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# China's economic reform: Success, problems and challenges

## 1 Introduction

The rise of China is a major episode in world economic history. From the late 1970s, China pursued market-oriented reforms and open policy. During the past two decades, China experienced extraordinary growth. Since 1978, GDP growth rates have averaged 10 per cent a year, and 10.7 per cent in the 1990s, rivaling the record achieved by Japan and the 'Four Tigers' (South Korea, Singapore and Hong Kong and Taiwan province of China) in their fast growing period.

In a short span of time, China has experienced three historic transformations simultaneously. First, China is undergoing economic transition from a planned economy to a market economy. Second, China is undergoing economic development from a traditional agricultural economy to an industrialised economy. Third, China is changing from autarky to an important player in the arena of world economy and politics. China's experience provides an ideal laboratory for economic research. The study of the Chinese economy can not only shed light on the causes and process of this massive growth surge, but also enrich our understanding of policy reform and institutional changes.

With China's growth occurring at a bewildering speed and arising from complex processes, it is not surprising that there has been much debate among economists over the basic interpretation of China's success. While some scholars tell us about 'the China Miracle' (Lin, Cai, and Li 1996), others claim 'Growth without Miracle' (Garnaut and Huang 2001). The experimentalist school highly praises China's gradual, piecemeal reform and believes the hybrid institutions (such as township and village enterprises, or TVEs) reflect the distinctive Chinese social and cultural background and are a genuine innovation of the Chinese political leaders. The convergence school, on the other hand, believes that the institutional infrastructure

that China needs for long-term growth has to converge to the best international practices in advanced economies (Sachs and Woo 2000).

China's explosive growth challenges many widely accepted tenants of policy analysis. Private ownership, democracy, and the rule of law, which are seen by new classical economists as necessary to economic development, were notably absent, at least at the earliest stage of China's reform. China is just like a student who never does his homework, but always outperforms his classmates in examinations. Why is the story of China unique? Is China showcasing a new type of economic system that is different from both socialism and market economy but is superior to both in stimulating economic performance, or are China's experiments mainly the product of political constrains rather than economic optimisation? Do we have the confidence to say that past success can guarantee future prosperity? What are the major challenges and constrains that China is facing?

This paper does not have the ambition to answer all these questions, but provides a survey and a preliminary analysis of China's economic reform. Section 2 provides a brief overview of China's economic development from 1949 to the present. Section 3 analyses the economic reform of the early 1980s. The planned economy was not sustainable because the government found that it increasingly difficult to keep a high growth rate and fulfil the goal of full employment. The reform took a gradual approach and the rise of the non-state sector made a major contribution the China's growth.

Section 4 discusses the formation of the triangle of the state-owned-banks (SOBs), the state-owned-enterprises (SOEs), and the government. We believe the equilibrium and dynamics among these three key players can largely explain the path and pattern of economic reform during the 1980s and 1990s. Section 5 provides another factor to explain China's economic reform, namely, the central-local relationship. The competition and tension between the central and local government has a tradition of thousands of years in China and still plays an important role in the formation and evolution of China's economic system.

Section 6 looks into the future and summarises the remaining tasks for China to accomplish in the near future in order to sustain high economic growth and social stability. We argue that China is facing an internal and external imbalance and a favourable policy package should help to maintain macroeconomic stability in the short term as well as pave the way for sustainable growth in the future. Section 7 tries to identify the key elements for a successful reform in China in the 21<sup>st</sup> century — what should be the strategic triggers for the reform, whether the current institutions are supportive to the reform, and how to find a potential institution which can act as a facilitator and coordinator for the reform.

## **2 Economic background**

In the early 1950s, GDP per capita in China was less than 119 Yuan or US\$ 40 (current prices). From 1953 to 1978, China's annual growth rate of GDP averaged 6.1 per cent. In the 1960s, China's growth rate was lower than that of Japan and

the 'Four Tigers', but higher than the ASEAN countries. In the 1970s, China's growth was lower than both the 'Four Tigers' and the ASEAN countries.

Although China's economic growth rate was comparatively speaking fairly remarkable during this period, the growth was not stable. The growth process was frequently interrupted by political campaigns like the 'Great Leap Forward' in 1958 and the 'Cultural Revolution' from 1966 to 1976. Eckstein (1977) pointed out that China's economic growth experienced a 'policy cycle'. China's economic policies changed so quickly that they hardly lasted for three years, which led to the boom and bust of the Chinese economy.

