# OVERVIEW OF CHINESE ECONOMIC REFORMS: INITIATIVES, APPROACHES AND CONSEQUENCES

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# I. INTRODUCTION

In the last quarter century between 1978 and 2004, the People's Republic of China (China) has transformed itself from a centrally planned economy to an emerging market economy and at the same time its economy has achieved nearly a 9.5 percent average growth rate. During this period, China's gross domestic product (GDP) per capita increased by about seven times and the living standard of ordinary Chinese people has improved significantly. To explain the impressive achievement, this paper provides an overview on major initiatives, approaches, and consequences of Chinese economic reforms in the past quarter century.

As a pre-reformed transitional economy, Justin Yifu Lin, Fang Cai, and Zhou Li explain, the Soviet-type planning system of China was endogenous to the choice of a comparative advantage-defying capital-intensive heavy industry oriented development strategy (hereafter CAD strategy). However, heavy industry is capital-intensive while China was a capital-scarce, low-income, agrarian economy in the 1950s. That is, the capital-intensive heavy industry was not China's comparative advantage at that time. Therefore, a set of distorted macro-policies was required for the Chinese government for the development of heavy industry (Lin, Cai, and Li 2000: 27-37).

In order to achieve the goal of the CAD strategy, China's pre-reform economic structure had three integrated components: (1) a distorted macro-policy environment which featured artificially depressed interest rates, over-valued exchange rates, low nominal wage rates as well as low price levels for living necessities and raw materials; (2) a planned allocation for credit, foreign exchange, and other materials; and (3) a traditional micro-management system of State-owned enterprises (hereafter SOEs) and collective agriculture. In this way competition was suppressed, and profits ceased to be the measure of an enterprise's efficiency (Lin, Cai, and Li 2000: 38-57).

Despite the fact that more than three-quarters of China's population lived from agriculture and labor-intensive light industries were consistent with China's comparative advantages, agriculture and light industries each received less than 10 percent of State investment in the period 1953-1985, while 25 percent went to heavy industry. As a result, the value of heavy industry in the combined total value of agriculture and industry grew from 15 percent in 1952 to about 40 percent in the 1970s.

However, the economy was very inefficient. A World Bank study shows that, even calculated at the most favorable assumptions, the growth rate of China's total factor productivity was merely 0.5 percent between 1952 and 1981, and only a quarter of the average growth rate of 19 developing countries included in the study (World Bank 1985).

With the low inefficiency and stagnation of the economy, the Chinese government launched economic reforms and adopted an opening-up policy by the end of 1978 to re-build the legitimacy of the Chinese Communist Party (CCP) ruling China after the torturing 30-year period of political turmoil, particularly the catastrophic Cultural Revolution from 1966 to 1976.

## II. MAJOR INITIATIVES OF CHINESE ECONOMIC REFORMS

The historic decision on "reform and opening-up" made at the Third Plenum of the CCP Eleventh Party Congress on December 18-22, 1978, marked the beginning of China's reform era. At the time, China had a clear desire to increase productivity and raise living standards by reforming its economic system and structure, but it did not have a clear objective of what the new system would be like. Furthermore, the reform did not have a well-designed strategy or policy measures.

Instead of being designed a *priori*, the choice of specific reform measures and the sequence of transition reflected the government's pragmatism toward the problems or crisis that emerged in the economic system and the opportunities that can be utilized to mitigate or solve the problems. The government's philosophy toward specific reform measures is best reflected by Deng Xiaoping's famous saying: "No matter it is a white cat or black cat, as long as it can catch mouse, it is a good cat." The sequencing of reform measures is best described by another Chinese saying: "To cross a river by groping the stones."

In retrospection, the first parts of Chinese economic reforms in the late 1970s and early 1980s involved implementing the contract responsibility system in agriculture, by which farmers were able to retain surplus over individual plots of land rather than farming for the collective. This was followed by the establishment of township and village enterprises (TVEs) owned by townships and villages. In addition, an opening-up policy was introduced by which China began to expand international trade and allow foreign direct investment. These initiatives immediately increased the standard of living for most of the Chinese population and generated support for later, more difficult, reforms.

The second phase of reforms in the late 1980s and early 1990s was aimed at improving the governance of SOEs through the enlargement of enterprise autonomy, creating market institutions and converting the economy from an administratively driven planned economy to a price driven market economy. Particularly, the difficult task of price reform was achieved using the dual-track system to prices and exchange rate, in which some goods and services were allocated at state-controlled prices, while others were allocated at market prices. Over time, the goods allocated at market prices were increased, until by the early-1990s they included almost all products.

The reforms of the late 1990s focused on closing unprofitable SOEs, establishing a social security system, and dealing with insolvency in the banking system. The focus was to create a viable banking system which could control the economy via monetary policy and issue loans on the basis of profit and loss, rather than by political orders. After the start of the 21st century, increased focus has been placed on the gap between rich and poor in China.

Through this cautious and gradual approach, China has been able to replace the

traditional Soviet-type system with a market system meanwhile maintaining remarkable records of growth and relative price stability during the transition process. The following subsections further elaborate the major initiatives of the reforms in detail.

