Commission on Growth and Development

WORKING PAPER NO.50

Explaining China's Development and Reforms

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Australian Government
AusAID
DFID Department for International Development
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THE WILLIAM AND FLORA HEWLETT FOUNDATION
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THE WORLD BANK

On behalf of the Commission on Growth and Development
1818 H Street NW
Washington, DC 20433
Telephone: 202-473-1000
Internet: www.worldbank.org
www.growthcommission.org
E-mail: info@worldbank.org
contactinfo@growthcommission.org

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About the Series

The Commission on Growth and Development led by Nobel Laureate Mike Spence was established in April 2006 as a response to two insights. First, poverty cannot be reduced in isolation from economic growth—an observation that has been overlooked in the thinking and strategies of many practitioners. Second, there is growing awareness that knowledge about economic growth is much less definitive than commonly thought. Consequently, the Commission's mandate is to "take stock of the state of theoretical and empirical knowledge on economic growth with a view to drawing implications for policy for the current and next generation of policy makers."

To help explore the state of knowledge, the Commission invited leading academics and policy makers from developing and industrialized countries to explore and discuss economic issues it thought relevant for growth and development, including controversial ideas. Thematic papers assessed knowledge and highlighted ongoing debates in areas such as monetary and fiscal policies, climate change, and equity and growth. Additionally, 25 country case studies were commissioned to explore the dynamics of growth and change in the context of specific countries.

Working papers in this series were presented and reviewed at Commission workshops, which were held in 2007–08 in Washington, D.C., New York City, and New Haven, Connecticut. Each paper benefited from comments by workshop participants, including academics, policy makers, development practitioners, representatives of bilateral and multilateral institutions, and Commission members.

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Abstract

China's remarkable economic performance over the last 30 years resulted from reforms that met the specific conditions of China at any point in time. Starting with a heavily distorted and extremely poor economy, China gradually reformed by improving incentives in agriculture, phasing out the planned economy and allowing nonstate enterprise entry, opening up to the outside world, reforming state enterprises and the financial sector, and ultimately by starting to establish the modern tools of macroeconomic management. The way China went about its reforms was marked by gradualism, experimentation, and decentralization, which allowed the most appropriate institutions to emerge that delivered high growth that by and large benefited all. Strong incentives for local governments to deliver growth, competition among jurisdictions, and strong control of corruption limited rent seeking in the semi-reformed system, whereas investment in human capital and the organizations that were to design reforms continued to provide impetus for the reform process. Learning from other countries' experience was important, but more important was China's adaptation of that experience to its own particular circumstances and needs.

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1. Introduction

China's rapid growth has been one of the most remarkable development experiences of our times. A country that was among the poorest in the world three decades ago with only $175 per capita income in 1978 (measured in 2000 dollars) is now a thriving middle-income country with a per capita income of more than $2,000. China's rapid growth has lifted hundreds of millions of people out of poverty. The poverty rate at $1/day purchasing power parity (PPP) consumption fell from over 60 percent of the population in the early 1980s to 10.3 percent in 2004 (Ravaillion and Chen 2004) China's remarkable success has sparked widespread interest among academics and policy makers alike in the way the country achieved its growth, and has challenged some conventional wisdom among economists on how other countries can achieve sustained high growth.

This contribution to the deliberations of the Growth Commission reviews China's development experience over 1978–2005.[2] It reviews the key steps in the reforms over the last three decades, and identifies a unique "Chinese approach" to these reforms. China's reforms themselves—increased reliance on the market, stronger property rights, opening up for trade and investment, stronger macroeconomic management—are by and large in line with what mainstream economics would predict to promote growth. However, the way in which China went about developing, implementing, and sequencing these reforms is unique. In part, China's approach was determined by the country's history and political context within which the reforms took place, but some core elements of the approach may contain lessons for other developing countries and the development community at large.

The next section of the paper reviews China's growth experience. Section 3 details China's approach to reforms and provides some explanation as to why China chose the reform path it took. Section 4 describes some of the sectoral

[1] Bert Hofman is with the World Bank. Jinglian Wu is with the Development Research Center of the State Council, China and the Graduate School at the China Academy of Social Sciences.

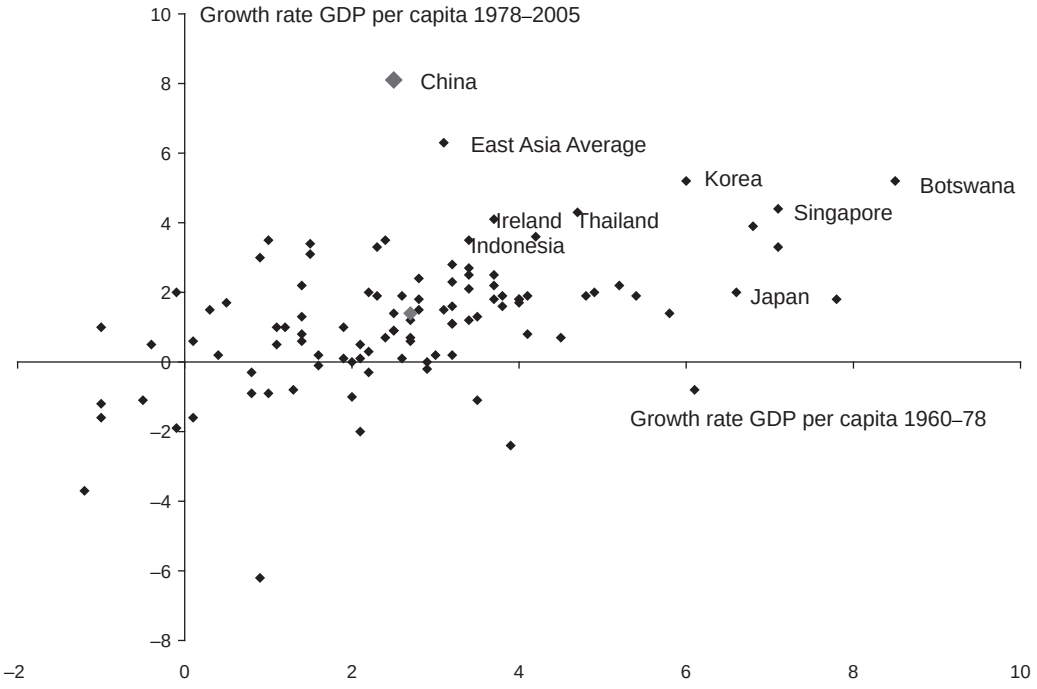
[2] Key sources for this article were Lin et al. (2003), Naughton (1995 and 2006), Wu (2005), Perkins (1988), Qian and Wu (2003), and Hofman et al. 2007. Where possible, these sources are directly cited, but the authors are indebted to these sources far beyond the direct citations.

reforms in depth; and section 5 concludes by reflecting on some lessons for other countries that China's experience has to offer.

2. China's Growth Performance

China's growth over the last 30 years is in a league of its own. Since reforms of the centrally planned economy started in 1978, China has managed to increase eightfold its GDP per capita, with annual GDP growth averaging more than 9.5 percent over 30 years, and GDP per capita growth of 8.1 percent in constant dollar terms (8.5 percent in constant RMB terms). China's growth over 1978–2005 is truly exceptional: of the 105 countries and country groupings for which data are available, China's growth in GDP per capita outranks all others by far (figure 1). This is in sharp contrast with the 20 years before reforms, during which the country was only an average performer with 2.1 percent per year in per capita GDP growth, and Japan, the Republic of Korea, Thailand, and resource-rich Botswana and Libya were the record holders. China has had consistently high growth in every decade of reforms since 1978, despite significant slowdowns in 1981, 1989, and 1990; which were followed by years of accelerated growth that quickly recovered lost ground.

Figure 1: China in a League of Its Own



Source: World Development Indicators (WDI) 2008; authors' calculations.

Table 1: China GDP per Capita Growth Decomposition

	1978–2005	1978–87	1988–97	1998–2005
GDP per capita	8.5	8.6	8.6	8.1
o/w labor productivity	7.7	7.2	8.2	7.8
o/w capital/worker	4.3	3.5	4.3	5.3
education/worker	0.4	0.4	0.5	0.2
Total factor productivity (TFP)	3.0	3.3	3.4	2.2

Source: National Bureau of Statistics Data (through CIEC) and authors' calculation, based on Hofman et al. (2007).