In the late 1970s, China embarked on a major program of economic reform. The last two decades have witnessed the dramatic transformation of the Chinese economy. During this period, real GDP growth averaged 9.5 per cent a year. In 1980, per capita income in China was RMB 460 Yuan (less than US\$ 150), and in 2004, this figure had reached RMB 10,128 Yuan (or US\$ 1,224), with major cities such as Beijing and Shanghai approaching US\$ 2,500. Even taking inflation into consideration, the Chinese people's living standards have risen almost sixfold in the last 20 years. If calculated on a purchasing power basis, the increase in the size of Chinese economy is even more impressive. The IMF found that on a purchasing power basis, the Chinese economy in 1990 accounted for just over 6 percent of world output, ranking third behind the United States and Japan (IMF 1993). More recent research by the World Bank suggests that based on purchasing power parity, China ranked the second largest economy in the world behind only the United States (World Bank 1997).

Before China launched its open door policy from the late 1970s, it was isolated from the world economy. China's exports were only US\$ 18 billion in 1978, its share of world trade was only 0.6 per cent. China was the 34th largest exporting country in the world. In the last two decades, China quickly transformed itself to an important trading power. Its foreign trade has increased almost 15 per cent annually in the past 20 years. In less than two decades, the total value of China's exports has expanded more than twenty-fold. In 2005 China's exports were US\$ 762 billion, its imports were US\$ 660 billion. Its trade dependence, measured by the ratio of the sum of imports and exports to GDP, was about 63 per cent.

In the late 1970s China was also a negligible participant in world capital markets. China scarcely had any foreign direct investment or foreign debt before the economic reform. This situation did not change much in early 1980s. Total foreign investment from 1979 to 1982 was less than US\$ 12.5 billion, an average of about US\$ 3 billion per year. In the early 1990s, China launched a new round of reforms and adopted more open foreign investment policies. After that, China experienced a dramatic increasing in foreign direct investment (FDI). Attracted by high expected returns and tax exemptions, FDI inflows increased by almost 50 per cent annually from 1992 to 1996. The trend has continued even after the Asian financial crisis. From 1993 China began to attract far more foreign direct investment than any other developing country. In 2005, the FDI flowing to China was US\$ 72.4

billion, second only to the United Kingdom and the United States (Ministry of Commerce 2006).

From other indicators, the change in China is also very impressive. Life expectancy at birth from 1960 to 1965 was 36.3, the lowest in East Asia. During the past thirty years this figure has increased continuously. By the year 2005, life expectancy at birth was 70 for males and 74 for females (WHO, 2006). Around 80 per cent of China's population was illiterate before 1949. By the mid-1990s, China had achieved virtually universal enrolment in primary education (Wang and Yao, 2001).

The widening income disparity in China has caught much attention recently. According to Chinese official statistics, the Gini coefficient in China rose from a low level of 0.33 in 1980, to 0.40 in 1994, and to 0.45 in 2002 (UNDP 2005).

**[REFERENCE PLEASE]** China's current income gap has surpassed that in India and Ethiopia and China is now one of the countries with the most unequal distribution in the world. The deteriorating trend for China's income distribution is the result of the growing urban-rural gap and regional disparities. The income gap between rural and urban areas decreased at the beginning of economic reform, owing to substantial growth of rural household income. However, since the mid 1980s, the rural-urban gap has widened. The ratio of urban to rural income rose from 1.71 in 1984 to 3.23 in 2003. The uneven regional income gap between the coastal and inland areas has also expanded in recent years (Table 1).

**Table 1                    Regional disparity: per capita net income of rural household (Yuan)**

<i>Region</i>	<i>1978</i>	<i>1985</i>	<i>1992</i>	<i>1995</i>	<i>1998</i>	<i>2001</i>	<i>2004</i>
Average	133.6	397.6	784.0	1577.7	2162.0	2336.4	2936.4
East region	164.1	513.0	1156.1	2346.1	3154.3	3832.1	4739.2
Central region	131.5	380.3	711.7	1422.3	2054.3	2177.1	2770.3
Western region	120.0	322.6	619.0	1051.6	1476.4	1692.7	2291.3

*Source:* China Statistics Yearbook, 2005.

### **3                    The political economy of the 1978 reform**

What was the impetus for market-oriented reform in China? Many papers hold that the inefficiency of the planned economy made it unsustainable. However, this theory cannot explain the timing of the reform. In our paper (Zhang and He 1998), we argued that the fiscal pressure faced by the government triggered market-oriented reform.

The relation between fiscal deficits and institutional change originated from Schumpeter (1918). He pointed out that 'the method of studying fiscal conditions is especially useful to analyse the turning point of social development'. A first glance may lead to doubts as to whether this 'Schumpeter's' Law applies to China. In the late 1970s, only in three out of eight years were there fiscal deficits (Table 2).

The deficit in 1976 was the largest, but accounted only for 3.8 per cent of total government revenue and 1.0 per cent of GDP.