#### **A. Opening-up Policy**

In 1978, China was largely a closed economy, with a trade-to-GDP ratio of 9 percent. Based on the successful experience of "export processing zones" in other Asian countries in the 1960s and 1970s, China decided in 1979 to establish four special economic zones (SEZs): Shenzhen, across the border from Hong Kong, Zhuhai, opposite Macao, Xiamen, across from Taiwan, and Shantou, on the coast of northern Guangdong. The SEZs were designed to import high technology, increase exports, earn foreign exchange, create jobs, assimilate foreign managerial and entrepreneurial skills, and attract foreign investment.

The SEZs became, effectively, laboratories in which the operation of the market economy was carried out. Should the experiment fail, its adverse impact could be minimized since the zones were located far away from China's political and economic centers. The strategy was relatively successful in attracting foreign capital, pioneering reform experiments and creating an export-orient economy. Thereafter, China has been gradually opening up coastal and border cities, major cities in the hinterland, and finally entire China. Particularly, China pursued a "coastal development strategy" in early 1988 to attract labor-intensive manufacturing industries from advanced economies to China.

Reforming the foreign trade regime is another aspect of China's opening-up policy. Prior to 1978, China had a few state-owned foreign trade corporations under the Ministry of Foreign Trade, all of which had little knowledge of the market economy and limited expertise in marketing Chinese products abroad. Since 1978, China has initiated a partial break-up of the monopoly control of foreign trade by a decentralization of trading rights to foreign trade organizations at provincial and lower level and to many enterprises. In addition, China has also devaluated the currency several times to a more realistic level. With the establishment of SEZs, foreign-invested enterprises (FIEs) gradually played an important role in exports and imports. In this process, China benefited enormously from its links with Hong Kong and the overseas Chinese, who helped the country develop its export industries through their international business network.

In terms of trade liberalization, tariffs were reduced from 56 percent on average in 1982, to 23 percent in 1996, to 15 percent by 2001, and to 9.9 percent by 2005. In addition, China gradually lowered its nontariff barriers. It progressively removed limitations on trading rights. The number of FTCs increased from less than 1,200 in 1986 to more than 35,000 in 2001. China's nontariff barriers were completely removed by 2005. China has gradually relaxed restrictions on market entry of FIEs. Increasingly, FIEs have been permitted to sell their goods and services in Chinese markets. In December 2001, China joined the World Trade Organization (WTO) to ensure further opening of its market to foreign competition and accessing foreign markets for its local enterprises.

## **B.** Agricultural Reform

In the beginning of Chinese economic reforms, the government had not intended to change the collective farming institutions with a household responsibility system (HRS). In the resolution adopted by the Third Plenum of the CCP Eleventh Party Congress, any type of household-based farming arrangement was explicitly prohibited. Nevertheless, a collective in a poverty-stricken area began to try out secretly a system of leasing a collective's land and dividing the obligatory procurement quotas to individual households in the collective in the late 1978.

Observing the advantage of the HRS in improving agricultural production, the central authorities later conceded to the existence of this new form of farming, but required that it be restricted to poor agricultural regions, mainly hilly or mountainous areas. However, the restriction was ignored in most regions and Beijing conceded again in late 1980. By the end of 1983, 98 percent of agricultural collectives in China had adopted this new system.

### **C. Decentralization of the Government**

As early as 1979, China started to devolve government authority in the form of delegating fiscal and administrative powers from the central government to the provincial and lower level governments. Local governments were encouraged and rewarded by promoting the economic development of their local economies. For the formal budgetary revenue starting in 1980, the "fiscal contracting system" (*caizheng chengbao zhi*), known by the nickname of "eating from separate kitchens" (*fenzao chifan*), replaced the previous system of "unified revenue collection and unified spending" (*tongshou tongzhi*), known as "eating from one big pot" (*chi daguofan*). Under the new fiscal system local governments, and many were allowed to retain 100 percent at the margin to make them "residual claimants." In addition, local governments also received "extrabudgetary funds," which were not subject to sharing, and "off-budget funds," which were not even incorporated into the budgetary process and thus not recorded.

The significance of the decentralization effort was evidenced by the fact that, in 1997, the central government controlled only 27 percent of total government expenditure, compared with 51 percent in 1978. Over the last quarter century, the central government also relinquished substantial power in other aspects of economic management, including authorizing local governments to approve large investment projects, transferring many formerly centrally administered SOEs to localities, and allowing localities to play a more important role in setting local industrial policies and using resources from financial institutions. Despite their side effects, these decentralization efforts greatly stimulated the local authorities' enthusiasm and provided them with substantial resources in promoting local economic development.

### **D.** Growth of the Non-State Sector

During the reform era, obviously, the engine of growth in China came not from

SOEs, but non-state enterprises. Between 1978 and 1993, the share of non-state enterprises increased from 22 percent to 57 percent, which happened without any privatization of SOEs and was entirely the result of fast entry and expansion of new non-state enterprises, particularly TVEs. In the period of 1981-1991, the number of TVEs, employment, and the total output value grew at an average annual rate of 26.6 percent, 11.2 percent, and 29.6 percent, respectively. As a result, the share of TVEs' output in the total value of industrial output increased from 7.2 percent in 1978 to 38.1 percent in 1993.