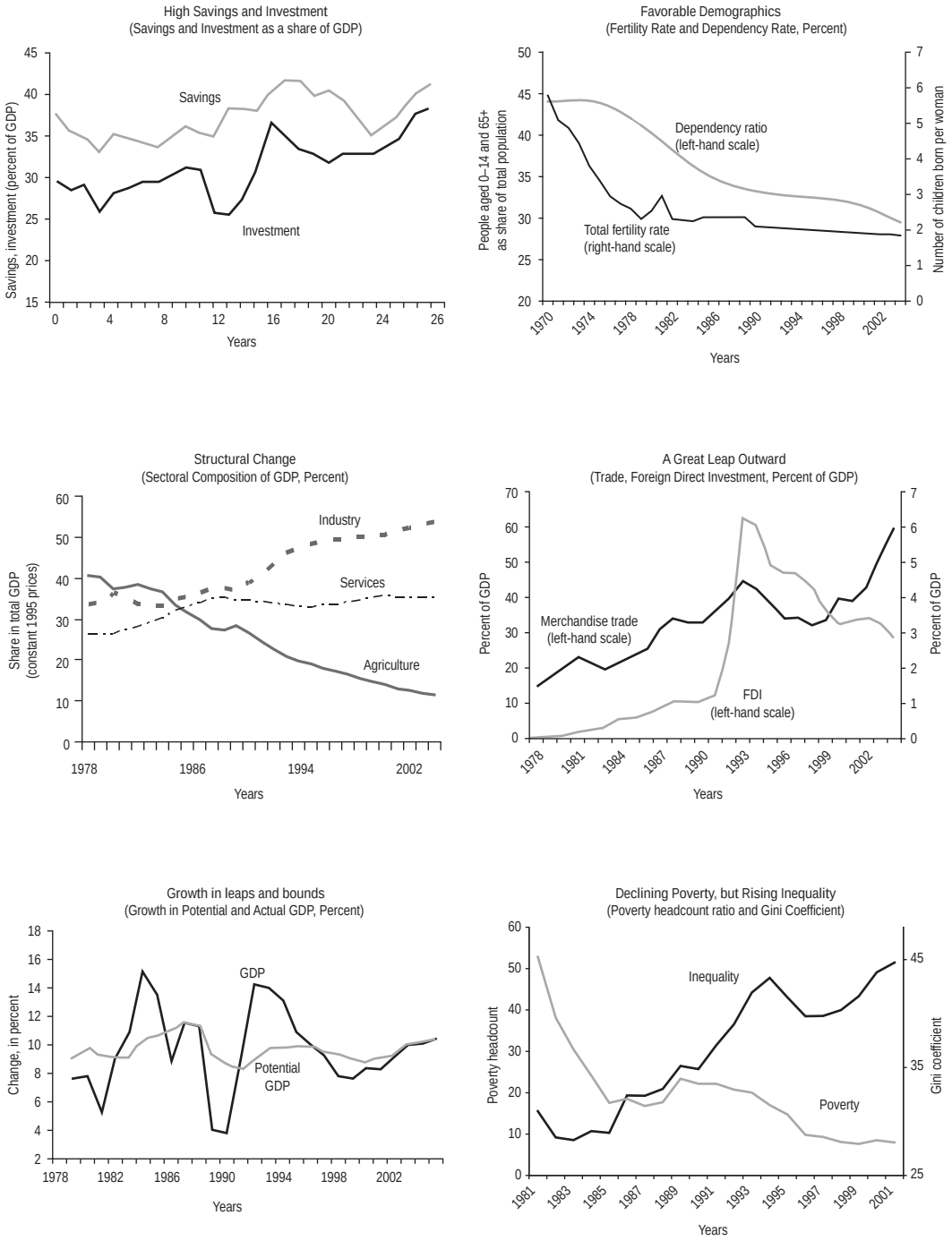
Note: TFP is estimated assuming an initial capital output ratio of 1.1 in 1965, a depreciation rate of 4 percent, and a capital share of 0.5, following Kuijs and Wang (2005).

China achieved the bulk of its increase in GDP per capita from an increase in labor productivity (table 1). Less than 10 percent of the increase was contributed by demographic factors (measured by the dependency ratio and labor participation ratio), considerably less than newly industrializing economies in their period of rapid growth (16 percent—see IMF 2006, figure 3.3) or ASEAN countries (18 percent).[3] China's relatively low demographic contribution can be explained by the fact that a larger part of its demographic transition was already completed before reforms took off, as a result of the population policy initiated in the early 1970s—well before the much-discussed one-child policy was introduced at the end of that decade. In the first decade after reforms, though, demographics explain about 20 percent of per capita GDP growth.

Capital accumulation driven by China's high savings and investment rate (figure 2) accounts for more than half of labor productivity increases over the reform period. The ratio of investment to GDP has been consistently high in China. Driven by high domestic savings, China was already investing a great deal before the reforms: on average gross fixed capital formation was above 30 percent of GDP in the 1970s, with a rising trend throughout the reform period. Contributions from human capital (measured as average years of schooling in the labor force) are relatively small with about 5 percent of total growth, which is in part explained by the fact that China already had a relatively high education standard for its per capita income in 1978, and since then only gradually increased this. The more recent sharp increase in tertiary education attendance is likely to increase education's contribution to overall growth in the future, but so far has had only limited effect on education standards in the workforce as a whole.

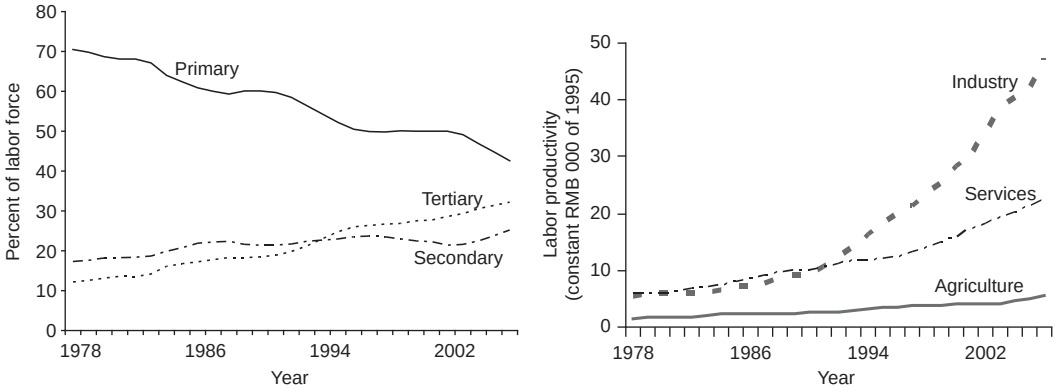
[3] In accounting terms, GDP per capita is determined by labor productivity, the dependency ratio, and the labor force participation ratio.

Figure 2: China's Growth Experience



Source: Hofman et al., 2007; Ravaillion and Chen, 2004; World Bank China Quarterly Updates, Various Issues.

Figure 3: Structural Transformation



Source: WDI 2008, Kuijs 2007.

Note: Primary industry is agriculture; "secondary" industry includes industry and construction. The share of the labor force in agriculture probably overestimates the number of people solely dependent on agriculture, as it does not account for off-farm activities.

TFP increase accounts for 40 percent of the increase in labor productivity, contributing 3.0 percentage points to GDP growth over the period 1978–2005. This remarkable increase can be ascribed to three transformations the Chinese economy underwent in the course of reforms: from a predominantly agricultural economy to one dominated by industry and services; from a practically closed economy to a relatively open one; and from a heavily state-dominated economy to a mixed-ownership economy (figure 3).