**Table 2 Fiscal deficits in the late 1970s**

	<i>Total government revenue</i>	<i>Total government expenditure</i>	<i>Balance</i>	<i>Deficit/revenue</i>	<i>Deficit/GDP</i>
	100 million Yuan	100 million Yuan	100 million Yuan	%	%
1971	744.73	732.17	12.56	1.69	0.52
1972	766.56	765.86	0.70	0.09	0.03
1973	809.67	808.78	0.89	0.11	0.03
1974	783.14	790.25	-7.11	-0.91	-0.26
1975	815.61	820.88	-5.27	-0.65	-0.18
1976	776.58	806.20	-29.62	-3.81	-1.01
1977	874.46	843.53	30.93	3.54	0.97
1978	1132.26	1122.09	10.17	0.90	0.28

*Source:* China Statistics Yearbook, 2000.

However, in the planned economy, the government controlled the allocation of capital, so the financial account automatically balanced. The official figures on the government budget hid the real cost of the planned economy. In order to maintain their legitimacy, political leaders had to maintain high economic growth and achieve full employment. On the eve of economic reform, these two goals became more and more difficult, if not impossible. Without reform, a fiscal crisis as well as a legitimacy crisis would have eventuated.

First, in the late 1970s, the capital-output ratio increased sharply, reflecting that the government was injecting more and more money into the state-owned sector in order to sustain the previous growth rate. This put financial pressure on the government and gradually the growth rate declined, and so did people's living standards. Thus the source for government revenue shrank and the discontentment of the people accumulated.

Second, in the planned economy, with the growth of population and the increase of labour supply, the government found it increasingly difficult to provide jobs for everyone. Because of the budget constraint, only a small proportion of the population could obtain welfare and other amenities. The fixed number of job positions was in sharp contrast to the growing number of new labourers, including the younger generation in the cities. Many high school and college students fell into unemployment the same day as they graduated.

The last resort of the government was to send tens of millions of young students ('Zhishiqingnian', which means educated young people) to the countryside. From 1962 to 1978, 17 million young students whose families were in the cities had to leave their parents and were sent to Dongbei, Neimeng, Yunnan and other remote rural areas, while almost all students whose families were in rural areas had to go back (Liu 1998). In 1978, when this policy was finally overturned, millions of

young people came back to the cities and cheered the family reunion. This policy adjustment increased the legitimacy of the new government led by Deng Xiaoping and his comrades. But the result was that the government then faced a serious fiscal problem. If the government still provided jobs for every unemployed 'zhishiqingnian' via the government budget, the total expenditure would be about four to five times the annual government revenue (He 1998).

The reform started from the late 1970s with a gradualist approach. More autonomy was given to enterprises, individuals and local governments to improve their incentives. The government withdrew from direct intervention, mainly to get rid of the heavy fiscal burden. The household responsibility system was introduced in rural areas. After paying contributions to the government, peasants could have residual claims. In 1978, when a rare drought hit Anhui province, several villages adopted the household responsibility system secretly. The government chose to endorse this grass-roots reform for fear that without giving autonomy to the peasants, another famine would come and shake the legitimacy of the government.

The household responsibility system spread quickly, and by 1983 covered 93 per cent of rural villages. The impact was almost immediate: agricultural productivity increased substantially and so did rural people's income. As Chinese economist Wu Jinglian pointed out: 'The emphasis of economic reform had been put on the state-owned industry from 1950s to 1980s, but with no breakthrough. It was only after the wide implementation of household responsibility system that reform showed a promising future' (Wu 1999).

Efficiency improvements in agriculture created a grain surplus and extra labor. With the rise of income levels and demand for goods, Town and Village enterprises (TVEs) mushroomed and became a driving force for China's growth. There is an on-going debate about whether China's rapid growth during the reform period was mainly driven by productivity or factor accumulation. Chow (1993) concludes that from 1952 to 1980, capital formation played a principal role in China's economic growth, while there was nearly no technological progress. For the reform period since 1978, Borensztein and Ostry (1996) find that the growth rate of total factor productivity rose to an average 3.8 per cent a year and accounted for more than one-third of the total increase in output. The non-state sector, including TVEs and later joint ventures, has been growing rapidly and attracting more and more labour. This labour mobility has proven to be one of the most important sources of productivity gains. During this process, the non-state sector also alleviated the unemployment pressure.

The reform in the early stage was Pareto-improving. Vested interested groups did not lose their privilege while at the same time, the rest of people became better off. In the 1980s the Chinese government tried to copy the success of rural reform and introduced a similar contract responsibility system in SOEs. However, the situation in SOEs was quite different. As happened in other transitional economies, 'insider control', which is the coalition between managers and workers, was rampant in

SOEs. Salaries and bonuses increased very fast at the price of falling profits. SOEs provided larger housing, more jobs and other welfare.