Rural industry already existed under the traditional system as a result of the government's decision to mechanize agriculture and to develop rural processing industries to finance the mechanization in 1971. The economic reforms created two favorable conditions for the rapid expansion of TVEs: (1) a new stream of surpluses brought out by the HRS provided a resource base for new investment activities. (2) The relaxation of rigidity in the traditional planned allocation mechanism provided access to key raw materials and markets (Lin 2004: 14).

The rapid entry of TVEs and other type of non-state enterprises produced two unexpected effects on the economic reforms. First, non-state enterprises faced hard budget constraints and were thus more productive than the SOEs. The dynamism of non-state enterprises exerted a pressure on the SOEs for further reforms. Secondly, the development of non-state enterprises significantly rectified the misallocation of resources. In most cases, non-state enterprises had to pay market prices for their inputs, and their products were sold at market prices. The price signals induced non-state enterprises to adopt more labor-intensive technology and to concentrate on more labor-intensive small industries than on SOEs.<sup>1</sup> Therefore, the production-factor structure of non-state enterprises was more consistent with the comparative advantages of China's endowments (Lin 2004: 15).

## E. State-Owned Enterprise Reform

Unlike the spontaneous nature of farming institution reform, the reform in the management system of the SOEs was initiated by the government. The reform has undergone four stages. In each stage of the reform, the government's intervention was reduced further and the SOEs gained more autonomy (Lin 2004: 13).

The first stage (1979-1983) emphasized several important experimental initiatives that were intended to enlarge enterprise autonomy and to expand the role of financial incentives within the traditional economic system. In the second stage (1984-1986) the emphasis shifted to a formalization of the financial obligations of the SOEs to the government and exposed enterprises to market influences. The government instituted a "two-track system" in which SOEs must first fulfill the production quota and sell at the government-set prices and then could produce beyond quota and sell at market prices.

<sup>&</sup>lt;sup>1</sup> For instance, in 1986 an average industrial enterprise in China had 180 workers and the fixed investment per workers was 7,510 yuan; whereas an average TVE had 29 workers and the fixed investment per worker was 1,709 yuan.

Price controls have been gradually relaxed and now no longer exist except in a very few areas such as grain price supports.

During the third stage (1987-1992), the contract responsibility system, which attempted to clarify the authority and responsibilities of enterprise managers, was formalized and widely adopted. The last stage (1993-present) attempted to introduce the modern corporate system to the SOEs. Steeper reforms toward privatization have taken place since the government decided to "let go of the small and hold on to the large" in 1997. By 2000, more than 80 percent of small and medium-sized enterprises completed their transformation through ownership diversification, which includes restructuring, mergers, leasing, contracting, joint-stock companies, and bankruptcies. Publicly listed companies are mostly large ones. In 2002, the government started to allow cross-national mergers between foreign and Chinese state enterprises and thus opened a new channel for reforming state enterprises.

## F. Financial Reform

Even after China's economic reforms began in 1978, the People's Bank of China (PBoC) continued to function not only a central bank but also a loan-issuing bank. A first step toward a true central banking system occurred in September 1983 when the PBoC was reconstituted in its modern form. Four newly separated specialized banks established in the early 1980s began directing lending activities in their particular spheres of influence: the Industrial and Commercial Bank of China, the China Construction Bank, and the Agricultural Bank of China handle domestic transactions, while the Bank of China specialized in international transactions.

Commercialization of the four specialized banks was fostered by the creation of three new policy banks in 1994: the State Development Bank of China, the Import-Export Bank of China, and the Agricultural Development Bank of China. Policy loans were transferred to these new institutions, with the four specialized banks becoming responsible for their own profits and losses. At the same year, a Budget Law enhanced central-bank autonomy by prohibiting the government from borrowing from the PBoC.

In 1997, the government issued US\$ 32.5 billion in bonds to help recapitalize the four big state-owned banks and, in 1999, established four financial asset management companies to purchase and manage bad loans from the state banks. By June 2005, the four asset management companies had disposed of 717.4 billion yuan's worth of nonperforming loans, with a cash recovery rate of 20.7 percent.

In order to fulfill China's commitment of the WTO to liberalize financial markets by the end of 2006, the Chinese government has accelerated financial reforms since the end of 2003. The recent financial reforms included a widening of interest rate margins, a liberalization of mechanisms for setting rates, modifications of banking laws, and the transformation of state-owned banks into joint-stock banks. In particular, in the beginning of 2004, the State Council decided to transform the Bank of China and the China Construction Bank into joint-stock banks. As a result, at the end of 2003 the State Council allocated US\$ 45 billion of official foreign exchange reserves to recapitalize these two banks.