First, China reallocated labor from low-productivity agriculture to higher-productivity services and industry. On net, the sectoral shift took place mostly from agriculture to services, which had been suppressed under the command economy, and which still lag behind what could be expected for an economy with China's per capita income. But industry's share increased as well, and, after a decline in the 1990s saw a rebound in recent years with an acceleration of industrial growth after China's WTO accession. These reallocations broadly followed the differences in labor productivity. The difference between labor productivity in agriculture and other sectors was already high at the onset of reforms, and rapidly increased after reforms started. The reallocation of labor explains a substantial part of measured TFP growth: Bosworth and Collins (2007) estimate that sectoral shifts in labor account for about a fifth of total labor productivity increases, estimates in line with those of IMF (2006) and Bloom et al. (2006)

The sectoral shift in the labor force went hand-in-hand with rapid urbanization, which is remarkable especially in light of the household registration system (*Hukou)* that discouraged rural residents moving to the city. Despite this, China's urban population increased from less than 20 percent in 1978 to more than 43 percent in 2005. If China's large floating population is taken into account (estimated at some 150 million people or some 12 percent of the

population), China's urban population is well over half the total population, and in line with what one would expect based on China's per capita income. Besides migration and natural population growth in the cities, reclassification of rural areas into urban ones plays a significant role: in China, about one third of urbanization is due to this phenomenon (Biller, 2006).

Second, China rapidly opened up its economy, changing from a virtually closed economy to one with more than 60 percent of GDP in trade, which is exceptionally high for a country the size of China. Foreign direct investment (FDI) played less of a role in terms of GDP, but China since the mid-1990s has been the largest recipient of FDI in the developing world. Foreign invested enterprises also explain a big part of China's export success, accounting for more than 60 percent of exports. In contrast to FDI, the rest of the capital account remained practically closed throughout the reforms, and only recently has China allowed limited portfolio flows in and out of the country. Structural change shifted the economy—and employment—from low-productivity agriculture to high-productivity industry and services.

Third, China's economy transformed from one dominated by state-owned enterprises (SOEs) and collective farms to one dominated by nonstate enterprises of many denominations (such as private, collective enterprises, township and village enterprises, and foreign-invested enterprises). In contrast with many of the former Soviet republics and Eastern Europe, China's planning system was not abolished overnight. Instead, the economy was allowed to "grow out of the plan".[4] Planning targets and material allocation within the plan grew more slowly than the overall economy, while prices followed a dual track (table 2), one within-plan and one outside of the plan, until well into the 1990s (Naughton, 1995). This preserved the level of existing production and allowed continued redistribution through the plan (Qian and Wu, 2003), while giving strong incentives to households and enterprises to grow at the margin and receive the outside-plan prices. Of course, the dual track also preserved the inefficiencies within the planning system, but this was politically to be preferred over a sudden move to the market. Furthermore, introducing market competition spurred efficiency gains within the planned part of the economy as well—not least because often the same firms operated in both the market and planned system. Today, the five-year plan still exists, although its nature has fundamentally changed, and it can now best be considered a strategic plan for the government rather than an all-encompassing plan for the economy as a whole.

[4] "Growing out of the plan" was a phrase originally coined by Barry Naughton in 1984 to describe the fact that within-plan targets of output were almost flat, while overall economy-wide targets showed a large increase.

Table 2: Growing Out of the Plan

	1978	1985	1995	2003
Share of all goods subject to market price (%)				
Retail	3	34	89	96
Producer goods	0	13	78	87
Farm commodities	6	40	79	97
Ownership of industrial production (% of output)				
SOEs	77	—	33[a]	22[b]
Collectives	23	—	36[a]	6.4[b]
Foreign, private, other	0	—	31[a,c]	72[b,c]

Source: Naughton (2006); OECD (2005); *China Statistical Yearbook*, various years.

Notes:

a. 1996

b. 2004.

c. The private share in investment is much smaller than that in production, as state enterprises continue to do more than 50 percent of investment.

Not everyone has benefited equally from China's growth. China's income inequality has been rising after an initial decline in the early years of reform that focused on rural reforms (figure 2). The country's Gini coefficient increased from 0.25 in the mid-1980s to more than 0.45 now. The sharp rise in China's inequality is partly due to the country's rapid transformation that compressed the process of modernization and rising inequality as first described by Arthur Lewis into a few decades, while it took a century or more in other countries. Changes in measured inequality were in part due because in-kind benefits under the planned economy—such as better housing, access to cars, and domestic personnel—were monetized under the market economy. But rising inequality also resulted from the country's development strategy: The coastal development strategy, which aimed to develop the coastal regions more rapidly than others, increased interprovincial inequalities, whereas the country's household registration system hampered rural citizens from competing for higher-paid urban jobs. And China's heavy reliance on investment and manufacturing meant that urban formal sector jobs became rapidly more productive than others, and wages rose in line with that productivity differential. Nevertheless, growth and inequality are not complements: as Ravaillion and Chen (2004) demonstrate, inequality rose in particular in times of a *slowdown* in growth and the poorest provinces rather than the richer ones show the highest degree of income inequality.

Macroeconomic management was a challenge throughout the reform period, and repeatedly bouts of reforms and rapid growth ran into problems of overheating and high inflation. The inflation was high by Chinese standards, that is, because even at the peak of the 1993–94 inflation, it never exceeded 20 percent year-on-year, which can be considered modest by the standards of other

transition countries. But for a government that was concerned about social stability, and with the hyperinflation of the latter days of the Guomindang government of the late 1940s etched in the collective memory, this was considered as far too high.

3. Explaining China's Reforms

In some ways, China's reforms followed many of the prescriptions mainstream economists would recommend. The country opened up for trade and investment, liberalized prices, diversified ownership, strengthened property rights, and kept inflation under control. However, to argue that China's reforms were a mere variation on the Washington Consensus is stretching the truth. At the same time, it is also hard to argue that China's experiences force economists to reinvent economics, and that a new paradigm, a "Beijing Consensus," is to replace the Washington one. What many observers can agree on, though, is that it was *the way in which China went about in reforming its system* that makes the country's reform experience unique. China's way of reforming allowed savings and investment to stay high throughout the reforms and enabled the productivity increases that kept growth high. Perhaps as important, the gradual reform path that China took allowed the existing capital stock—human as well as physical—to be reallocated rather than rendered obsolete by the transition shock in relative prices that many Eastern European Countries and former Soviet republics underwent.

China's way was, of course, a very different one from that followed by other transition countries, and with very different results. However, although often compared, China and most other transition countries were simply too different in terms of initial economic conditions, political development, and external environment to make comparison of much use. When China started its transition in 1978, it was a desperately poor, predominantly rural, agricultural country with a highly inefficient industrial sector oriented to heavy-industry. It had barely 20 years' history of central planning, which was marred by the failure of the Great Leap Forward and the political disruptions during the Great Proletarian Cultural Revolution. The country was neither integrated in the world economy or in the Council for Mutual Economic Assistance (COMECON). Internally, in part due to Mao's determination to enable individual regions to survive economic isolation in case of a war, industry was never as concentrated as in Eastern Europe and the former Soviet Union, and when central planning relaxed, competition among regions and their enterprises became possible. Perhaps most importantly, although the country changed its policies after 1978, the state and the ruling party remained intact throughout the reforms, so China could focus on the economic and social transition instead of a political one.

In contrast, most of the other transition countries were middle income, highly urbanized and industrialized, and had experienced more than 40 years and sometimes 70 years of collectivization and state planning. They were highly specialized in production structure and integrated in the COMECOM, with heavy concentration of industry in often monopolistic enterprises. The gradual reforms initiated in the system, first in Hungary and later in the Soviet Union had met with only limited success, especially in the latter country. Reforms started under conditions of large macroeconomic imbalances and a large monetary overhang so price liberalization led to an almost immediate and disruptive jump in inflation, which eroded people's savings. But the biggest difference was undoubtedly the collapse of the political systems throughout the former Soviet Union and Eastern Europe, which made a gradual transition of the economic system, if at all feasible, virtually impossible.

China's reforms had their cautious beginnings after the death of Mao Zedong in 1976. In a difficult political environment, Deng Xiaoping's 1978 "Truth from facts" speech at the end of 1978 (Deng 1991) became the breakthrough for reform; it was followed by the Communiqué of the Third Plenary Session of the 11th CCCPC, which laid out a tentative program of reform to move away from the planned economy (see table 3 for the main reform steps since 1978). How to reform and what to reform was still quite unclear, and, as Perkins (1988) argues, it is unlikely that there was any blueprint for reforms from the beginning. What was clear for the leadership, though, was that the country had to move away from that planning system in order to make progress in living standards and development.[5] The failure of the Great Leap Forward and the disruptions during the cultural revolution had resulted in a very modest economic performance according to official statistics. According to some welfare indicators such as grain consumption and consumer goods purchases, hardly any progress had been made since 1957.