## **4 The triangle of State enterprises, State banks and government**

A natural result of the gradualist approach was that the distribution of national income became tilted to individuals rather than the government. As a result, the share of government revenue in GDP dropped sharply from 31.2 per cent in 1978 to 22.4 per cent in 1985 and 10.8 per cent in 1996.

As its fiscal capacity declined, the government began to shift the burden of raising funds to support SOEs to state-owned banks. Government intervention in economic activities was still pervasive, although less obvious. In 1984, the People's Bank of China transferred its commercial banking function to the newly founded four specialised banks and assumed the role of central bank. The mono-bank system now evolved into a two-tier system. The reform of 'loan for grant' started in 1983. From then on SOEs turned to the state-owned banks for their funding. The debt ratio of SOEs increased substantially and in the 1990s this ratio was still above 80 per cent.

Fiscal weakness and lack of a modern social safety network meant government had to count on SOEs to protect employment and provide social welfare. This approach sacrificed economic efficiency but could avoid social turmoil associated with 'shock therapy'. SOEs were more like communities than profit maximising units. Most SOEs have their own kindergartens, schools and hospitals. The heavy social burden greatly hurt the competitiveness of the SOEs and eroded their profitability, which in turn resulted in the accumulation of non-performing loans in China's banking sector. Government interventions also made it more difficult to evaluate the performance of the banks. The bank managers could easily shift their responsibility of bad loans to government since it was difficult or even impossible to distinguish the commercial losses and the intervention-induced losses.

At the first stage of China's reform, the triangle relationship between the government budget, SOEs and state-owned banks seemed very stable. Because of the high economic growth and the Pareto improving nature of the reform, the disposable income of households increased dramatically. Most of their money went to the state-owned banks because people did not have other alternatives to invest. More than 60 per cent of individual financial assets are in the form of bank deposits. The state-owned banks successfully collected money from households, and the government could conveniently utilise state-owned banks to transfer private savings to SOEs.

Local government reinforced the 'iron triangle' between the government budget, SOEs, and state-owned banks. Unlike other planned economies, most Chinese enterprises are of small and medium size and local governments own most of the SOEs. Local governments have a strong incentive to protect local enterprises. For

a long time, the branches of the state-owned banks worked in parallel with the local administration hierarchy. State-owned banks had their branches and affiliates in every province, every city. Because they were so closely related to local politics, branch managers often found themselves in a very difficult situation if they wanted to cut loans to ailing SOEs. These branch managers faced an asymmetric incentive: if they agreed to give loans to the SOEs but the loans turned bad, they could use government intervention as a scapegoat; if they extended loans at the will of local officers, they could improve their relationship with the local government and get rents. Thus it is no surprise to see that branch managers had an incentive to maximise their lending and then force the central bank to issue more money to finance their lending losses. This resulted in inflationary pressure and to a large extent, determined the boom-bust cycle in the socialist economic system.

The soft budget constraint faced by SOEs and the moral hazard problem resulting from government intervention makes a large proportion of the loans extended to SOEs unrecoverable. Yet the funding keeps flowing into the state-owned sector. On the other hand, the vigorous and competitive non-state sector accounts for 75 per cent of total output and more than 50 per cent of employment in urban areas, but cannot get sufficient financial support from the state-owned banks.

We have sketched the complexity and the interconnectedness of reforms in SOEs, and in financial and fiscal areas. From the above discussion we can see that the banks' problem is actually the problem of the ailing SOEs, and SOEs' problem is actually the problem of an ill-functioning public finance system. Fiscal weakness is the Chinese economy's Achilles Heel. How to solve the problem? The answer lies partly in strengthening fiscal revenue and domestic capital markets and partly in developing as quickly as possible a modern social security system.

## **5 The central-local relationship**

One critical component of China's economic transition is decentralisation. More autonomy was given to local governments and enterprises. Generally speaking, decentralisation helps to encourage local reform experiments and also gives local officials a strong incentive to stimulate economic growth. But at the same time, decentralisation also revealed and even exacerbated some of the deep-rooted problems in China's economic and political system: local protectionism, rampant corruption, and increased inequality.

It should be noted that even before China's market-oriented reform, the economic structure in China was quite diversified. China never achieved a highly specialised, nationwide planned economy as in the Soviet Union. China's economy consisted of parallel, and to a great extent self-sufficient, provincial economies. Using the vocabulary of Chandler (1962) and Williamson (1975), Qian and Xu (1993) compare the Chinese economy to a multi-divisional (M-form) and the Soviet Union to a unitary (U-form) organisation.