# G. Moving toward to a Market Economy

At the outset of reform, China desired reform in order to increase productivity and improve living standards, but at no time did the leadership think that it was going for a full market system. The "Decision on Issues Concerning the Establishment of a Socialist Market Economic Structure," adopted by the Third Plenum of the CCP Fourteenth Party Congress in November 1993, was the turning point on China's road to markets. Since 1994, China's transition has moved into a new stage which aimed to replace the planned system with a market system (Qian 2000: 15-17).

First, unlike the previous strategy of "to cross the river by groping the stones," the "Decision" emphasized the importance of coordination among various aspects of reforms. Second, in the early stage of reforms, particularistic contracting played a dominant role, such as fiscal contracting, managerial contracting, and household contracting. For the first time, the "Decision" called for a rule-based market system to create a level playing field.

Third, the "Decision" focused on the building of market-supporting institutions, such as formal fiscal federalism, a centralized monetary system, and a social safety net. Finally, the "Decision" addressed the enterprise reform issue in terms of property rights and ownership, rather than, as before, one of "expanding enterprise autonomy."

Moreover, the CCP Fifteenth Party Congress held in September 1997 made a major breakthrough on ownership issues. In the "Decision" of November 1993, state ownership was still regarded as a "principal component of the economy" while private ownership was a "supplementary component of the economy." In the Fifteenth Party Congress, state ownership was downgraded to a "pillar of the economy" and private ownership was elevated to an "important component of the economy". One and half years later, private ownership and the rule of law were incorporated into the Chinese Constitution in March 1999.

# III. APPROACHES OF CHINESE ECONOMIC REFORMS

Chinese economic reforms are not guided by a well-founded theory or followed a pre-determined blueprint. In general, these reforms were not the results of a grand strategy, but as immediate responses to pressing problems. In some cases, such as the closing of SOEs, the government has been forced by events and economic circumstances to do things that it did not want to do. In retrospection, there are three salient approaches to explain the features of Chinese economic reforms: (1) a pragmatic and incremental approach; (2) a micro-first and self-propelling approach; and (3) dual-track and growing-out-of-plan approach.

# A. A Pragmatic and Incremental Approach

Two major principles appear to underlie Chinese economic reforms. The first principle is pragmatism, which is embodied in Deng Xiaoping's dictum to seek truth from facts. The criteria for success are determined by experiment rather than by ideology. The second is incrementalism. Instead of announcing and implementing a national program, typically, an idea is implemented locally or in a particular economic sector, and if successful after extensive experimentation it is gradually adopted throughout the nation.

Incrementalism has many advantages in promoting economic reforms in the way that experimentation can provide useful structural learning experience and new revenues for the potential supporters for the reform program in the next stage, and most importantly, create market supporting institutions, such as legal and financial systems. That is, incrementalism could reduce the transitional costs and increase the reform benefits; minimize the uncertainty of economic reforms and maximize the possibility of success.

For instance, the HRS in rural areas was developed through the initiatives of local governments. In 1978 when the rest of China's rural areas were operating under the collective farming system, in Fengyang County of Anhui Province, several households in a village began to contract with the local government for delivering a fixed quota of grain in exchange for farming on a household basis. The practice was imitated by other counties in the province and promoted by the provincial government before it was promoted by the central government. By 1984, almost all farm households across China had adopted the HRS.

Another example concerns famous special economic zones. In 1980, China established four such zones in Shenzhen, Zhuhai, Shantou, and Xiamen to allow foreign investments and market mechanisms to work when the rest of China was still under central planning. Many successful practices were tested inside these zones, such as new accounting methods, employment practices, and marketing techniques. After the successful experience in the four zones and other coastal cities, many local governments requested the special treatments of foreign investment from the central authorities and thus opening-up policy was rapidly prevailed all over China in late 1980s and 1990s.

In addition, the support generated by the momentum of earlier reform success in the 1980s provided a political basis for the further reforms in the late 1980s and 1990s and even the ideological change in the 1990s. The early agricultural reform created constituencies who were, with their increased wealth, interested in developing rural industrial firms and liberalizing markets. In 1997 because of the earlier massive entry of non-state enterprises, the state's share of output in the industrial sector accounted for only 25.5 percent of the national total, which clearly made privatization of SOEs much easier politically. Similar actions in 1978 would have very different political consequences when the state's share was about 80 percent (Qian 2000: 21-23).

The experience in Eastern Europe and the former Soviet Union shows that, even

though a big bang approach<sup>2</sup> is adopted, the transition from a centrally planned economy to a market economy will still be a slow, gradual process. China's approach did not disrupt the production in the State sector. Therefore, the incremental approach in China achieved the same positive effects of the big bang approach but avoided its costs (Wei 1993).

## **B.** A Micro-first and Self-propelling Approach

Justin Yifu Lin, Fang Cai, and Zhou Li argue that Chinese economic reforms were characterized as a "micro-first and self-propelling approach" (Lin, Cai, and Li 2000: 137-180). They summarize this approach as follows: First, the government took measures to improve the micro incentives by granting partial managerial autonomy and profit-sharing to the micro units (such as HRS, SOEs, TVEs, and local governments) so as to increase incentives for expanding production. In addition, the government encouraged the local and private initiatives in institutional innovations in this stage.