Important for the direction of reforms was also the background of the political leadership that came to power after Mao's death. Both Hua Guofeng and Deng Xiaoping had suffered during the Cultural Revolution, Deng because of his ideas on agricultural reforms that he proposed after the Great Leap Forward in the early 1960, and again during the final days of Chairman Mao.

Gradual Reforms

Reforms developed only gradually, starting in the rural areas with the household responsibility system and township and village enterprises, and some initial steps to open up the economy to foreign trade and investment, which only started to play a significant role in the 1990s in the 1990s. Gradual also were the moves on the financial sector and SOE reform, which were much discussed

[5] In Deng Xiaoping's meeting with Robert McNamara in April 1980, Deng indicated that China would open up, reform, and modernize—and that it was likely to succeed with or without the Bank, but that the success would be smoother and faster with Bank support.

throughout the 1980s but gained momentum only in the mid-1990s. "Feeling the stones in crossing the river" became China's mode of economic reform, implementing partial reforms in an experimental manner, often starting in a few regions, and expanding them upon proven success. Only with the 1993 *Decisions on the Establishment of a Socialist Market Economy* [6] did a broader overall strategy emerge. Yet, this, too, was implemented gradually and experimentally rather than comprehensively.

Table 3: Major Reform Steps in China 1978–2005

Year	Reform step
1978	*Communiqué* of the third Central Committee of the Chinese Communist Party (CCCPC) plenum of the 11th party congress initiating "four modernizations"
1979	"Open door" policy initiated, foreign trade and investment reforms begin. Law on Joint Venture Companies passed
1979	Limited official encouragement of household responsibility system
1979	Three specialized banks separated from the People's Bank (the central bank).
1980	First four special economic zones created
1980	"Eating from Separate Kitchens" reforms in intergovernmental fiscal relations
1984	Individual enterprises with less than eight employees officially allowed
1984	Tax for Profit reforms of SOEs
1986	Provisional bankruptcy law passed for SOEs
1987	Contract responsibility system introduced in SOEs
1989	Tiananmen square events trigger retrenchment policy, halt on reforms
1990	Stock exchange started in Shenzhen, Shanghai
1992	Deng Xiaoping's "Tour through the South" reignites reforms
1993	Decision of the third plenum of the CCCPC of the 14th party congress to establish a "socialist market economy" paved way for fiscal, financial, SOE reforms
1994	RMB convertible for current account transactions
1994	Tax-sharing system reforms introduced
1994	Policy banks established, commercialization of banking system announced
1995	Central Bank Law, Banking Law, Budget Law enacted
1997	Comprehensive plan to restructure SOEs adopted, "grab the big, let go of the small"
2001	China's accession to WTO
2003	3rd CCCPC plenum of the 16th party congress, decision to "perfect" the socialist market economy
2004	Constitution amended to guarantee private property rights
2005	Construction Bank, Bank of China initial public offerings
2006	6th CCCPC plenum of the 16th party congress establishes the goal of "Harmonious Society"

Source: Hofman et al. 2007.

[6] The Communiqué of the third Central Committee of the Communist Party of China plenum of the 14th party congress.

There were several reasons for this gradual approach to reforms. First, gradualism was a means to circumvent political resistance against reforms (Wu 2005). While, as mentioned, the political ideology of class struggle of the Cultural Revolution had been put to rest after Mao's death, many in the communist party retained a deep suspicion against the market, and instead trusted the "administrative" system (including the party) more. Second, gradual, experimental reform was a pragmatic approach in a heavily distorted environment in which "first best" solutions were unlikely to apply. Experimental reforms, confined to specific regions or sectors, allowed the authorities to gather information on effects that could not be analyzed in advance. They were also necessary to develop and test the administrative procedures and complementary policies needed to implement the reforms. With proven success the experiment could be expanded to other regions and sectors. Third, experimental reform may have suited the Chinese culture well as a means to avoid loss of face: if an experiment did not work, it could be abandoned as an experiment, rather than considered a policy failure.

China's gradual strategy reinforced the credibility of reform over time. By making reforms one step at a time, and starting with those most likely to deliver results, the government built up its reputation for delivering on reform. With every successful reform, the likelihood that the next one would be a success as well undoubtedly increased. It also gradually built up the experience and skills for the design and implementation of reforms. Thus, by gradually reforming, China built up its "reform" capital.

Decentralization and Experimentation

Decentralization to local government became a powerful tool for progress: within the confines of central political guidance from the China Communist Party (CCP). The provinces and local governments received increasing authority over investment approvals, fiscal resources, and policies. Provinces, municipalities and even counties were allowed, even encouraged, to experiment with reforms in specific areas, and successful experiments then became official policy and were quickly adopted throughout the county. In a way, by decentralizing, China turned the country into a laboratory for reforms.

The fiscal system and the political organization within the party were key in aligning subnational government incentives with that of the center. The fiscal reforms introduced in 1980, which became known as "Eating from Separate Kitchens," formed a de facto tax contracting system, with high revenue retention rates for local governments, in particular for those local governments that were set for growth. For instance, Guangdong province only had to pay a lump sum in revenues to the central government, and could retain 100 percent of the rest. This distributed the benefits of reforms to a large part of the population as well as to local government and party officials, who therefore had strong incentives to pursue growth and promote a market economy (Qian and Weingast 1997).

Within the party, the personnel promotion system was largely based on achieving growth. The dominant criteria for promotion within the party were growth itself, creation of employment, attraction of FDI, control of social unrest, and achievement of birth control targets. Four out of these five were closely aligned with GDP growth. Experience in the regions also counted heavily in the promotion to higher-level party posts, which provided the most talented with the incentives to gain that experience, and to demonstrate their capacity to reform and spur growth.

Taken together, this environment provided a strong incentive for growth. A disadvantage was imperfect macroeconomic control and repeated bouts of inflation driven by local government loosening of investment and credit controls. Further, these conditions gave rise to local protectionism, which threatened to undermine China's unified market and competition among domestic firms. When in 1992 reforms regained momentum after the retrenchment following the 1989 Tiananmen events, and inflation reemerged, the agenda became one of centralization of policies, with major effects on macroeconomic conditions. The fiscal and financial reforms that followed were aimed at creating the tools for macroeconomic management in a market economy (see section 4).

Pragmatism and Transitional Institutions

China's approach to reforms provided the room for the country's own particular institutions to emerge, which suited the country's purposes well at any given point on its reform path.

The "dual track" system for growing out of the planned economy discussed in section 2 was of course the preeminent of all transitional institutions. It allowed a continuation of the planning system, which avoided the collapse of production that was likely to have occurred at market prices, and allowed for a continued redistribution of resources and income through the planning system. At the margin, though, the system allowed a nonplanned economy to emerge, and one that also provided the information needed to gradually reform within-plan prices and mechanisms in such a way that by the time of the abolition of most material planning in the mid-1990s, plan and outside-plan prices had been largely aligned.

Similarly, the de facto fiscal contracting system installed after 1980 gave strong incentives for growth to subnational governments by leaving much of the incremental revenues in the provinces. The growing control over resources by local officials provided them with the incentives to pursue the reforms and attract the investments needed to promote growth. The downside, as is discussed below in section 4, was a growing loss of macroeconomic control, and when inflation became the dominant concern in the early 1990s, the system was replaced by a more mainstream tax sharing system, although not without a considerable political struggle led by then Vice Premier Zhu Rongji.