During the traditional planned economy, all revenues accrued to the central government and all expenditures were also budgeted for by the central government.



Local governments were responsible for collecting taxes, but they had to remit most of their collections to the central government and wait for the central government to assign expenditures to them. As the agency of the central government, local governments did not have much discretion in their spending. Most of the fiscal revenue came from the profits of the state-owned enterprises. Thus the tax administration system was quite simple and crude. There were relatively few taxpayers (SOEs) and the accounts of SOEs were easy to monitor, since the government already controlled the price and production plan.

The fiscal pressure at the end of the 1970s led to a series of major reform endeavours that shaped China's central-local relations. A contractual revenue sharing system was introduced in the early 1980s. Central and local governments were asked to 'eat in separate kitchens' (fen-zao-chi-fan), which means the central and local governments now had their separate revenues. The central government negotiated with each province regarding the contractual terms of shared revenues. But these contracts strongly reflected the bargaining power of each province against the central government and led to widening disparities among different provinces. Although the central government revised these contracts several times, attempting to change the situation, the central-local government relationship remained uncoordinated and changeable.

Although the revenue-sharing system provided a strong incentive for the local governments to promote economic growth, it also encouraged them to minimise the amount of revenues remitted to the central government. Local governments tried to transfer more revenues to their own pockets and as a result, extra-budgetary and off-budget funds expanded. A major source of off-budget funds for the local governments was profits from local enterprises. Thus local governments were then motivated to control local private enterprises in order to secure their own revenue streams.

As a result, the central government's share of total budgetary revenue declined from 51 per cent in 1979 to 28 per cent in 1993, while the ratio of total (local and central) budgetary revenue to GDP decreased from 29 to 13 per cent (Ma and Norregaard 1998). A climate of distrust surrounded intergovernmental fiscal relations. The central government blamed the local governments for the continuing fiscal decline and the local governments saw the repeated changes in revenue sharing rules as a lack of credibility of the central government. The deteriorating and chaotic fiscal position in the early 1990s led the central government to launch a radical reform in 1994. The revenue sharing system was replaced by a tax share system, which redefined the assignment of revenue between the central and the local governments.<sup>1</sup>

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<sup>1</sup> Central taxes include customs duties; the consumption tax; VAT revenues collected by customs; income taxes (from central enterprises, banks and non-bank financial intermediaries); the remitted profits, income taxes, business taxes, and urban construction and maintenance taxes of the railroads, bank headquarters and insurance companies; and resource taxes on offshore oil extraction. Local taxes consist of business taxes (excluding those named above as central fixed

The purpose of the 1994 fiscal reforms was not only to provide sufficient revenue for government, especially the central government, but also to redesign the tax structure and eliminate its distortions. From 1996, the revenue to GDP ratio started to increase. In 1996 it was 10.9 per cent and in 2004 it reached 19.3 per cent. The share of the central government in total revenue increased substantially from 22 per cent in 1993 to 55.7 per cent in 1994. The share of the central government in the total revenue then declined slightly in the late 1990s, but increased again from 1998. In 2004 this figure was 54.9 per cent. While more revenue went to the central government, the transfer payments from the central to local governments remain grossly under-funded.

The issue of extra-budgetary and off-budget financing of local governments appeared to worsen after the reform. The 1994 fiscal reform only addressed the reassignment of revenue, but the expenditure assignments were left untouched. Local governments are responsible for the financing of social safety networks and minimum income support, as well as building new infrastructure and providing urban utilities.

Local governments faced more intensive pressures to collect enough revenue. As a result, they had to rely on extra-budgetary and off-budget financing. A usual practice was to establish government-owned companies and use these companies to borrow money from banks. In recent years, local governments have become increasingly enthusiastic about land sales, because this has become the major way for local governments to increase their revenues. In 2003, 42.5 per cent of local government revenue was off budget, and the share of off-budget expenditure to total local expenditure was only 22.2 per cent. This implies that some of the off-budget revenue was actually used to finance the basic service expenditure, since the local government could not levy enough tax to cover these items (Hussin and Stern, 2006).

The behaviour of the central and local governments can largely be explained by the fiscal constraints they face. With a deteriorating fiscal situation, each level of government tries to pass the fiscal burden to a lower level of government and to guarantee enough revenue for itself. The responsibility of providing public goods was gradually shifted to the lowest level of government, the county and village governments. County and village level governments now cover 70 per cent of the expenditure on rural education and 55-60 per cent of the expenditure on rural public health services. The fierce competition among local governments to attract foreign investments, their unbound avarice to grab land from farmers, their haste

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incomes), income taxes and profit remittances of local enterprises, urban land use taxes, personal income taxes, the fixed asset investment orientation tax, urban construction and maintenance tax, real estate taxes, vehicle utilisation tax, the stamp tax, animal slaughter tax, agricultural taxes, title tax, capital gains tax on land, state land sales revenues, resource taxes derived from land-based resources, and the securities trading tax. Only the VAT is shared, at the fixed rate of 75 per cent for the central government and 25 per cent for the local governments (Wong 2000).

to sell SOEs, can all be attributed partly to the mismatch between revenues and expenditure responsibilities for the local governments.