Second, the government introduced a dual-track price and allocation system allowing the resources to be allocated increasingly by the micro units to the previously suppressed, more productive sectors, while maintaining the normal production of the SOEs. Third, the government liberalized the price when the commodity was largely allocated by the market track. Fourth, the government gradually introduced and strengthened the necessary market institutions during the above process.

They argue that most economic problems that appeared during the economic reforms – for example, the cyclic pattern of growth and the rampant rent seeking – can be attributed to the inconsistency between the distorted policy environment and the liberalized allocation and enterprise system. Therefore, the Chinese government constantly faced a dilemma: to make the macro-policy environment consistent with the liberalized micro-management institution and resource allocation mechanism or re-centralize the micro-management institution and resource allocation mechanism for maintaining the internal consistency of the traditional economic system.

A return to the traditional economic system would also mean a return to economic stagnation. Because the government was reluctant to increase the interest rate as a way to check the investment thrust, it had to resort to centralized rationing of credits and direct control of investment projects – a return to the planned system. The rationing and controls gave the inefficient State sector a priority position, not the emerging, dynamic, and efficient non-state sector. Consequently, the pressure of inflation was reduced, but slower growth followed. Therefore, no matter how reluctant the government was, the only sustainable choice was to reform the macro-policy environment and make macro-policies consistent with the liberalized allocation and micro-management system.

They elaborate that China's granting partial autonomy to micro units cracked the integrity of the traditional system. Once the integrity of the traditional economic system

<sup>&</sup>lt;sup>2</sup> A big bang approach includes stabilization, price liberalization, and privatization. This approach was favored for the transition in Eastern Europe and the former Soviet Union by the western economists.

was cracked, the institutional changes evolved in a way that was self-propelling toward the replacement of the traditional system with a more efficient market system. The old planned allocation mechanism and distorted macro-policy environment gradually became unsustainable and were finally discarded.

# C. Dual-track and Growing-out-of-plan Approach

The basic principle of the dual-track approach is as follows. Under the plan track, economic agents are assigned rights to and obligations for fixed quantities of goods at fixed plan prices as specified in the preexisting plan. In addition, a market track is introduced under which economic agents participate in the market at free-market prices, provided that they fulfill their obligations under the preexisting plan. As the economy grew, the proportion of resources that was allocated according to the planned prices became increasingly small. As a result, the economy is able to "grow out of the plan" on the basis of the market track expansion by state or/and non-state enterprises (Naughton 1995).

For instance, the commune (and later the households) was assigned the obligation to sell a fixed quantity of output to the state procurement agency as previously mandated under the plan at predetermined plan prices and to pay a fixed tax to the government. Subject to fulfilling this condition, the commune was free to produce and sell whatever it considered profitable, and retain any profit. Under the dual-track, the state procurement of domestically produced grains between 1978 and 1988 remained essentially fixed, while there was almost a one-third increase in grain output (Qian 2000: 12-13).

Industrial liberalization also shows how the economy could grow out of the plan. For coal, China's principal energy source, the planned delivery was increased somewhat from 329 million tons in 1981 to 427 million tons in 1989, but the market track increased dramatically from 293 million tons to 628 million tons in the same period. For steel, China's major industrial material, the plan track in absolute terms was quite stable, but the share of plan allocation fell from 52 percent in 1981 to 30 percent in 1990. In the cases of both coal and steel, because the plan track was basically "frozen," the economy was able to grow out of the plan on the basis of the market track expansion by state or/and non-state enterprises (Qian 2000: 13).

In terms of consumer goods, the share of transactions at plan prices in retail sales of consumer goods declined from 97 percent in 1978 to only 30 percent in 1990. Note that transactions at market prices include transactions at guide prices, which are government-set prices but with reference to market supply and demand. By 1996, the plan track was reduced to 16.6 percent in agricultural goods and only 7.2 percent in total retail sales of consumer goods.

In terms of employment, between 1978 and 1994, employment in the non-state sector increased by 318.8 percent, whereas employment in the state sector increased by only 50.5 percent. Moreover, within the state sector, there are two tracks. Beginning in 1980, while preexisting employees maintained their permanent employment status, most

new hires in the state sector were made under the more flexible contract system and often at lower wage rates. The proportion of state-permanent employment in nonagricultural employment declined sharply from 60 percent in 1978 to 26 percent in 1994 (Lau, Qian, and Roland 2000: 141).

Lawrence Lau, Yingyi Qian, and Gérard Roland (2000) argue that the dual-track approach to market liberalization has two advantages: it can liberalize markets without creating losers and thus is politically appealing, and it can also achieve efficiency under certain conditions. They assert that the introduction of the market track provides the opportunity for economic agents who participate in it to be better off, whereas the maintenance of the plan track provides implicit transfers to compensate potential losers from market liberalization by protecting the status quo rents under the pre-existing plan. In addition, on the one hand, the plan track system maintains the stability in the economy and allows the SOEs to operate continuously, and on the other hand, the market track system provides the resources, incentives and signals to the non-state sector as well as the SOEs to allocate resources to the dynamic areas of the economy, the labor-intensive sector. Thus, the dual-track approach is, by design, Pareto-improving.

