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**James Riedel, Jing Jin & Jian Gao: How China Grows**

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## Overview of Economic Reforms and Outcomes

SINCE THE POLICY reform process began in 1979, China's economy has undergone rapid growth and structural change. If ever there was any doubt that "policy matters," China's experience over the past 25 years should dispel it once and for all. The reforms themselves did not, however, cause growth and structural change, but rather created incentives and institutions, absent in the socialist planned economy, that were a necessary precondition for growth and structural change to occur. It was up to those who participated in the economy—individuals; state-owned, collectively owned, and privately owned firms; as well as government workers and officials—to respond to the newly created incentives and institutions to bring about growth and structural change.

Because the record on growth and structural change in China is remarkable, much effort has been given not only to describing the reforms themselves but also to assessing China's overall approach to reform. No one can dispute that China has been successful, but observers have debated whether an alternative approach to economic reform in China would have yielded even better outcomes than the one chosen. On one side of this debate are those who argue that China's "gradual" and "experimental" approach to reform was appropriate, if not optimal, given the political and socioeconomic conditions that existed at the outset of the reform process (Naughton 1995; Rawski 1994; Lau, Qian, and Roland 2000). On the other side are those who argue that even better outcomes would have obtained if China had avoided experimentalism and instead had more vigorously embraced old-time religion, adopting as

quickly as possible the incentive systems and institutions of a typical market economy (Sachs and Woo 2000).

At the heart of this debate is the question of whether China succeeded because of, or in spite of, the gradual, experimental approach it adopted. It has been argued that China's superior performance as compared to other transition economies had far less to do with the gradual, experimental character of the reforms than with the conditions that existed at the outset of the reforms (Riedel 1993; Sachs and Woo 1994). In 1979, after more than a decade of economic and political turmoil, China's economic resources were grossly underutilized and misallocated, with 70 to 80 percent of the labor force in the rural sector largely unemployed or underemployed. From such a starting point, almost any improvement in material incentives was bound to have a significant positive impact on growth and structural change. Proponents of gradualism, however, argue that a more rapid approach would have created many more losers from the reform process who could have generated a political backlash that might have derailed the process altogether. The gradual, experimental approach, the key feature of which was decentralization through a system of contracts between higher and lower levels of government, created incentives and rewards that, so it is argued, co-opted potential adversaries of economic reform into accepting and participating in the process.

This debate is likely to continue for years to come, since it can never be resolved conclusively. It cannot be resolved because the proof on both sides is a counterfactual outcome and as such requires a replay of history. As an ancient Greek philosopher noted, "Even God cannot change the past."<sup>1</sup> For this reason, we avoid weighing in on this debate and instead simply review briefly (in the following sections of this chapter) the basic facts about the reforms and their outcomes. As this review indicates, both characterizations are valid—the reform process was incremental and experimental, while the

<sup>1</sup> Agathon, 446?–c.401 B.C., from Aristotle, *Nicomachean Ethics*, VI.2.1139b.

outcome of the process was to bring about the convergence (albeit slowly and still far from complete) of incentives and institutions toward those of a typical market economy. It is also evident from this review that experimentalism is waning, while acceptance of conventional wisdom on market incentives and confidence in their outcomes are gaining ground. Thus the convergence outcome of the reform process, which has been under way for more than two decades and has already fundamentally changed the character of China's economy, is likely to accelerate. Indeed, that outcome is almost guaranteed as a result of China's entry into the World Trade Organization, which effectively locks China onto the convergence path (Woo 2001).

Instead of debating what could have been, we prefer to concentrate on what can be and what is required to make it happen. In this chapter we review past reforms and their outcomes to give perspective on what follows. In chapter 2 we review the literature on the sources of growth in China to identify the driving force of growth and to determine whether it is sustainable. Much of the literature argues that investment, not technological change or total factor productivity growth, has been the driving force of growth in China, but that investment, unlike technological change, cannot be counted on to sustain growth in the future because of diminishing returns to capital deepening. We take issue with this interpretation and argue instead that investment in China has not only been the engine of growth, but also the source of technological progress and structural change. We proceed in chapter 3 to examine the financing of investment through saving in the private, public, and foreign sectors. This examination reveals a glaring weakness that threatens the sustainability of future growth—China's underdeveloped financial sector. In chapter 4 we assess the state of the financial sector, the sources of its weakness and the measures that are needed to allow it to play its increasingly important role in the economy. After 25 years of reform, the emphasis of policy reform must shift from mobilizing unemployed resources and correcting gross inefficiencies to maximizing efficiency in the allocation of China's scarce capital