Perhaps the most successful example of a transitional institution was the Township and Village Enterprise (TVE), an enterprise form that operated outside the plan, but which was owned and to some extend managed by local governments across rural China. Born out of the Collective Production Brigades, these enterprises were highly successful in expanding production and creating employment, even though their ownership form was far from the private ownership that standard theory predicted would work best. However, as argued in Qian and Wu (2003), in an environment where private property was in many circles frowned upon and hardly protected by law, creating an ownership form that aligned the interests of the local government with that of the enterprise was crucial for its emergence and survival. Although perhaps not the most efficient ownership form imaginable, it was a feasible one, one that was more efficient than the prevailing State Enterprise form, and as such it increased the efficiency of the economy as a whole. As protection of property rights improved, the success of the TVEs started to falter, and in the last decade they have been overtaken by private and foreign-invested companies as the main source of growth and job creations. Increasingly, TVEs are being turned into private companies.

The study and formulation of reforms was institutionalized itself. Starting with the China Academy of Social Sciences in the early days of reforms—the only place in which the study of "western" economics had continued—a variety of think tanks sprang up to study and promote reforms. Among the most influential was the Development Research Center (DRC) of the State Council, a policy research organization directly under the cabinet, which provided a continued stream of inputs for reforms. Another influential body was the Systems Reform Commission (SRC) (formally the State Commission for the Reform of the Economic System), whose very task was to propose reforms in the system. The DRC and SRC, while government organizations, were set up to provide the highest leadership with options for reforms in the economic system and economic policy. Not burdened by institutional interests like many traditional government departments, these organizations became the source of many of the reforms undertaken in the 1980s and 1990s.

Why Did Gradual Reforms Work?

Why did gradual reform work in China while it failed in most other former Soviet republics and Eastern Europe? Indeed, as others have pointed out, gradual reform of the planning system is likely to fail because reforms lack credibility, undermining positive responses by economic actors, and because rent-seeking occurs in a semi-reformed system. This did not happen in China, at least not to an extent that led reform to fail, for several reasons: the strong commitment to reform expressed by China's leadership; a gradual improvement in the legal framework to protect private investment and property; and at times forceful action against corruption.

Deng Xiaoping's 1984 statements that reforms and opening up were to last for at least 50–70 years,[7] and his 1992 "Development is the hard truth" statement, are good examples of strong commitment to reform. This and consistency in reform actions at least in part substituted for the formal trappings of a market economy. More tangible were the rewards that officials within the party system received for delivering on key reform goals: growth, attracting FDI, creating employment, and maintaining social stability (apart from meeting targets on population control). Changes introduced in the 1980s to the rules of succession in party and state also helped to avoid political disruption—with the exception of the Tiananmen events (Keefer 2007). More recently, changes in the party constitution that reflect former President Jiang Zemin's "Three Represents," which opened up party membership for entrepreneurs, solidified the position of the nonstate economy. Increasingly, the legal system included protection of property rights. This started in the area of reforms where codified property rights were needed most—foreign investment. The 1979 Law on Sino-Foreign Joint Venture Enterprises (JVEs) stipulated that the state shall not nationalize or expropriate joint ventures. The 1994 company law explicitly recognized private companies. But it was not until 1997 that the CCP recognized the role of private enterprises as being a useful force in the "early phase of socialism," and not until 2004 that private property gained equal status with state property in China's constitution. The Property Law passed in March 2007 established equal protection under the law for all ownership forms.

Finally, the often stern action against corruption probably limited opportunistic behavior by insiders who could have abused the semi-reformed system. The numbers show that corruption was far from absent. Nevertheless, the considerable resources invested in the state and Party apparatus and the numerous cases brought before the Party's disciplinary committee or prosecuted by the state procurator—even at the highest levels—suggest a seriousness in fighting corruption that is often lacking in states dominated by one party. Within the Party, the Organizational Bureau is responsible for day-to-day monitoring of party member behavior and the Party disciplinary committee punishes abuse of power, party indiscipline, or corruption. Within the government, the Ministry for Supervision, supported by supervision departments in every agency, investigates allegations of corruption and imposes administrative sanctions, whereas the state procurator is responsible for criminal investigations. The Supreme People's Procurator is the country's highest anti-corruption body. In 2005, 41,449 government employees (0.1 percent of the total) were probed by the procurator's offices for corruption and dereliction of duty; of these, 30,205 were brought to court.[8]

It should be noted that the gradual, decentralized, experimental reforms did not always work, and worked better for some areas of reform than for others.

[7] See for instance: Deng Xiaoping, "Our magnificent goals and basic policies," in Deng (1994).

[8] Jia Chunwang, procurator-general, in his 2006 work report to the parliament.

Reforms in the pension system, a major building block in enterprise reforms, took a long time to take off. When initiated at the local level, these reforms resulted in a large diversity of local systems, which in the end neither met old age income security goals, nor promoted labor mobility due to the lack of portability of pensions form one locality to the other. Economy-wide reforms such as tax reforms, intergovernmental fiscal reforms, and exchange rate reforms were also hard nuts to crack for a government that preferred gradual reforms, and this arguably led to prolonging systems that had outlived their usefulness. Delays in adjusting the tax system to the emerging market economy led to a steep fall in tax revenues, which dipped below 10 percent of GDP in the mid-1990s, whereas the outdated system of intergovernmental fiscal contracts eroded central government share in total revenues to below 30 percent. And arguably, holding on to the de facto fixed exchange rate system from 1994 until recently added to the growing macroeconomic imbalances that China still experiences at present.

4. Major Reform Areas

Agricultural Reforms

China's reforms took off with two fundamental changes in agricultural policies—one planned, and one emerging from local initiatives. The *Decisions of the 3rd Plenum of the 11th CCCPC* (Major Documents, 1991) at the end of 1978 had decided to increase procurement prices for several agricultural products, increasing rice, and to reduce the mandatory state grain procurement quotas in order to grant collectives more autonomy in managing their affairs. At the same time, however, the *Decisions* explicitly condemned individual farming (Naughton, 2006:241). Yet, experiments with the household responsibility system (HRS) were already taking place in several provinces, notably Anhui and Sichuan, which rewarded individual households on the basis of their output rather than on their inputs as had been the case under the collective system. The experiments themselves had even been tried in the early 1960s in the aftermath of the Great Leap Forward, which had caused a massive famine at the end of the 1950s in an attempt to spur industrial development.

While the HRS system was officially still rejected in 1979, except for remote areas where collective organization was impractical, by 1980 it had expanded to areas with food shortages. By 1981 the policy became the official line (Du, 2006:3, 4) and by the end of 1982 more than 90 percent of agricultural households were subject to some form of contracting. Land leases emerged during the same period, starting with 3 year periods, then 5, and ultimately up to 30 year leases, which steadily shifted land user rights from the collectives to the farmer. The result of the new policy was dramatic, with grain output increasing by a third in the period 1979–1994, and steadily increasing thereafter. Even more

remarkable, crops like cotton and oilseeds, along with meat production, expanded even more rapidly (Naughton, 2006: 242), as households diversified away from rice, while, as shown before, the share of the labor force in agriculture rapidly declined. The rapid productivity increases in agriculture that allowed for these developments were the combined result of the change in the incentive system increase in yield per hectare of grain crops, the increase in fertilizer use, and increased mechanization as a result of the sprawling rural industry that emerged after the reforms. By the start of reforms, China had already introduced the hybrid rice of the green revolution, and had expanded its irrigation network already substantially.

Trade and Investment Policies

China reformed it trade and investment policies in its characteristic gradual manner, over time as well as across geographical space. "Opening Up to the Outside World" was a core plank of China's economic reforms. In fact, *Kaifang, Geige,* or "Opening Up and Reforms," was for years a synonym for reforms itself. China was practically a closed economy, with very limited trade and financial interaction with the rest of the world, and with self-sufficiency as the proclaimed policy goal. The economic reform initiated in 1978 brought a dramatic change to this situation, and over the last 30 years China has become one of the most open countries in the world, with trade volume reaching 64 percent of GDP in 2005. China's degree of openness is rare among economies with similar size of population or GDP. China has also been very successful in attracting FDI: the country received about a quarter of all FDI to developing countries over the last 10 years and a record $60.6 billion in 2004, some 9.9 percent of global FDI. The reforms that achieved this consisted of three parts: (i) a gradual liberalization of the trade planning system; (ii) gradual reforms in the exchange and payments system; and (iii) opening up to FDI.