# **IV.** CONSEQUENCES OF CHINESE ECONOMIC REFORMS

Chinese economic reforms have been brought enormous impact on China's economic landscape. Between 1978 and 2003, China's GDP increased by more than nine times and the average growth rate was 9.5 percent; while China's GDP per capita increased by about seven times and the average growth rate was 8.2 percent. In addition, this paper explores three major consequences of Chinese economic reforms: the diminishing role of the state sector, global integration of the Chinese economy, and the contribution of FDI in China's economic development.

## A. Diminishing State Sector

By 1978, shares of all nonpublic enterprises had shrunk to zero, and China's gross industrial output value (GIOV) was produced entirely by SOEs (77.6 percent) and collectively owned enterprises (22.4 percent). The reforms have brought remarkable changes to the state sector. First, the share of GIOV produced by SOEs decreased from 77.6 percent in 1978 to 13.0 percent in 2003. Second, SOEs have been consolidating through mergers, bankruptcies, and regrouping. The number of industrial SOEs declined from 118,000 in 1995 to 23,228 in 2003.

Third, China's SOEs have nearly completed separating themselves from the social functions of providing housing, day care, hospitals, and schools for their employees. Fourth, as a generic term, "state enterprises" now often refer to SOEs with 100 percent state ownership and state-holding enterprises with mixed ownership. The government has also relaxed the restriction that the state in a state-holding enterprise must hold more than 50 percent of the shares (or the absolute majority) to a plurality. In 2003 the proportion of GIOV produced by state-owned and state-holding enterprises was 37.5 percent.

#### **B.** Integrating China into the Global Economy

After quarter-century economic reforms, the Chinese economy has been deeply integrating into the global economy. In 1978, China was largely a closed economy, with a trade-to-GDP ratio of 9 percent. By 2004, this figure reached 70 percent. China's foreign trade rose from US\$ 21 billion in 1978 to more than US\$ 300 billion in 1997 and more than US\$ 1,150 billion in 2004. The ranking of China in the world's trading nations jumped from thirty-second in 1978 to third in 2004. After 2001, China was often described as a "world factory" to describe China's high market share in global manufacturing export market (Zhou 2003).

Nevertheless, is China really a "world factory"? According to statistics of the Chinese customs, in 2002, China was the top producer for more than 100 products in the world. These products stretched over more than 10 kinds of industries, such as the electric appliances, communication equipment, textiles, medicine, machine tools, chemicals, etc. Among them, machine tools, tractors, containers and chemicals accounted for some 85 percent of the total global output, followed by the textiles (70 percent), telephones and displays of communication equipment (50 percent and 42 percent respectively), and televisions and electrical appliances (29 percent).<sup>3</sup>

According to research by the United Nations Conference on Trade and Development, Chinese products accounted for 6.1 percent of the global export market in 2000, increasing from 1.6 percent in 1985, led by the extensive expansion of manufactured goods that are based on non-natural resources, increasing from 1.5 percent in 1985 to 7.8 percent in 2000. Among those not based on natural resources, the export market share of products with low technology increased from 4.5 percent in 1985 to 18.7 percent in 2000; the export market share of products with medium technology increased from 0.4 percent in 1985 to 3.6 percent in 2000; and the export market share of products with high technology increased from 0.4 percent in 1985 to 6 percent in 2000. These results indicate that although China is quite competitive in products with low technology, she is not at all weak in high-tech products.

In regards to the export structure, the proportion of primary products and manufactured goods based on natural resources dropped by a wide margin, whereas manufactured goods not based on natural resources soared by a large margin, increasing from 50 percent of 1985 to 87.1 percent of 2000. The proportion of products with low and medium technology in total exports increased rapidly in the 1980s, then stabilized and began to fall in the 1990s. However, the proportion of high-tech products rose from 2.6 percent in 1985 to 22.4 percent in 2000. With respect to China's ten largest export products, while low technology products were still the largest category in 2000, medium and high-tech telecommunication equipment, automatic data processing machines, parts and accessories of computers have already entered the list of the six largest exports. The market share of Chinese high-tech products in the world is expanding rapidly (See Table

<sup>&</sup>lt;sup>3</sup> "China Was the Top Producer for More Than 100 Products in the World" (in Chinese), China Central Television, December 19, 2000, < http://www.cctv.com/news/financial/inland/20021219/100243.shtml >, accessed on August 18, 2003.