We do not see that so-called pro-market local government has become a check and balance to the central government. It is too simplistic to picture the local governments as reformists and the central government as conservative. The competition among local governments is actually good news for the central government because they can use yardstick competition to evaluate local officials' performance. When there was disobedience in local governments, the central government did not find it difficult to fire those defiant provincial governors and impose its policy, as in the case of Beijing governor Chen Xitong and Shanghai governor Chen Liangyu.

## **6 Unfinished revolution: Chinese economy at the turning point**

High economic growth is so important to China that if it drops a little to, say, 7 per cent, that would be regarded as a recession. Why so? My favorite metaphor is inspired by the Hollywood movie *Speed*. A terrorist has set a bomb under a bus. If the speed of the bus slows down, the bomb will explode; if the speed is too fast, the bomb will also explode. China is in a similar situation. A lot of problems lie underneath the high growth: increasing inequality, massive pollution, a fragile financial system, emerging issues such as energy security and political reform. We cannot stop the bus to dismantle the bomb. We cannot stop economic growth to reform the system. High growth can facilitate economic reform. It is much easier to launch a reform plan when the economy is growing fast. Growth provides more revenue for the economy as a whole and part of the new revenue can be used to compensate the losers and avoid backlash. Growth also increases the credibility of the government, which is very important for the success of policy. Recession, on the other hand, sends a signal about the incompetence of the government and ignites distrust as well as discontent in society.

It is safe to say that in the near future, China will be able to sustain quite robust economic growth. If so, why should we bother to reform the economy? The problem is that China has entered a new era in its development process, with a set of challenges largely different from those of the recent past. Some of these challenges have arisen from the very pattern and success of high growth since the reforms began. If these challenges cannot be handled properly — and many argue China has left the harder fiscal reforms until last — China will lose its momentum of growth and, worse, the fruits of successful reform could be ruined by the resulting widespread discontent and instability.

The major challenge for the Chinese government is to handle the internal and external imbalances and reorient the growth to a more sustainable path. Savings are high, consumption is low and investment is inefficient.

Even compared to other East Asian economies, China's savings rate is still extraordinarily high. One reason for this is the precautionary saving habits of households. The lack of a social safety net and the anxiety brought about by rapid social transformation are factors that cause Chinese people to save more. In most rural areas, for example, there is no medical insurance, nor any form of insurance to support the elderly. Another reason for cautious consumption is that, though government revenue increased dramatically in the last few years, it has mainly been channeled to investments on infrastructure projects such as highways and airports, rather than public expenditures on health, education and other 'public goods'. Without sufficient supply, the prices for those public goods remain high and a once-universal welfare system has fallen apart.

**Table 3 Saving rate and the distribution of saving (per cent)**

Year	National saving rate	Household saving rate	Government saving rate	Share of different sectors in total saving			
				Households	Government	Non-financial enterprises	Financial enterprises
1992	40.3	31.1	31.0	52.3	14.6	30.5	2.5
1993	41.7	29.9	32.4	46.3	15.0	36.0	2.8
1994	42.7	32.6	29.0	50.3	12.2	35.4	2.1
1995	41.6	30.0	29.6	48.2	11.7	38.3	1.8
1996	40.3	30.8	31.7	52.9	13.5	31.4	2.2
1997	40.8	30.5	32.3	50.9	13.8	34.3	1.0
1998	40.0	29.9	30.0	51.0	13.2	34.3	1.5
1999	38.6	27.6	31.0	48.0	14.9	35.6	1.4
2000	38.5	25.5	32.5	42.8	16.5	39.1	1.5
2001	38.9	25.4	35.9	41.6	19.5	38.2	0.8

Source: China Annual of Statistics, 1999-2004.

In recent years, enterprise saving has also increased dramatically. Most of the profits have gone to a handful of large monopolistic SOEs and they have kept the profits in their own companies and own sectors. Small and medium sized enterprises, however, continue to have difficulty getting loans from the banks or getting listed on the stock market, so they have to rely on self-finance. They save their profit for investment.