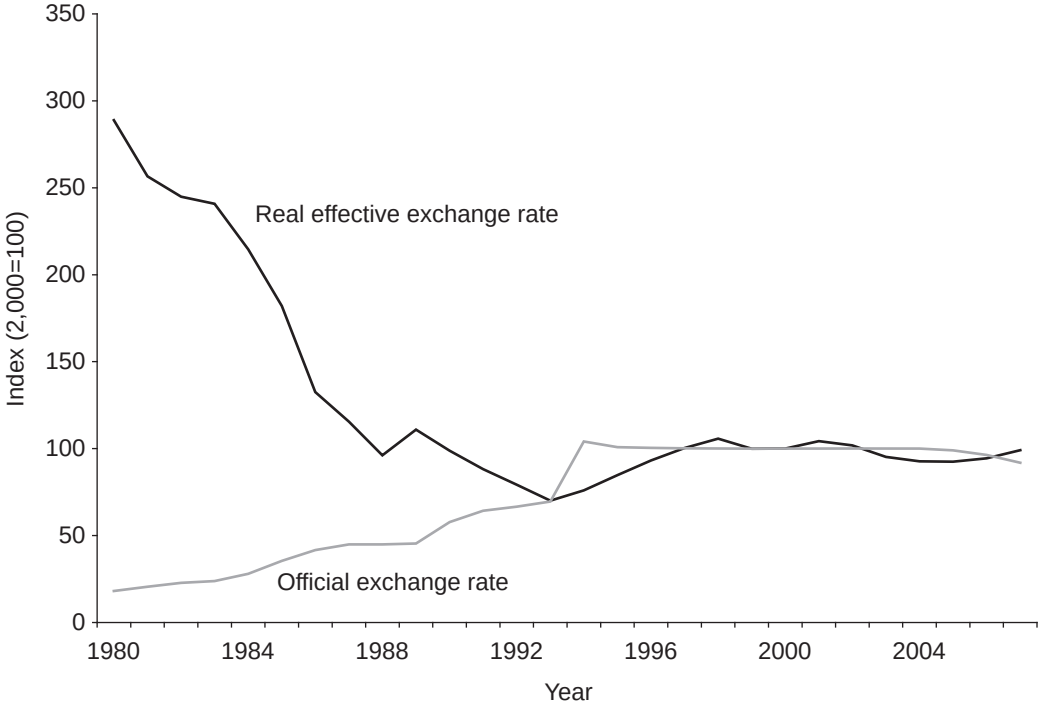
Prior to reforms, foreign trade was part of the plan, and exclusively conducted through 12 foreign trade companies (FTCs), which had a virtual monopoly on trade, and could procure and sell goods for exports and imports at planned prices. With the start of reforms, these FTCs gradually lost their monopoly on foreign trade because of an increasing number of FTCs (by 1986 there were already 1,200 FTCs) and because of the Special Economic Zones, which allowed foreign-invested companies to trade completely outside the trade plan (World Bank, 1994:26).

Tariff reduction had played a minor role in trade liberalization during the first decade and a half. Average tariffs had only been reduced from 56 percent in the early 1980s to 43 percent by 1992. Probably, the trade distortions in the area of nontrade barriers, notably the trade planning system and exchange restrictions, dominated tariffs in the early days of reforms. The run-up to the WTO accession in December 2001 saw a major reduction in tariffs as well as other barriers, with average tariffs falling from over 40 to 15 percent by the time

of entry in 2001, and the average tariff rate was reduced to 10 percent in 2005. Further, the reform of the tax system—with the introduction of a VAT and the concomitant introduction of rebates of VAT paid on exported goods—gave a further boost to trade, as did the unification of the exchange rate in 1994 and the convertibility of the renminbi on the current account in 1995. In addition to tariff reductions, key commitments with respect to opening up the economy in banking services and trade and distribution rights as well as better protection of intellectual property rights had moved forward by the end of 2005.

The second leg of China's opening up was the gradual reforms in the exchange system (figure 4). At the start of reform, the Bank of China was the only bank that was allowed to conduct business in foreign currency. To attract FDI, foreign banks were allowed to set up branches in special economic zones (SEZs), but they were not allowed to conduct business in renminbi. The first foreign-owned bank, Nanyang Commercial Bank, started operations in 1982. By 1986, all domestic banks were allowed to conduct foreign exchange business in order to increase competition and to revitalize the banking industry.

Figure 4: China's Exchange Rate



Source: WDI 2008.

Note: A decline in the real effective exchange rate denotes a depreciation. The official exchange rate index is in RMB/US$.

The authorities allowed domestic firms and local governments to retain part of the quota of the foreign exchange earnings starting 1979. Domestic enterprises had to surrender all foreign exchange earnings to the state and received RMB at the official exchange rate. At the same time, the firm also received—and could retain or sell in the swap market—retention quotas equivalent to a share of the foreign exchange surrendered. This share varied over the time and also depended on the source of the exchange earnings. The remaining retention quotas were allocated directly by the foreign exchange administration (SAFE) to the local governments' retention quota account, to the central government quota account, and to be purchased by the People's Bank of China (PBC), China's central bank, at the prevailing swap rate. The RMB proceeds from the PBC purchase went to the firm. Entities could use their foreign exchange retention quota to buy foreign exchange at official rate and to import products with prior approval from the Ministry of Foreign Trade. The share of foreign exchange retention quota was gradually increased. By end of 1993 when the retention system was abolished, total foreign exchange retention had reached 80 percent of export proceeds.

A dual exchange rate system was also used for motivating firms to generate foreign exchange earnings. In parallel to the official exchange rate, the authorities set a trade settlement exchange rate at 10 percent above the average break-even point (a PPP equilibrium exchange rate) as of 1981, while the official rate was much lower than the equilibrium rate. At the onset of the introduction of the dual exchange rate, the settlement rate was 2.8 yuan/dollar while the official rate was 1.5 yuan/dollar. The authorities depreciated the official rate gradually and eventually unified the two rates on January 1, 1985. The unified rate was set at 2.8 yuan/dollar initially. In 1986, swap centers were established in some cities where Chinese enterprises with retained foreign exchange or retention quotas and foreign-funded enterprises in SEZs were permitted to trade foreign exchange at a rate higher than official rate. The official exchange rate was unified with the swap rate in 1994 together with the establishment of current account convertibility of the RMB. Unification was done at a rate of RMB 8.6 to the dollar (the prevailing swap center rate before unification), a rate that gradually appreciated to 8.27 in 1997, and then remained fixed until 2005 when the country moved to a managed float. Since 1994, the exchange rate has remained remarkably stable both in nominal terms against the dollar as well as in real effective terms. While this undoubtedly provided for stable incentives for exporters, it also fueled macroeconomic imbalances after China's export performance accelerated following WTO entry in 2001.

A third pillar of China's opening-up policy was SEZs. Enterprises in those zones enjoyed tax exemptions and reductions as well as usually better infrastructure and often better government services. The evolution of FDI policies is the most striking example of China's gradual expansion of reforms across geography. In 1980, the first SEZs were established in four coastal cities

(Shenzhen, Zhuhai, and Shantou in Guangdong, and Xiamen in Fujian) in the provinces Guangdong and Fujian, hometowns of many oversea Chinese investors, with the aim to promote exports and economic growth. These zones were given the freedom to offer special advantages to attract foreign investors. Within four years (1981–84), the trade volume of Shenzhen SEZ increased by 60 times. To scale up the success of these zones to the entire coastal region, the open-door policy extended to 14 coastal cities in 1984 and to the deltas of the Yangtze, Pearl, and Minnan Rivers in 1985. In 1988, the policies were expanded to Hainan Island and another 140 coastal cities and counties including Nanjin, Hangzhou, and Shenyang in 1988. After the coastal regions took off in the 1980s, the open-door policy was gradually extended to the inland region in the 1990s. A big leap was made in 1999 when the whole western region was opened for FDI (Catin, Luo, and Huffel, 2005). Meanwhile, foreign-invested enterprises outside SEZs enjoyed considerable advantages over domestic enterprises as well, including lower income tax rates, and often lower prices for land and utilities granted by local government eager to attract FDI. As a consequence, much of China's success in exports is due to foreign-invested firms, whose share in exports rose from 1 percent in 1985 to more than 50 percent in 2005 (Lardy, 2003).