Product	1985	1990	1995	2000
I Export market share (%)	1.6	1.8	4.8	6.1
1. Primary products	2.4	2.6	2.5	2.3
2. Manufactures based on natural resources	1.1	1.3	2.1	2.7
3. Manufactures not based on natural resource	1.5	3.4	6.1	7.8
Low technology	4.5	9.1	15.5	18.7
Medium-sized technology	0.4	1.4	2.6	3.6
High technology	0.4	1.4	3.6	6.0
4. Other	0.7	0.7	1.4	1.8
II Export structure (%)	100.0	100.0	100.0	100.0
1. Primary products	35.0	14.6	7.0	4.7
2. Manufactures based on natural resources	13.6	8.2	7.4	6.9
3. Manufactures not based on natural resource	50.0	76.2	84.6	87.1
Low technology	39.7	53.6	53.5	47.6
Medium-sized technology	7.7	15.4	16.9	17.3
High technology	2.6	7.3	14.2	22.4
4. Other	1.4	0.8	1.0	1.1
III Principal exports (%)	14.2	30.2	38.5	41.5
1 Baby carriages, toys, games and sporting goods	2.5	7.3	8.4	8.5
2. Footwear	1.2	4.6	7.2	5.5
3. Telecommunications equipment	0.4	1.9	3.5	4.9
4. Automatic data processing machines, units	-	0.3	1.6	4.1
5. Outer garments, knitted or crocheted	3.6	4.4	4.1	3.9
6. Parts and accessories of computers, etc.	0.1	0.3	1.8	3.6
7. Outer garments, women's and girls', textile	3.8	5.5	4.8	3.5
fabrics	1.8	3.6	3.6	2.8
8. Travel goods (trunks, suitcases, etc.)	0.3	1.4	2.3	2.3
9. Articles n.e.s. of plastic materials	0.5	0.8	1.3	2.3
10.Furniture and parts thereof				

Table 1 China's Competitiveness in World Trade, 1985-2000

Source:

United Nations Conference on Trade and Development. 2002. World Investment Report 2002:

Transnational Corporations and Export Competitiveness. New York: United Nations. pp. 161-62.

However, China's global competitiveness in world trade is primarily based on processing and assembling exports. Moreover, a large part (more than 50 percent) of the processing exports is a part of the global division of labor: multi-national enterprises rely on China mainly for her cheap labor in processing; local enterprises in China generally do not possess advanced technology or strong research and development capability. In 2002, 55.3 percent of China's exports were processing exports. Meanwhile, FIEs accounted for 52.2 percent of China's total exports.

In particular, the contribution of processing exports and FIEs is more prominent in the development and exports of the high-tech industry. The added value of the high-tech industry increased by three times from 1995 to 2001, and the average growth rate reached 19.3 percent per year. Meanwhile, the value of high-tech exports rose to US\$ 67.9 billion

in 2002, from US\$ 10.1 billion in 1995; the proportion of high-tech products in China's total exports went up to 20.9 percent in 2002, from 6.8 percent in 1995. However, processing exports constituted the majority of high-tech exports: 70.2 percent in 1993, 86.2 percent in 1998, and 89.6 percent in 2002. Moreover, FIEs accounted for a considerably high proportion of high-tech exports: 71.5 percent in 1996, 76 percent in 1999, and 82.2 percent in 2002.

Therefore, Wang Mengkui, director of the Development Research Center of the China State Council, emphasized that China is not the "world factory", but rather "a production workshop in the global processing plant".<sup>4</sup> Chinese scholars are generally unwilling to admit that China is a "world factory"; instead, they assert that "the world processing plant" should be used to describe the status of China in the global division of labor (Jin 2003).

## C. FDI's Contribution to China's Economic Development

In the last fifteen years, FDI has been tremendously contributed to China's economic development in various aspects. Since 1994, China has continued to be the largest FDI recipient in the developing world; its annual inflow has been only next to that of the United States. At the end of 2002, the number of approved foreign-invested enterprises (FIEs) in China had reached 424,196. The contractual FDI was US\$ 828.1 billion; the realized FDI was US\$ 448 billion.<sup>5</sup> Of more than 420 thousand of approved FIEs, over 200 thousand have closed or ceased operation, which accounts for 48 percent of FIEs in total. There are around 220 thousand existing registered, functioning FIEs (Ministry of Commerce 2003a).

In 2002, the ratio of realized FDI in China to GDP was 4.3 percent in 2002. Basically, the contribution of FDI to China's economic development takes six different forms (See Table 2).

(1) **Investments.** In 1993, FDI made up 12.1 percent of China's total social fixed asset investments. In 2002, it was 10.1 percent. From 1993 to 2002, the annual average of FDI as a proportion of total fixed asset investments in China was 12.5 percent.

(2) **Industrial output and value-added.** The industrial output of FIEs as a proportion of Chinese industrial output increased from 9.2 percent in 1993 to 33.4 percent in 2002. In addition, the value-added of FIEs as a percentage of Chinese industrial value-added increased from 11.0 percent in 1994 to 25.7 percent in 2002.

(3) Exports. The value of goods exported by FIEs in 1993 was US\$ 91.7 billion,

<sup>&</sup>lt;sup>4</sup> "Chinese Officials: China Is Not a World Factory" (in Chinese), *China Times*, April 1, 2003.