With domestic saving rising faster than investment, China's trade surplus, which is equivalent to the savings surplus, has increased. Usually, when one country has a trade surplus, it will invest the revenue abroad and thus support a capital account deficit. By contrast, China has a 'twin surplus' of both the current account and capital account. This puzzling phenomenon can be partly explained by the 'round tripping' of Chinese capital going abroad and then coming back to China in the form of foreign capital to take advantage of preferential policies. This happens when Chinese citizens register companies off-shore. They re-invest in China and

their revenues are judged by some to account for as much as 50 per cent of foreign direct investment.

The external imbalance has two results. First, China has accumulated a large amount of foreign exchange reserves (now more than US\$1 trillion). Although a country needs foreign exchange to pay its foreign trade and debts, too much of it becomes a burden. China invests between 70 and 80 per cent of its foreign exchange reserves in US\$ assets, mainly US treasury bonds. The return ratios of US treasury bonds are so low that, taking inflation and operational costs into consideration, China is hardly breaking even. Further depreciation of the US dollar also exposes China's foreign exchange reserves to more risks.

Second, the pressure for the Renminbi (RMB, meaning 'People's Currency') to appreciate is a key challenge for the Chinese government. The appreciation of the RMB will lead to a decrease in exports and increase in imports, thus directly reducing the trade surplus. But radical appreciation will have a negative impact on both the Chinese economy and the world economy.

On 21 July 2005, the People's Bank of China (the central bank) announced its decision to adjust the exchange rate policy. It revalued the exchange rate of the RMB against the US\$ by 2 per cent and declared that the exchange rate would be decided by reference to a currency basket. However, 2 per cent is way below the widespread perception in the market of a required appreciation of 5-10 per cent. The ambiguity of the new regime discourages import and export enterprises because prices and profits are becoming unpredictable. It is important to set the rules clearly and adhere to the new rules. However, simply adjusting the exchange rate is not sufficient to correct the imbalances in the Chinese economy, because China's trade sector does not seem to be very sensitive to the change. Appreciation of the RMB also has an undesirable income distribution effect, because imported agricultural products are cheaper and the market for domestic agricultural products will shrink and in turn lead to a decline in the income of rural farmers.

A more appropriate policy should be to increase domestic expenditure. An increase in expenditure will lead to an increase in imports, and a decrease in the amount of domestic products available for export, thus helping to achieve a trade balance. An increase in public investment will also reduce the gap between domestic saving and investment, and drag China back to a more balanced path of growth. Compared with other countries, even developing countries with the same income level, China's expenditures on education and public health are way below the average (Table 4).

**Table 4 Social expenditure of selected countries (percentage of GDP)**

<i>Country</i>	<i>Education</i>	<i>Public health</i>
Australia	4.8	6.4
Japan	3.7	6.4

Korea	4.6	2.8
India	3.3	1.2
Brazil	4.1	3.4
Russia	3.7	3.3
Indonesia	3.3	1.2
Thailand	4.2	2.0
China	2.3	0.5

*Source:* UNESCO Institute of Statistics (2006) online database of Education Indicators and WHO (2006) World Health Report.

The fiscal situation in China is very healthy. The primary deficit to GDP ratio is below 2 per cent, and the public debt to GDP ratio is only 26 per cent. In the last few years, the growth rate of taxation has outpaced the GDP growth rate by more than 10 per cent. It is fair to say that China still has quite a lot of potential to borrow money today without worrying about the burden of accumulated debt in the future.

If we agree on increasing public expenditure, then where should we allocate the money? The public expenditure program should be concentrated on broad strategic areas that are most likely to create the conditions for future growth. It could include rebuilding a well-functioning social safety net for both urban and rural populations; increasing investment in human capital by providing better health and education; internal transportation and communication infrastructure to help achieve a more integrated domestic economy; and a rural development program for the poorest regions which have been left behind by the boom on the East coast and many of the 43 megacities. The new government is promoting a harmonious society; but a harmonious society can be achieved only by providing sufficient public goods as well as speeding up economic reforms.

Many economists worry that public expenditure programs will lead to massive government intervention and corruption. This concern is legitimate and the public expenditure program should be carefully planned. But, compared to the past practice by which local government got their funding mainly through bank lending, financing them through the budget system is more transparent and easier to oversee. Modern history shows that democracy is not an artificially designed regime, but stems from the endless quarrelling, bargaining and compromising in the budget process. A well-functioning public finance system is the constitution for the market economy since it defines the boundaries between the government and the market. China can be transformed into a more prosperous, open and dynamic country by a public expenditure program and its hidden agenda.

## **7 A new agenda for China's economic reform**

China's economic reform indicates that market economy is more than price liberalisation and privatisation. Many supporting institutions are equally important. During the transition period, sometimes the first best solution cannot be pursued directly and we have to accept second best solutions. Without a blueprint and well

designed plan, China has been muddling through all the unpredictable and complex situations and achieved remarkable success.