resources, and nothing is more critical to the efficient allocation of capital than an effective financial system. Chapters 5, 6, and 7 assess the banking sector, bond market, and stock market and the reforms that have been undertaken to improve the functioning of China's financial institutions and markets. We observe (in chapter 5) that while the government has made banking sector reform a high priority and has taken measure to recapitalize the state-owned banks and improve their governance, reform of the banking sector is still far from complete. The government has also acknowledged the importance of well-functioning bond and stock markets, but few concrete measures have been taken to achieve this objective. Indeed, we observe (in chapters 6 and 7) that the dominance of state-owned banks in the financial system is also a major obstacle to the development of the bond and stock markets in China.

While the main focus of this study is long-term growth, in the final chapter we shift the focus to the short run. Our aim in chapter 8 is to explain the ups and downs of the economy. We give particular attention to the role that government policy, macroeconomic policy in particular, has played in fueling and dampening major swings in the economy. We argue that investment has not only been the engine of long-term growth, but also the source of "boom-bust" cycles in China. Furthermore, we argue that underdevelopment of the financial system is not only an obstacle to sustainable long-term growth, it is also a source of short-term instability and an impediment to effective macroeconomic stabilization policy. Ongoing reforms in the financial sector are beginning to moderate the macroeconomic cycle and make macroeconomic policy more effective, but further reforms are needed to give policymakers the tools they need to keep the economy on a high and stable growth path.

### 1.1. AGRICULTURAL REFORM: 1979–85

The term *gradual* has been used to describe China's economic reform because it proceeded in a stepwise manner. The term is

misleading if it is meant to imply slowness, given that the first step in the reform process transformed, in fewer than five years' time, the dominant sector of the economy. By 1984, agricultural collectives had been replaced by the household responsibility system, under which collectively owned land was assigned to individual households that were free to sell their output at market determined prices after fulfilling their contractual obligation to deliver a portion of output to the state at the government-fixed procurement price. By early 1985, the state had abandoned obligatory procurement quotas in agriculture altogether and replaced them with purchasing contracts between the state and farmers, though there was backsliding on this policy in subsequent years (Lin 1992, 39).

The restoration of family farming and the marketization of agriculture provided powerful incentives to expand production and raise efficiency. The rate of growth of agricultural output increased from 2.9 percent per annum from 1952 to 1978 to 7.6 percent from 1978 to 1984, more than half of which has been attributed to the improvement of incentives that occurred when collective agriculture was replaced with the household responsibility system (Lin 1992). In addition to the household responsibility system, increases in procurement prices and decreases in agricultural input prices also contributed to the expansion of agricultural production, although according to Lin, Cai, and Li (2003, 145) no such changes "made as significant a contribution as the household responsibility system."

The acceleration of growth in the agricultural sector led to increases in real per capita rural income on the order of 15 percent per year for the period 1978–85. Because of a relatively high propensity to save in the rural sector, a significant proportion of the increased rural income was saved in credit cooperatives, put in bank deposits, or invested in new rural enterprises (World Bank 2003, 3). As a result of these investments, the share of employment in agriculture fell from 62 to 53 percent between 1978 and 1985, while the share in rural township and village enterprises rose from 7 to 14 percent (World Bank 2003). Thus, in just five years' time, a major structural transformation was well under way,

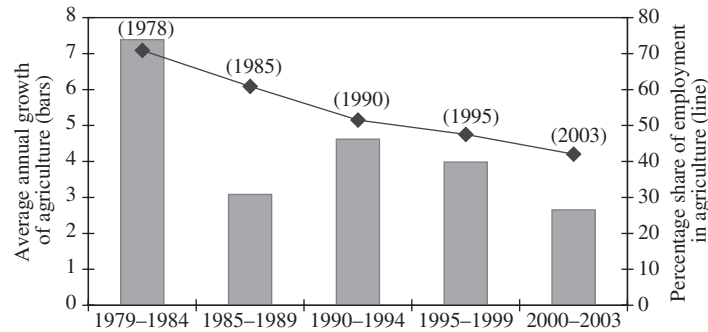


Figure 1.1. Average Annual Growth and the Employment Share of Agriculture, 1979–2003 (percentages). Source: *China Statistical Yearbook 2004*.

one that would continue steadily for the next two decades, although subsequently to be driven by sources other than the growth of agricultural output, which as figure 1.1 indicates never again matched the record of the period from 1978 to 1985.