<sup>&</sup>lt;sup>5</sup> A lot of FDI flowing into China (especially in the early to mid-1990s) was of Chinese origin. "Round tripping FDI" may in some years have accounted for one third of the total inflow. Since the tax reforms of 1994 and later years, fiscal incentives for round tripping FDI have diminished significantly, but it still happens. Under WTO rules (level playing field between all enterprises regardless of ownership) all fiscal incentives for round tripping FDI should completely disappear.

increasing to US\$ 169.9 billion in 2002. In addition, the proportion of exports by FIEs to all China's exports increased from 27.5 percent in 1993 to 52.2 percent in 2002.

(4) **Foreign exchange.** In 2002, foreign exchange balances held in China's banks by FIEs amounted to US\$ 47.1 billion, which accounted for 72.7 percent of the foreign exchange balances held in China's banks by corporations. In addition, FIEs accounted for 63.7 percent of the increase in corporate foreign exchange balances.

(5) **Tax revenues.** In 1993, tax revenues from FIEs were RMB 22.7 billion, which was 5.7 percent of China's total tax revenues. In 2002, tax revenues from FIEs were RMB 348.7 billion, which accounted for 21 percent of China's total tax revenues (Ministry of Commerce 2003).

(6) **Employment.** At the end of 2002, direct employees in FIEs were over 23.5 million accounting for 11 percent of China's urban workers.

Year	Realized FDI	The ratio of FDI	The contribution	The contribution	The ratio of total				
	(billion USD)	in fixed asset	of FDI to	of FIEs to Chinese	tax revenues from				
		investment (%)	industrial output	exports (%)	FIEs (%)				
			(%)						
1993	27.52	12.1	9.2	27.5	5.7				
1994	33.78	17.1	11.3	28.7	8.5				
1995	37.52	15.7	14.3	31.5	11.0				
1996	41.73	15.1	15.1	40.1	11.9				
1997	45.26	14.8	18.6	41.0	13.2				
1998	45.46	13.2	24.0	44.1	14.4				
1999	40.32	11.2	27.8	45.5	16.0				
2000	40.72	10.3	22.5	47.9	17.5				
2001	46.88	10.5	28.1	50.1	19.0				
2002	52.74	10.1	33.4	52.2	20.5				

 Table 2. FDI's Contribution to China's Economic Growth: 1993-2002

Source : <u>http://www.FDI.gov.cn</u> ; <u>http://www.mofcom.gov.cn</u>

Notes: 1. FDI: foreign direct investment.

2. FIEs: foreign-invested enterprises.

Overall, from the results of econometric analysis by Chinese scholar Jinping Zhao, 2.7 percentage points of China's annual average GDP growth rate of 9.7 percent during the 20 years from 1980 to 1999 came from the direct and indirect contributions of FDI; i.e., a significant contribution of about 28 percent to China's economic growth (Zhao 2001). A study undertaken by Wanda Tseng and Harm Zebregs, economists in the IMF, shows that FDI contributed 3 percentage points to China's average economic growth rate of 10.1 percent in the 1990s; i.e., a contribution of around 30 percent to China's economic growth (Tseng and Zebregs 2002).

# V. CONCLUSION AND LESSONS

In the last quarter century, China has been experiencing three dimensional transformation of the economy: from a planned economy to a market economy, from an agrarian economy to an industrial economy, from a relative closed economy to a relative

open economy. During the reform process, China adopted an incremental, micro-first, and dual-track approach to the transition. Over the quarter-century economic reforms, China has been maintaining very rapid economic growth rates with diminishing state sector, integrating itself into the global economy and remarkable contribution by the FDI. Generally speaking, Chinese economic reforms were relatively successful compared with Eastern Europe and the former Soviet Union.

Based on the above discussion, we may learn seven major lessons from Chinese economic reforms. First, the most important principle for a successful transition from a planned economy to a market economy is pragmatism. Second, the incremental approach generates the momentum from earlier reform success and thus provides a political basis for the further reforms.

Third, the micro-first approach creates constant pressure to complete the transition process to a market economy. It is imperative for a transitional economy to complete the reforms in macro policy environment after the reforms in micro management institution and resource allocation mechanism. Only by removing the institutional incompatibility can the economy set forth a sustained, smooth growth path (Lin 2004: 29).

Fourth, institutional changes that create incentives, impose hard budget constraints, and introduce competition should not only apply to firms but also to governments. Indeed, reforming government is an important component of economic reforms. Fifth, it is better to dismantle the existing institutions after the new ones are put in place, or allow the new ones to emerge from the old, to avoid an institutional vacuum (Qian 2000: 30-31).

Sixth, successful reforms rely on political support, which in turn depend on delivering tangible benefits to a large majority of the population. Compensating potential losers in the reforms is both a political and economic issue, and reforms that do not create many or big losers can be politically acceptable *ex ante* and sustainable *ex post*. The dual-track approach has been a concrete mechanism to achieve this objective (Qian 2000: 31).

Finally, with successful transition from a planned economy to a market economy, the new development strategy of the transitional economy moves from a CAD strategy to a comparative advantage-complying labor-intensive industry oriented development strategy (CAC strategy).

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