Financial Sector Reforms

China's financial sector reforms started in earnest only fairly late into the reforms. The 1993 *Decisions* on the socialist market economy paved the way for a modern banking system, but it was not until the Asia crisis that the authorities realized the importance of a solid financial sector, and not until the bankruptcy of one major Chinese investment bank in 1998 (the Guangdong International Trust and Investment Corporation, GITIC) were the *Decisions* effectuated. While the country had initially taken a number of reform steps, notably to reestablish the role of the central bank, it was more than 15 years into the reforms before they were accelerated. China undertook these reforms at a time when, with the exception of FDI, it had a practically closed capital account. China's reforms were traditionally gradual, and have been conducive to growing out of the severe problems the financial sector was plagued with by the mid-1990s—although many issues remain. China's financial sector reforms can be seen to consist of a gradual increase in the type and number of banks combined with a gradual relaxation, and then abolition, of most restrictions on lending by those banks.

Before reforms, China's financial system was typical of that of other Soviet-style planned economies. The PBC was the only bank in the planned system, and functioned as central bank, commercial bank, and state treasurer at the same time. The bulk of fixed asset investment was paid for by the budget, whereas the banking system predominantly provided working capital "loans" that by and large served as an accounting method for the plan rather than as genuine loans. Households, meanwhile, barely had savings and financial assets were practically limited to cash. China's reforms initially focused on the breakup of the

monobank system, and started by creating four specialized banks from the PBC: (i) the Agricultural Bank of China specializing in rural finance; (ii) the People's Construction Bank of China, specializing in investment financing; (iii) the Bank of China, specializing in international financial transactions; and (iv) the Industrial and Commercial Bank of China, focusing on working capital financing. The state-owned commercial banks (SOCBs) have remained the mainstay of the banking system throughout reforms, but their market share has gradually declined from almost 100 percent in the mid-1980s to about 55 percent now. Entry of national joint-stock banks (including CITIC and Everbright), city commercial banks (successors of the urban credit cooperatives), and rural credit cooperatives that had been in existence since the 1950s gradually eroded the SOCBs market share. Competition from nonbank financial institutions, including trust and investment companies and security companies added to the differentiation in the financial sector. The 1994 reforms created the state-owned policy banks (Agricultural Development Bank of China, China Development Bank, and Export-Import Bank), which, in principle, served to relieve the commercial banks from their policy function. Nonstate share ownership was allowed after 1994, and foreign stakes in banks up to 25 percent of total shares were allowed under the conditions of China's WTO entry in 2001. Foreign banks were allowed in China in SEZs at first, and gradually expand their (foreign exchange) business throughout China. Since end-2005, foreign banks have been subject to national treatment concerning renminbi business.

Financial sector policies were gradually relaxed. In the early stages of reforms, the credit plan remained the dominant policy instrument. The plan allocated individual credit according to the state's investment priorities, at state-set interest rates that varied per sector, leaving little discretion to the banks themselves. The credit plan gradually was relaxed, first by allocating credit per sector within an overall credit limit, leaving it to banks to allocate individual loans. Directed lending was refinanced by the central bank. After passage of the Banking Law in 1994 and the abolition of the credit plan in 1995, banks were in principle free to lend to whomever they wanted. In practice, however, government influence, notably local government influence on banks, remained significant. As a result, the banks continued to build up nonperforming assets, which, however, after passage of the central bank law, were no longer refinanced by the central bank. For the SOCBs this situation started to change after the 1990s, for three reasons: (i) the Asian financial crisis had brought home the point that a weak financial sector could trigger a crisis; (ii) progress in state enterprise reforms had reduced the necessity to keep lending to those enterprises for reasons of social stability; and (iii) the state development banks had gradually build up the capacity to take over the policy lending function from the commercial banks. By 1998, therefore, a major financial sector reform started to take shape: SOCBs embarked on a major financial and operational restructuring, closing branches, centralizing lending authority to provincial branches and head

offices, and shifting nonperforming assets to newly created asset management companies. Weak nonbank financial institutions were closed and resolved, including the large Guangdong International Trust and Investment Corporation. Banks were recapitalized on several occasions, in part by making use of China's bulging international reserves, and in part by issuing state bonds to the asset management companies.[9] In contrast to the situation in the mid-1990s, by the new century China had the fiscal means to absorb the costs of financial sector reforms. Further, interest rate liberalization and widening of margins between regulated deposit rate and minimum lending rate allowed for a return to profitability of the banks. In addition, pressures from external competition committed to under the WTO accession helped accelerate banking sector restructuring. Restructuring results have been impressive: The number of commercial bank branches dropped from some 145,000 in 1992 to 80,000 in 2005 (World Bank 1995 and *China Statistical Yearbook*), whereas the share of nonperforming loans in the portfolio fell drastically. Although numbers from the early 1990s are hard to get, NPLs were thought to be about 40–50 percent of the portfolio, and official numbers suggest that even as recently as 2001, the NPL ratio was almost 30 percent. Now, the official number is below 10 percent,[10] even though some believe that the actual number could be considerably higher.

Compared to these commercial banking reforms, other financial sector reforms have lagged in China. In rural finance, attempts to reform the Chinese rural finance system have focused on the rural credit cooperatives (RCCs). In 1983, the RCCs were separated from the Agricultural Bank of China (ABC) and attempts were made to convert them into true cooperatives. ABC management, however, resisted this reform, and it was not until 1996 that the separation and the shareholding structure of RCCs were formally changed. The third round of reform in 2003 allowed the conversion into different ownership types and organizational structures and has resulted in hybrid ownership structures with little resemblance to true cooperatives. This last round of reform also included recapitalization of RCCs by the PBC. The program has represented a costly venture for the PBC, which swapped special bills in exchange for nonperforming loans of participating RCCs. The program results in terms of sector consolidation have been important, as 2,300 individual RCCs have been consolidated and reorganized into 9 regional cooperative banks, 40 rural cooperative banks, and 175 country-level RCC Unions. However, unlike in the banking system where the interest rate can be as high as 400 percent of the base rate, RCCs are still limited to 230 percent of the base rate (about 6 percent per year), a rate often not enough to sustain commercially viable rural finance.

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[9] China used international reserves to capitalize a company, *Huijin*, which in turn bought newly issued shares of the state banks, after the capital of the banks was whipped out to write down nonperforming assets. Other NPLs were bought at face value by the asset management companies, by using government bonds that were used to capitalize these companies.

[10] Data from the China Bank Regulatory Commission

State Enterprise Reforms[11]

Until 1993, state enterprise reforms focused on increasing efficiency within the existing system of ownership and philosophy of state dominance in ownership of enterprises. The belief was that SOE inefficiency was not inherent in the system itself, but the result of too much interference of the state, weak management, lack of funds, and the like. Thus, reforms became a matter of expanding "enterprise rights" in relation to the state. Reforms started with experiments in Sichuan province in 1978 that granted more autonomy to SOEs in production and sales decisions and personnel appointments, and granted enterprises the right to retain some of their profits in funds management by themselves. These experiments were expanded nationwide in several 1979 State Council Decisions. Inspired by the rural reforms, enterprise rights were further expanded with the "Enterprise Contracting System" in 1983, which de facto made the enterprise, not the state, the residual claimant on profits, as the amount of profits to be handed over to the state (or the amount of losses to be made) was contracted. The subsequent emergence of inflation slowed the implementation of the contracting system, and the "Tax for Profits" reform that turned part of the obligation of profits delivery into tax payments gained the upper hand. The enterprise contracting system made a comeback in 1987, though, with more emphasis on profit sharing above a contracted minimum profit delivery, reduction of losses in loss-making enterprises, priority for investments for technological upgrading, and linkage of the enterprise wage bill to the profitability of the company. The managerial rights were further enhanced by the 1992 State Council "Regulation on Transforming the Management Mechanism of Industrial Enterprises Owned by the Whole People."