## 1.2. INDUSTRIAL REFORM: 1978–93

Agriculture was the obvious place to start the reform process, since it was in the agricultural sector that most people lived and earned their income. The government's top priority, however, was heavy industry, both before and after the reforms commenced. Indeed, the agricultural commune system was designed specifically to squeeze as much surplus out of the agricultural sector as possible to invest in state-owned heavy industry. The commune system was abandoned simply because it did not work either to adequately feed the people or to generate sufficient surplus to shift the center of gravity of the economy from agriculture to industry. The privatization and marketization of agriculture were practical necessities, ideological concessions that were required to further the fundamental objective of industrialization, with heavy, capital-

intensive, state-owned industry at the “commanding heights” of the economy.<sup>2</sup>

The lack of a comparative advantage in heavy industry dictated a state-led strategy, as is evident from the fact that every other developing country pursuing a similar strategy engaged to some degree in central planning, state ownership of industry, high levels of protection, and industrial subsidies. In China, with its communist ideology, these practices were simply carried to the extreme. When the reforms began in 1978, virtually all industry was owned by the state or by collectives, and so it remained until the early 1990s, when the landmark decision was made to replace central planning with a “socialist market economy” and then subsequently to acknowledge formally the importance of private ownership and the rule of law.<sup>3</sup>

When the reforms began in 1978, it was recognized that industrialization was hampered not only by the failures in the agricultural sector, but also by the poor performance of state-owned industrial enterprises themselves. Thus, concurrently with the reform of the agricultural sector the government began a prolonged, incremental process of reforming state-owned enterprises. The aim of the reforms was to increase the efficiency of SOEs by improving the incentive system. Toward this end, SOEs were given successively greater autonomy in production and investment decision-making and an ever greater share of the profits they generated through a variety of profit remittance contracts and management responsibilities systems.<sup>4</sup>

The reforms undertaken to improve the efficiency and prof-

<sup>2</sup> It has been argued that “to a large extent, the displacement of dogmatic ideology in favor of pragmatism was due to a backlash to the Cultural Revolution . . . They [the leadership] were convinced that without economic development the Party cannot survive, in other words, the necessary condition for maintaining Party’s power and regaining popular support is economic development” (Qian and Wu 2000, 12–13).

<sup>3</sup> Both private ownership and the rule of law were finally incorporated into the Chinese constitution in March 1999.

<sup>4</sup> These are described in detail in Lin, Cai, and Li 2003.

itability of SOEs met only limited success, since none adequately resolved the basic principal-agent problem inherent to state ownership. However, other reforms, in particular the dual-track pricing scheme that freed up prices at the margin while maintaining planned prices for SOE quotas, did allow SOEs to participate in China's expanding market economy and led to some improvement in resource allocation in the SOE sector.<sup>5</sup> However, the fundamental problem of low efficiency and profitability in the SOE sector remained. The common view, according to Lin, Cai, and Li (2003, 156), is that "one-third of the country's SOEs incur explicit losses, one-third incur implicit losses, and only the remaining one-third are making profit." Moreover, the losses of SOEs had negative consequences throughout the economy, in particular in the banking sector, where they saddled the state-owned commercial banks with a large stock of nonperforming loans.

Since the mid-1990s, when the bulk of bad loans was accumulated, the government has taken a number of measures to make SOEs more accountable for their profits and losses, as well as to subject them to the threat of bankruptcy and closure. As a result, as figures 1.2 and 1.3 indicate, the number of SOEs has declined by about half since the mid-1990s, and the shares of SOEs in industrial output and employment have declined dramatically.

How then did China achieve an average annual growth rate of 9.2 percent from 1978 to 2004 if the growth effects of the agricultural reforms petered out by 1985 and the reform of state-owned industrial enterprises was only moderately effective? The answer is revealed in figure 1.4, which shows that industrial growth in China was driven by non-state-

<sup>5</sup> The dual-track price system is portrayed by some (e.g., Lau, Qian, and Roland 2000) as a Pareto-optimal policy that introduced price flexibility while avoiding political opposition from those who would have lost had price controls simply been abolished. Woo (2001) disputes that China avoided losers because of the dual-track price system and argues that by creating enormous opportunities for corruption, the dual-track price scheme did in fact create social unrest aimed principally at officials who exploited these opportunities.



Figure 1.2. Number of Nonfinancial SOEs, 1988–2003. Source: Anderson 2005b, 12.

