, political reform has taken place in several ways. The People's Congress, which once only rubber-stamped the legislation introduced, now exercises more political power. The legal system has been strengthened to the extent that citizens can and have sued the government for violating their rights. That does not mean that the courts' decisions are all free from political influence. Third, there are many more public elections at the village level to select government officials. The Chinese government is introducing political reform at a speed which most Western observers consider too slow, but it is the speed at which the government is comfortable, given its knowledge and experience and its interest in maintaining power and social stability. Some observers may speculate that unless the government introduces democratic reforms more rapidly, there will be political instability or economic reform will stop. Regarding the latter possibility, it should be pointed out that even if economic reform were to slow down, the existing economic institutions are sufficiently close to those of a functioning market economy that economic growth can continue at a reasonably high speed for another decade, as it has done in the last decade. Serious political instability seems unlikely because the majority of the population appears to support the government.

In conclusion, economic reforms in China are likely to continue in the manner and direction described above. Because of the strong fundamentals of the Chines economy, demonstrated by its good performance during the recent financial crisis, substantial growth will continue for perhaps another decade after the current crisis ends. What will happen after that, I would not wish to predict.

Note

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