The Two Decades of Chinese Economic Reform Compared

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I. Introduction

Despite the various economic imbalances at the time of the reform in 1978, China has exhibited a remarkable pace of growth. The four factors that accounted for the 8 percent and 9.5 percent annual growth in real GDP per capita between 1978 and 1995, and between 1989 and 1998, respectively, were high savings ratio, reduction in agriculture's work-force, pragmatic reforms, and receptive economic conditions (World Bank, 1997). A prolonged period of continued positive macroeconomic performance suggests that China is rising to become an economic power.

This paper examines and compares the three different types of reform programs in each of the two decades of economic reform in China. Section II discusses the three key reform programs of the 1980s (rural reform under the “family responsibility system”, price reform and fiscal reform) and the reasons and consequences of these reform programs. Section III looks at the three reform programs in the 1990s, which included the Austerity Plan of 1993, the banking reform in 1995 and the state-owned enterprises reform in 1997. Section IV compares the economic reform programs between the two decades in the light of sustainable development and growth, and considers the policy implications of the reforms in the 1990s. Section V concludes the paper.

II. The Three Reforms of the 1980s

Chinese economic reform began with rural reform introduced in the late 1970s under the “family responsibility system”. It was intended to improve the income and output of rural households. Once the government agricultural output quotas were fulfilled, rural households could sell their agricultural surplus in the private market. Rural reform was a success and the growth of income in the form “wanyuan hu” (household with income over 10 thousand RMB yuan) soon spread to different parts of the country, especially the coastal regions. For example, the per capita consumption index (1978 ＝ 100) of agricultural residents increased to 199.0 in 1986, while the corresponding index for non-agricultural residents increased only to 158.1. The percentage of rural households that received a net income between RMB 500—2,000 was only 1.6 percent in 1980, but increased to 22.16 percent in 1985. Accumulated income growth in the rural areas resulted in a rise in aggregate demand, especially in consumer and light industrial goods. The increase in aggregate demand was matched by increase in industrial capacity and imports. Light industrial output, as a proportion of total output, first rose from 31.2 percent in 1978 to 36.7 in 1981, but since 1983, the share of heavy industry output again exceeded that of light industry output (Li, 1994, p. 57). The rigidity of the industrial structure failed to tilt the balance in favour of light industry. Industrial bottlenecks emerged in 1987, leading to speculation and inflation. In both 1985 and 1988, high inflation coexisted with a decline in industrial output.

Rural reform led to income growth, but domestic industrial output expansion was limited by the structural imbalance between heavy and light industries. Rapid inflation in 1987—1988 generated speculation. Industrial inputs were held up by speculators, who found it more profitable to hold on to the industrial materials than selling them to enterprises for production, causing a slow down in the growth of industrial output in 1986 and 1987. The falling supply of industrial raw materials and inputs in turn encouraged further price increase in the product market. A vicious circle emerged as price increase (excess demand) was not matched with rise in outputs while industrial inputs remained under utilized (excess capacity). The lesson of rural reform concluded that the rise in income would be inflationary if there were not corresponding increase in industrial supplies.

In October 1984, a dual price system was introduced as a measure to promote market economy (Wu and Zhao, 1987). An official price coexisted with the emergence of a market price in non-official markets, typically in agriculture produce and imported household items. The price reform, however, concentrated mainly on the price of final products, but lacked reform in the price of factors of production (land, labor and capital). In the state sector, wage comprises of two parts: a take-home net monetary benefit and a non-monetary wage comprised of various welfare-related goods provided by state-owned enterprises. Wage reform has been slow, as nominal wage increases would require increase in state subsidy. Consequently, product price rose at a faster pace than wages rates, leading to a decline in real wage.

Land belongs to the state and rent and land transactions are a central decision. The state-imposed interest rate ceiling often ended up with a negative real interest rate. Bank credits were given out for non-economic reasons, and the large bank loans resulted in high monetary growth and inflation rates (Li, 1989, 1994 and 1997). Restriction in the market price of capital in the form of an interest rate ceiling has effectively kept the opportunity cost of capital below the market price for a long period of time. Extensive growth advocates believed that more financial capital, in the form of state appropriation or state bank loans, would promote investment and growth.

On the contrary, the “intensive growth” advocates warned that a below-market interest rate ceiling could not discourage low-productivity investment.