However, the 'cross the river by touching the stone' approach adopted by the first generation reformists cannot guarantee that China can sustain its vigour. Without a comprehensive and forward looking plan, China's economy may become stuck in the mud and lose its momentum. The issues that the second generation reformists now confront are quite different from their predecessors and a deeper process of reform is required.

The first generation reformists were charismatic political leaders. A small handful of leaders can rely on the leverage of an authoritarian political system to pursue market-oriented reform. Give more freedom to the farmers and then there will be no famine. Give more freedom to private entrepreneurs and then all kinds of non-SOEs will mushroom. Give more freedom to local government officials and then they will change themselves from communist disciples to market economy preachers. All these reforms are politically difficult but technically simple. Let there be light and then there was light.

Second generation reformists are promoted from lower rank bureaucrats. They do not have the aureole of the first generation political leaders. Most of the time, they have to make compromises with their peers and even subordinates. Thus it is understandable that the style of the new generation is consensus building. They are more careful and cautious. This approach prevents the government making fatal mistakes, but it may also cause the government to miss the best opportunities.

The good news is that there is a surprising consensus across different levels of government and also across society on the need for reform. The central government must tap this sentiment to work out a comprehensive set of changes. The public finance system, financial sector reform, and social programs like education and public health should be the priorities of this new agenda for reform. The package of reforms will be complex, difficult and protracted. The second generation reform requires the political leaders to cooperate with both the local officials and officials from different departments of the Chinese government, and convene enough support from society.

Tensions between the central and local governments stem from the mismatch of revenue and expenditure responsibilities. Knowing the local governments are constrained by their capacity to raise revenue, the central government has had to tolerate local governments seeking 'self-reliant' solutions outside the budget. It is time to change this situation and form a modern budget management system and a well-functioning public sector. The central government may need to write off the debt of the local governments as they have done to rescue State-owned banks. The local governments are in the red because they have had to shoulder the fiscal burden for the central government. New sources of revenue need to be designed for the local governments. For example, local government bonds should be encouraged, since it will make it easier for the government and people to track

where and how much public money is spent. The next step of the reform requires revamping expenditure assignments, revising revenue assignments, including conferring some real fiscal autonomy on local governments in exchange for extending budgetary scrutiny over off-budget resources, and revising the Budget Law to guarantee these assignments.

The political leaders also have to work with officials from different departments of the Chinese governments. China has undertaken several rounds of administrative reforms. Administrative reform in 1998 downsized the original 40 ministries and committees to 29, and also downsized 50 per cent of government employees. The Chinese government has also established a merit based civil service system. In recent years, the Chinese government has not had any difficulty recruiting excellent and ambitious people.

However, in many cases, government departments are becoming vested interest groups and the major obstacle for further reform. While the top leaders are trying to cool down the investment in real estate, the Ministry of Construction, however, often openly shows its sympathy to developers. The Ministry of Railway, which is responsible for both the pricing of and investment in railway transportation, is reluctant to increase investment.

The coordination of different departments is another headache for the Chinese government. Channels for information sharing are impeded. When one government department issues a new policy, they are not required to inform and consult with other related departments. Responsibilities of each department often overlap with others and at the end, nobody takes any responsibility.

Government reform should not be targeted at simplifying the administrative structure. A more important task is to redesign the organisation structure of the government. Some government departments have too much competency, including probably the National Development and Reform Commission, which inherited most of the power of the former Planning Commission. Other departments, like the Ministry of Finance and the Central Bank, need to have more jurisdiction and independence.

No government agency is responsible for the design and review of economic policy from a nationwide view. The Economic Reform Committee used to play this role but was abolished in the 1998 administrative reform. It may be unrealistic to establish new agencies facilitating coordination among different departments, but sometimes a unified code can be introduced for every department to follow, thus reducing transaction costs in the hierarchy.

What should the international community do to foster the next generation reform in China? In the 1980s, international organisations like the World Bank were very active and influential in China. Their influence faded, unfortunately. This is partly because of the learning curve, since Chinese officials and experts now know much more than before. But it is also because the international communities fail to propose policy suggestions attractive to the Chinese government. Rather than the



general argument that China should pursue a market economy or more economic freedom, Chinese politicians need more detailed and tailor-made proposals. Such kinds of proposals should take China's complicated political, economic and social situation into consideration. Outsiders' policy suggestions have often been viewed as naive or unrealistic because they did not include those domestic factors.

International communities can do better by targeting manageable objectives and providing user-friendly analysis. They can also do better by providing international experience, both the successful and failed examples. One good example is worth a thousand theories. This is especially true for most Chinese politicians, because they are trained as engineers, they are very practical and favour examples above abstract theories.

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