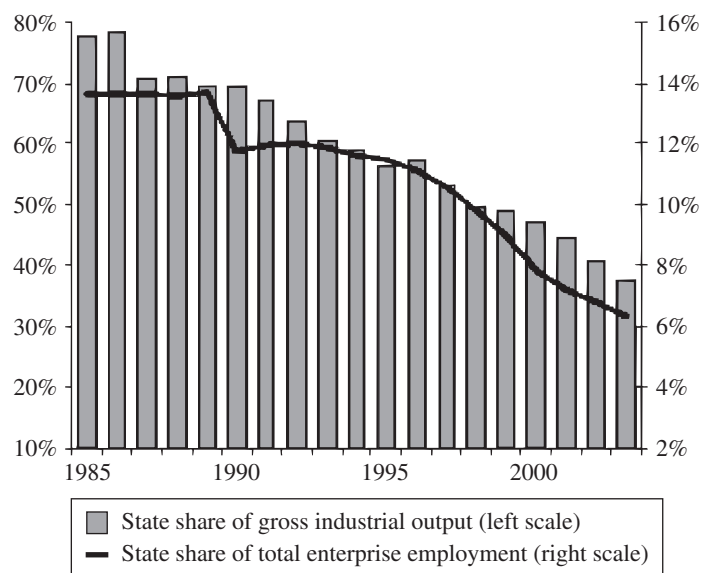


Figure 1.3. SOE Output and Employment, 1985–2003. Source: Anderson 2005b, 12.

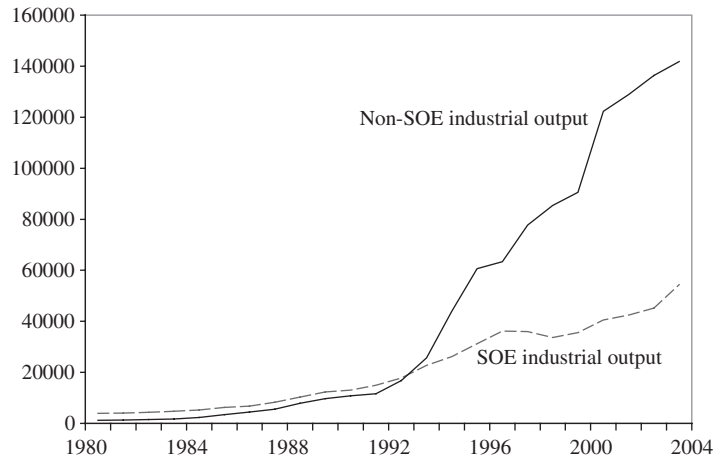


Figure 1.4. Industrial GDP in State-Owned and Non-State-Owned Enterprises, 1980–2003 (RMB 100 million). Source: *China Statistical Yearbook 2004*.

owned enterprises, in the 1980s by the collectively owned rural township and village enterprises and in the 1990s by domestic and foreign privately owned industrial enterprises. Non-state-owned enterprises did not displace state-owned ones, however, since the latter also grew steadily, albeit at rates well below those of collectively owned enterprises in the 1980s and privately owned enterprises in the 1990s.

How was it possible for China to have it both ways—to allow the relatively inefficient state-owned enterprises to continue to expand and, at the same time, to achieve rapid growth in the non-state-owned industrial sector? Two things were necessary for this outcome: (1) a surplus of resources and (2) a set of institutions and incentives that would allow markets to form and resources to flow to the nonstate sector. The first condition, as we have already noted, was met in part by the massive reservoir of unemployed and underemployed labor in the rural sector. The second condition was met by the implementation of a sequence of policy reforms that allowed the formation of markets and provided incentives to

undertake economic activity outside the central plan and, after the central plan was abolished in the early 1990s, outside the state sector.

The key reform that spurred the growth of the collectively owned township and village enterprises in the 1980s was fiscal decentralization. Administrative decentralization in the late 1970s had shifted managerial jurisdiction over a large number of SOEs to subnational governments. The profit contract system implemented in the early 1980s thus had the effect of allowing a significant proportion of revenue, previously collected by the central government, to accrue to the SOEs and their subnational government owners, who in turn negotiated fiscal contracts with the central government. Subnational governments were allowed to retain revenues they collected above and beyond those they had contracted to transfer to higher-level governments, and in turn were required to finance their own expenditures through self-generated and shared revenues.