Although the reforms to increase enterprise autonomy had some achievements, inefficiencies in the enterprise system continued, and enterprise losses increased. Moreover, bouts of investments by the SOEs that were insufficiently checked by considerations of profit and efficiency repeatedly caused overheating of the economy. Thus, the 1993 *Decisions* of the 3rd Plenum of the 14th Party Congress shifted emphasis of the reform to institutional innovation, and establishing a "modern enterprise system" became the goal, with, as the *Decisions* described it, "clearly established property rights, well-defined powers and responsibilities, separation of the enterprise from the government and scientific management." The December 1993 company law laid the basis for an experiment in corporatization of 100 SOEs, but the outcome of that experiment was altogether disappointing, as most of the enterprises involved did little more than turn themselves into shareholding companies with the same owners as before, and little change in terms of ownership diversification and management practices. It was only in 1999 after the 4th session of the 15th CCCPC in 1999 that a broader program of reforms began, which

[11] This section is largely based on Wu (2005) Chapter 4.

included diversification of shareholders' ownership, selloff of parts of SOEs through IPOs, management buyouts of smaller SOEs, and breakup of monopoly SOEs. Supporting reforms in the banking system allowed for a reduction in debt burdens on SOEs by means of debt-equity conversion, whereas social obligations such as education, health care, pensions, and housing were gradually shifted off the books. Emerging unemployment insurance schemes allowed for *xiagang* (a scheme by which unemployed workers are still affiliated to the enterprise that let them go) and outright layoffs. Finally, the State Assets Supervision and Administration Commission was established to enhance and regulate the role of the state as the owner.

It is too early to tell whether this latest round of reforms has lasting positive effects, but since the early years of this century profitability of SOEs has risen sharply. Contradictions remain, however, and interference from the state remains an issue for the larger SOEs, notably in the appointment in senior managers. Strategically, many SOEs remain active in competitive industries that produce market goods, and they continue to be the dominant creditors of bank loans, even though their share in industrial production has shrunk to less than a quarter of the total. Finally, despite higher profits, SOEs still show far lower returns than domestic and foreign private enterprises (Dollar and Wei, 2007).

Macroeconomic Policy

China's economy showed a pattern of strong fluctuations in economic growth and inflation throughout the 1980s and 1990s. Each wave of reforms was taken as a signal by local governments to reduce control over enterprises. In the case of SOEs, this led to easy credit from the state banking system. In any case, SOES were less concerned about profits and losses—a soft budget constraint much like that in other transition countries. Monetary policy only started to play a role after the mid-1990s. Although the monobanking system was broken up in 1979, until effectiveness of the central bank law in 1995, local influences on monetary expansion was large (World Bank 1994). Local branches of the central bank were in charge of part of the credit plan, which was often superseded by local or central leaders' desire to have their projects implemented, and for which credit from state banks was mobilized. State banks in turn received policy loans from the central bank to refinance their policy lending to state enterprises (Hofman, 1993). Expansionary periods (1979–80, 1984–85, 1988–89, 1992–94) were followed by periods of retrenchment, which were de facto managed through the planning system, notably the fixed investment plan. Monetary policy only played a minor role in managing demand: interest rates remained controlled well into the current decade, but even a more flexible interest policy probably would have failed to control (investment) demand in the presence of SOEs that were less concerned with the bottom line. Changes in deposit interest rate were used on occasion to increase deposits and reduce consumer demand.

Fiscal policy played a subordinate role in the first decades of reform, as it had done in the socialist planning period. Moreover, gradual price liberalization, combined with increased entry of nonstate enterprises in the economy, had gradually eroded the tax base, whereas the intergovernmental fiscal system, which was largely a tax contracting system, had given strong incentives to local governments to grow but also to turn budgetary revenues into "extrabudgetary funds" that were largely outside the control of central government. By the mid-1990s general government revenues had fallen to 10 percent of GDP (down from more than 30 in 1978) and the central government share of these revenues had dropped below 30 percent. Meanwhile, extrabudgetary funds had become as large as budgetary funds. Although budget deficits remained small, quasi-fiscal operations through the banking system were substantial, with 5–7 percent of GDP in the early 1990s. The recourse to the banking system for policy purposes had created a growing amount of nonperforming loans in the banking system. At that point in time, China would have been highly vulnerable to a financial crisis were it not for its closed capital account.

Since the 1993 *Decisions* China has gradually established the instruments of modern macroeconomic management. The central bank law and the reorganization of the central bank system recentralized control over monetary policy, whereas the establishment of three policy banks that were bond-financed with state guarantee reduced the need for the central bank to finance policy loans with the creation of high-powered money. The acceleration of SOE reforms in the late 1990s also reduced the need for banks to continue to finance loss-making state enterprises. The fundamental reforms in the fiscal and intergovernmental fiscal system in 1994 gradually increased the share of government revenues in GDP (to some 19 percent of GDP now), and also increased the central government share of those revenues from less than 30 to almost 60 percent. The creation of a government bond market also allowed the government to pursue a more active fiscal policy and seek noninflationary means of financing the deficit.[12] This proved useful in mobilizing a fiscal stimulus in the aftermath of the Asian crisis, which did not hit China directly, but did lower growth rates significantly in 1998 and 1999. Meanwhile, monetary policy gained in importance through the gradual liberalization in interest rates, starting with the interbank rate in the mid-1990s, and a gradual liberalization in lending rates. Today, rates in urban areas are liberalized, but restrictions remain in rural areas, where interest rates are capped, as are deposit rates.

Despite progress in establishing indirect instruments of macroeconomic management, China still relies in part on administrative measures to manage demand. A key reason for this is China's exchange rate policy, which, after unification of the exchange rate in 1993, remains a tightly managed float with

[12] China had issued government bonds to finance the deficit since the early 1980s. However, these often took the form of forced placement of bonds with banks, and even with individual state enterprise employees and civil servants.

only limited flexibility, and some would argue an undervalued exchange rate. The consequence of this policy is that monetary policy remains in large part determined by the balance of payments surpluses. Since the early 2000s, these surpluses have seen a steady rise, and domestic liquidity has been abundant and has fed an investment boom. In 2004 and again in 2006 the authorities took a number of administrative measures to control investment demand—notably that of SOEs, and provided banks with "guidance" to reduce lending growth, notably to sectors the government seeks to discourage In addition to these administrative measures, an increasingly flexible exchange rate since 2006 has been used in an attempt to slow balance of payment inflows. Furthermore, increases in reserve requirements and issuance of central bank bills have been used to absorb liquidity and slow domestic money growth, although the authorities have been reluctant to let interest rates increase sharply.

5. Conclusions

China's development success was built on its own particular style of reforms. Starting with a poor, heavily distorted economy, China pursued reforms that in substance did not differ greatly from the reforms pursued by other developing economies—liberalization of the price system, opening up for trade and foreign investment, commercialization of the financial sector, privatization of the economy—all while maintaining a reasonable level of macroeconomic stability. However, the way in which China pursued these reforms has been radically different from most other economies: it pursued reforms in a gradual, experimental way, by using decentralization and incentives to reform for local governments as a means to discover the transitional institutions most useful for China at any given point in time.

China grew rapidly in part because it had already invested heavily in physical and human capital before reform began, and gradual reforms then reallocated productive capacity to better use. China's financial system was effective in raising the substantial finance needed for its capital-intensive growth, while a closed capital account and increasingly strong banking supervision avoided the type of financial crisis that other developing countries experienced in their course of reforming the financial sector. At the same time, China's financial sector also reduced the pressures for reform in SOEs, and past investment would probably have been made more efficiently with less financial repression (Dollar and Wei 2007).

China also grew rapidly because it was able to sustain its reforms over long periods of time, whereas other countries' reform processes saw more swings in the pendulum, in part driven by the political cycle. Part of China's success in sustaining reform has been its ability to develop domestic capacity to design home-grown reforms suited to its conditions. Within a one-party political setting,

China avoided capture and concentration of power by building institutions within the party and government that put a check on power abuse and corruption, although the latter was not completely avoided. Decentralization and competition among regions limited opportunities for rent seeking and encouraged institutional innovation, while the fiscal system and the evaluation system for party officials strongly encouraged growth. As China grows richer and policy objectives are no longer all aligned with growth, tradeoffs between various policy objectives will emerge, and packaging measures to ensure the benefits of reforms are spread will become more important.

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Bert Hofman, *Country Director, World Bank*
Jinglian Wu, *Development Research Center of the State Council, China*

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