While the dual price system was meant to improve resource allocation through the “market” mechanism, it ended up in severe economic distortions. A market price sums up the cost of production and the surplus held by producers. The direction of a market price formation should begin with the calculation of various cost items. Thus, it would be the case of putting the cart before the horse if market price of a final product was fixed without making corresponding adjustment to factor payments. The typical example found in a distorted wage system was “xiahai” (securing a second job) among professionals and workers. The lesson is that price reform must first begin with adjustments in factor price.

Fiscal reform in the form of profit tax substituting for profit remittance in 1980 was intended to change the channel of revenue submission. Enterprises would have a greater degree of incentive in production, and tax revenue would then be related to their business profit. New tax reform measures were complicated, subject to tax abuse and resulted in a continuous decrease in the average tax rate (Blejer and Szapary, 1990). Tax evasion and avoidance were common. Consequently, profitable enterprises were reluctant to pay profit-tax, while loss-making enterprises continued to receive state assistance. China's fiscal revenue to GNP ratio declined from about 31 percent in 1978 to 17.8 percent in 1987 (Wu, 1989). Furthermore, China's budget had been in deficit since the early 1980s. The “soft budget” problem was due primarily to the weakness in budgetary control, as budget deficit coexisted with “extra-budgetary” surplus (Qian and Roland, 1996). Budgetary measures were complicated by the “central-province” debate (Wong, 1991, 1997). While some analysts argued that fiscal deficit amounted to only a small percentage of national income (1.18 percent of GNP in 1998), others worried about the prolonged period of deficit. The difficulty in fiscal reform suggests that fiscal efficiency is the more important issue than the fiscal system or the various tax rates.

Economic reform of the 1980s over-concentrated in the pursuit of extensive growth. Investment activities had focussed on the greater availability of capital resources. Despite the achievements of a rapid growth in income, consumption, investment and exports, little attention was given to the sequencing, consistency and sustainability of investment activities. Emphasis on the intensiveness, or depth, of reform was lacking. Various unintended consequences produced a multiplier effect. For example, price inflation and speculation reinforced each other, and economic overheating coexisted with periodic fall in the growth of output. Expansion in state appropriation and domestic bank loans led to a rapid growth in money supply.

III. The Three Reforms of the 1990s

Two issues in the first half of 1993 called for immediate and drastic actions. There were three kinds of exchange rates: the official rate, the swap rate and the black market rate. On June 1, 1993, although the official rate was set at RMB 5.7 to the US dollar, the swap rate deteriorated from RMB 8.2 to RMB 10.8 to the US dollar, and the black market rate had increased by 48 percent in the first six months of 1993. In the countryside, grain prices failed to keep up with inflation, and the real income of peasants declined. The huge amount of remittances from relatives in the wealthier coastal regions to their family members in the interior could not be cashed. Economic overheating in 1992/93 was partly caused by industrial bottlenecks and inflation, and partly by investments being channeled to low-productivity or unrelated projects, such as luxurious real estate development and stock market speculation.

It was against such an imminent economic background that the 16-point Austerity Plan, released on July 3, 1993, was introduced to cool off the economy. The Austerity Plan consisted of four major features. Various monetary controls (such as credit restrictions, rise in interest rate and consolidation of the banking system) were extensively used. The sudden drop in capital funding limited the supply of loans. Investment priorities were redirected to ease industrial and economic bottlenecks, to promote long-term infrastructure development, especially in the interior region. This change in investment priority marked the first step in the emphasis of intensive growth, which was thought to further encourage domestic and foreign investment and deepen development. The last feature was the end to price reform on final products. The Austerity Plan successfully used monetary instruments to cool down the economy, raised the importance of intensive growth, and the emphasis on investment that can sustain development.

In the 1995 Central Bank reform, the People's Bank of China shall implement independent monetary policies and be free from regional governments putting pressure for loans. There are three categories of banks under the central bank (Tang and Li, 1997). In principle, the four state-owned commercial banks do not need to handle state activities and can behave like a commercial bank and compete among them, but in reality, these banks still face the huge triangular debt accumulated in the past. The three policy banks conduct mainly policy-related investments, such as infrastructure projects. Various commercial and regional banks comprise the third category of commercial banks. While the 1995 Central Bank Law aimed to introduce financial efficiency in the banking sector, it concentrated on institutional and structural reform, and lacked explicit reform in prudential aspects. National banks are still not firms that act as a full financial intermediaries and contest with other banks in the financial market. There is also the choice between sector-oriented banks and comprehensive banks. Under the current structure, most banks are either concentrated on economic sectors or operate on a regional basis. Such banks can specialize, but face a narrow portfolio, lack liquidity and competitiveness. Both state and non-state banks would become more efficient should they become comprehensive banks that function fully according to market disciplines. Nonetheless, the 1995 bank reform was a huge step towards macroeconomic efficiency in the banking sector.