One consequence of these measures was to create strong incentives for subnational governments to engage directly in economic activity, leading to the development of rural township and village enterprises, which flourished in the 1980s. Because these enterprises were collectively owned, they were able to skirt the formal and ideological prohibitions against private enterprise. Moreover, since the TVEs operated outside the central plan, they could exploit market opportunities that were excluded in the plan, in particular the production (and ultimately the export) of labor-intensive, light-industrial products in which China, with its abundant supply of labor, had a natural comparative advantage. Because the TVEs received little or no support from the government, they were compelled by competition to strive for efficiency, thus avoiding, at least for a number of years, some of the pitfalls of the SOEs.

### 1.3. TRANSITION TO A MARKET ECONOMY: 1994–2003

By the early 1990s, the engine of industrial growth in China was running out of steam. The township and village enter-

prises, in effect, became victims of their own success. As they became more successful, the lack of clearly defined property rights became an issue. As they grew larger, the absence of scale economies became more evident and they became more bureaucratic, acquiring some of the attributes of SOEs (Qian and Wu 2000, 15). Fiscal decentralization, it is argued, created revenue incentives that encouraged subnational governments to engage in protectionist behavior and practice “backward specialization” by duplicating small enterprises across subnational government jurisdictions (Yang 1997). In effect, the centrally planned economy gave way to many regionally planned economies under the control of subnational governments (Young 2000b).

Problems in the SOE sector also intensified over time, and by the early 1990s SOE losses, financed increasingly through bank loans that the SOEs all too often were unable to repay, began seriously to undermine the banking system. In addition, the state found itself, as a result of fiscal decentralization in the previous decade, increasingly unable to control the macro economy, with inflation accelerating and the currency becoming significantly overvalued. In addition to its economic woes, China began in the late 1980s and early 1990s to encounter unprecedented social unrest, fueled by the deteriorating economic situation and public cynicism about official corruption. If all of that were not enough, the collapse of the Soviet Union in 1991 must have helped the leadership realize that the status quo was no longer viable.

Thus the stage was set for a major change in course when the Fourteenth Party Congress met in September 1992, just months after Deng Xiaoping’s famous “Southern Tour” to mobilize support for reform even more radical than what had come before. With the Party’s endorsement of a “socialist market economy,” the leadership began in 1993 to formulate reforms that would replace the fiscal contract system with a tax assignment system that more closely resembled fiscal federalism. Reforms were adopted to recentralize the monetary system, corporatize SOEs, and for the first time acknowledge the private sector as “a supplementary component of the

economy” (Qian and Wu 2000, 10). The private sector was upgraded to “an important component of the economy” at the Fifteenth Party Congress in September 1997, and its role formally incorporated in the constitution in March 1999. In addition, in 1994 the dual foreign exchange market was abolished, and in 1996 current account transactions were made fully convertible.

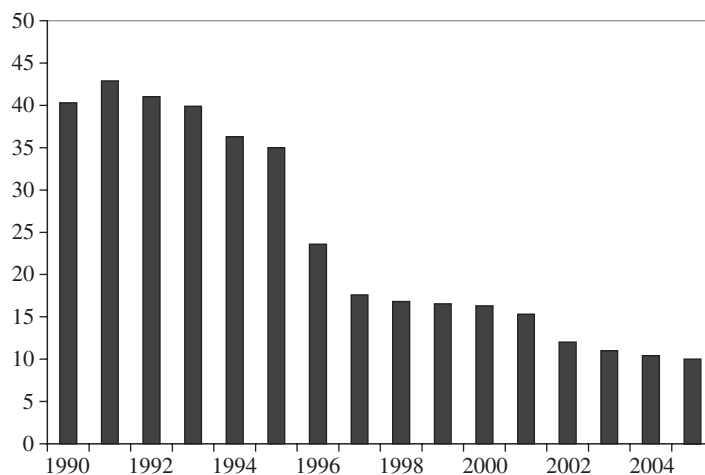
The reorientation of the reform process in the 1990s provided a much needed impetus to industrialization by invigorating the private sector. The share of private firms in industrial output increased from practically nil in the mid-1980s to a majority share of 57 percent by 2004. In the economy as a whole, if one includes the agriculture sector, the private and collective sectors together account for about 75 percent of GDP. The state-owned enterprises sector, on the other hand, still accounts for a disproportionately large share of capital outlays (about 40 percent) and a disproportionately small share of employment (about 8 to 9 percent).