Large state-owned enterprises (SOEs) are “mini-societies” that performed a multiple number of tasks and their production units bear the financial burden of all other non-productive units. The reform of SOEs is ultimately a problem of employment. Instead of having one SOE embracing production and the provision of various welfare-related goods, separate “single-task” enterprises can be established to supply different goods with a market-determined wage system and welfare provisions become market-based.

The 15th Party Congress held in late 1997 preferred a two-tier solution to the reform of SOEs. One is the formation of a shareholding, or joint stock system (gufenhua). SOEs are asked to market their assets and shareholding that take the form of limited liability, joint stock companies or listed companies. There are several potential problems in the shareholding system. It would become a “wage-pooling” exercise if workers were forced to acquire the shares, while the management and incentive structure remained. A situation of excess supply will develop, as some inefficient and loss-making SOEs may have to be given away free. Owing to a lack of legislation on corruption and money laundering, gufenhua has allowed the new bosses to engage in questionable practices.

The other is the “protect the large, release the small” (zhuada fangxiao) strategy. The state continues to pump national resources into several hundred elite SOEs in the hope that they will be turned into “flagship” conglomerates and multinationals (jituangongsi). Smaller SOEs are asked to “find their own solution”. The government will let go 53,000 small SOEs, some of which could absorb the redundant workers laid-off from bigger enterprises. Financing of SOEs reform would be split into three ways (write-off, redefinition and stock issues). Various problems arose from the zhuada fangxiao strategy. The final number of identified SOEs and the way to handle the released workers had become controversial. Auctioning was considered as an “insider” game as it was used as a means to “get rid of” the debts, while the management has been agreed among the potential bidders prior to the auctioning. A number of unemployment reports have been disclosed, though some of these figures may be exaggerated due to the need to gain political sympathy. The 1998 government work report acknowledges that “assisting laid off workers to find new job and guaranteeing their basic needs is a pressing task for the government in 1998.”

An alternative, two-folded strategy can be considered. On the one hand, triangular debts should be “frozen”, or “hospitalized”, while new loans have to follow market principles. This ensures that the existing level of bad debts would not deteriorate, and repayment can be made once enterprises become fully marketable. On the other hand, each SOE should come up with its own “timetable” in the restructure of loans, corporatization of management, and re-orientation of production so as to solve their debt problem. Unsuccessful SOEs would be required to declare bankrupt at the end of the time period.

The three reforms in the 1990s shared a common characteristic. They were all related to input factors in the productivity equation. While the Austerity Plan re-directed investment priorities, reforms in financial prices and the institutional structure of banks would promote financial efficiency. Reform in state-owned enterprises improves productivity, leading to a more efficient market wage system that would reflect more accurately the price of final products.

IV. Intensive Growth, Financial Deepening and Policy Implications

The three reforms introduced since 1993 emphasized the need for a strong and consistent macroeconomic base for sustainable growth and development. There are four related elements in sustainable growth. Growth has to be intensive, implying that the productivity of capital and labor is equally important, as is their availability. Investment in infrastructure serves as a pre-requisite to other investments. The backward and forward linkages in output and employment are important elements. A balanced growth approach implies that development of the interior should be encouraged.

Increase in the productivity of factor inputs can be achieved through technical change in physical capital and educational improvement in human capital. Advance in physical capital can be introduced via high-technology production or through foreign direct investment. Productivity of financial capital can be improved through a process of financial deepening. The shortage of such financial resources as domestic savings, foreign investment and bank loans is not the crucial constraint in growth and productivity, but rather institutional rigidities such as a government-imposed interest rate ceiling that led to inefficiencies in investment. One issue was the loose credit policy exercised by national banks and the falling role of the interest rate as the opportunity cost of capital and as a “screening” mechanism (Li, 1994, 1997).

Unlike much of the 1980s, a positive real interest rate was imposed at various times since 1993. Both the growth rates of inflation and money supply are kept under control. Under the new system introduced in April 1996, all enterprises wishing to borrow money from state financial institutions are required to apply for a Loan Certificate from the Central Bank. In view of the falling inflation rate, however, the interest rate was adjusted downwards in 1997 in order not to burden the enterprises with interest payments. The argument for a lower interest rate is to reduce enterprises' inability to repay debts. The contrary argument, however, is that if debts were not hospitalized, repayment will be difficult in any case.

A process of financial deepening at the institutional level can be pursued in two aspects: the involvement of foreign banks and a more matured non-bank financial sector (EAAU, 1999). Upon China's accession to the World Trade Organization, the domestic banking sector will have to open up for foreign competition within three to five years. This probably requires domestic banks to increase their efficiency. Given their existing debt burden, national banks may not be able to compete successfully with foreign banks. One solution is the establishment of private banks. In addition to the Minsheng Bank, five more private banks are under consideration for a licence in 2001. Secondly, the promotion of a more matured and efficiently operated non-bank financial sector is advantageous as there are increased demands for personal and business financial services, as SOEs reform deepens (World Bank, 1997).

Economic overheating in the past was caused by industrial bottlenecks, and the lack of complementary development in infrastructure, such as energy and transport. Expansion in infrastructure enables industries to increase productivity and provides a long lasting impact on growth, opens up the interior regions, and permits such activities as tourism to prosper. For growth to be sustainable, industries must provide as many linkage effects as possible. Forward linkages include wholesale and retail trades, marketing and post-sale services, customer feedback and product development. Backward linkages include training of workers, employment, product design, research and development, supply of materials, and so on. These linkages can create and provide a cluster of industries that could further develop the interior region. The five Special Economic Zones will continue to enjoy their privileges and remain the country's pacesetters and the most favourable investment destinations. Five “economy belts” will be created so as to attract foreign investments to the poorer Western regions. These belts will link the poorer regions to either the richer zones or neighbouring countries.

The State Council supervises monetary policy and through the People's Bank of China, instructions are directly given to national banks and other financial organizations. Corporate and treasury bonds have become an important instrument. The effective use of monetary tools and control has been extensively applied since 1993, including the closure of banks and financial institutions and a reduction in the number of branches of the People's Bank of China. Successful monetary policy can promote the corporate image of banks and deepen financial sector development. Although some argue that the use of monetary policy has its own limits, monetary policy can be exercised effectively through the different banking and financial institutions. Monetary policy, therefore, has become the more effective macroeconomic policy.

By comparison, the operation of fiscal policy depends on local governments, tax bureau, individual enterprises and households. Fiscal efficiency thus depends on time and a tax-payment culture. Although tax collection is said to have improved in recent years and private firms are contributing increasingly a greater proportion of government tax revenue, China's central government revenue to GDP ratio has been low. In 1995, for example, the ratio is 5.56, while the same ratios for the USA and Singapore are 19.89 and 34.88, respectively. The efficiency of personal income tax payment is low, due to the presence of hidden income and an immature tax reporting system. The fiscal experience under central planning was a “one way traffic” in which fund was usually “handed down” from the state in the form of subsidies, and tax revenue was collected mainly from SOEs. With economic decentralization and the development of a market economy, personal tax submission turns the fiscal system into “two way traffic” in which individuals pay income tax to the state. Given the soft nature of China's fiscal framework, monetary policy is the more effective and direct economic policy.

V. Conclusion

While macroeconomic reform is the common feature in the last two decades, reform at the microeconomic level should be the next step. Efficient management includes the adoption of a corporate culture at both the state and enterprise levels and a reduction in agency cost and moral hazard. Corporate governance defines the rights and responsibilities of agents and separates ownership from control. Efficient managerial decisions in large corporations require a considerable degree of delegation and diffusion. Agency costs that include the cost of structuring, monitoring, and contracts will emerge unless rent-seeking activities are eliminated. Microeconomic managerial reform could focus on three themes: efficient government administration, establishment of conglomerates and advanced technology. Efficiency government administration requires the deployment of civil servants. Since 1994, an open examination system was introduced to recruit civil servants. The Ninth National People's Congress held in March 1998 decided to reduce the number of ministries from 40 to 29, while the number of government administrators and employees will be halved to four million. Many ministries and institutions are asked to slash their budget deficits and to become financially independent.

Although economic reforms in the 1990s have received domestic as well as overseas praises, there are various potential “landmines”. The more notable issue is that a balance has to be made between the rate of unemployment and the rate of job creation. The failure to resettle the displaced workers could spill over to other areas, creating social uncertainty and instability. The moral hazard problem may result in wastage and distortion of resources. A rise in income must be matched by a rise in physical output so that growth in the nominal sector is matched by growth in the real sector.
Prime Minister Zhu Rong-ji has claimed to be a student of the late Deng Xiao-ping for his pragmatic attitude. If the late Deng Xiaoping's economic reform of the 1980s were regarded as a “re-instatement of economics in China” (Lin, 1981), Zhu Ron-gji's economic reform of the 1990s would be a “re-instatement of economic efficiency in China”.

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