#### 1.4. FOREIGN TRADE AND INVESTMENT

The opening up of China’s economy to trade and foreign direct investment has been an important ingredient in the growth of the nonstate sector, particularly in industry, where China possesses a strong comparative advantage in labor-intensive manufactured products. As in other areas of the economy, liberalization of the foreign trade and investment regimes proceeded incrementally, gradually replacing administrative controls on imports and exports with tariffs and quotas and then subsequently reducing tariff rates and abolishing quotas.<sup>6</sup> As figure 1.5 indicates, by the time China entered the WTO in 2001, the average tariff rate had been reduced to 15 percent, and it has continued to decline since then.

In addition to tariff reductions, nontariff barriers have also

<sup>6</sup> See Lardy 2002 for a detailed description of the process of trade liberalization since 1978.



*Figure 1.5.* Average Tariff Rates in China, 1990–2005 (percentages). Note: The average tariff for 2005 is the rate committed to in the WTO. Source: Wu 2004, 96.

been largely eliminated. Import licensing is limited to less than 4 percent of all imports, and the monopoly of state trading companies was abolished in all but a few sensitive product categories (Lardy 2003, 6). As a result of these measures, the share of exports and imports in GDP increased from 4.6 and 5.2 percent, respectively, in 1978 to 28 and 26 percent in 2004. Accompanying the growth of trade, the structure of exports also changed dramatically, with manufactures' share in exports increasing from about 10 percent in 1978 to 90 percent in 2004.

Foreign investors have had legal status in China since the reform process began in 1979, but their operations were restricted to equity joint ventures in specific sectors and geographical regions.<sup>7</sup> Given the government's overriding concern for SOEs, foreign direct investment was encouraged

<sup>7</sup> For a comprehensive survey, see Lemoine 2000.

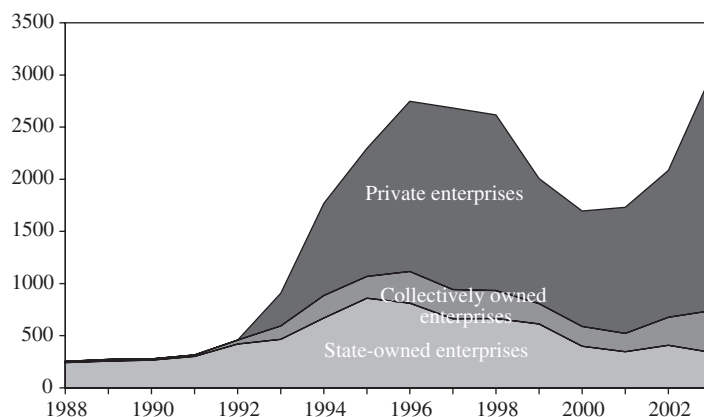


Figure 1.6. Foreign Investment, by Type of Ownership of Enterprise Invested In, 1988–2003 (RMB 100 million). Source: *China Statistical Yearbook 2004*.

mainly in labor-intensive export-oriented industries. Foreign direct investment flourished in the 1990s in part because domestic private companies were constrained, by lack of access to credit and ambiguities about their legal status, from taking up the investment opportunities that were opened for foreign investors (Huang 2005).<sup>8</sup>

Thus, the shift in the orientation of the reform process in the early 1990s had a dramatic impact on the volume and destination of FDI inflows to China. As figure 1.6 indicates, in the 1980s most FDI was in joint ventures with SOEs, while in the 1990s the bulk of it was wholly owned and in joint ventures with private companies. Foreign direct investment has, therefore, not only contributed to growth and industrialization, but also to changing the ownership and production structure of the economy.<sup>9</sup>

<sup>8</sup> This issue is discussed in detail in chapter 3.

<sup>9</sup> By the year 2002, FDI contributed as much as 30 percent to manufacturing production in China (Lardy 2003).

### 1.5. FINANCIAL SECTOR

The fourth pillar of China's economy, along with agriculture, industry, and foreign trade, is the financial sector, arguably the weakest and, at this stage in the reform process, the most crucial for sustaining growth in the future. Important reforms have been undertaken in the financial sector, including the restoration of a commercial banking system, the emergence of a fledgling bond market, and the establishment of stock exchanges in Shanghai and Shenzhen, and these reforms have not been without success. Several common indicators of financial development have improved dramatically, in particular the ratios to GDP of liquid liabilities of the financial system (M2), bonds outstanding, and stock market capitalization.

When one looks more closely at these and other indicators of financial development in China, as we do in chapter 4, one finds that there is less than meets the eye. For example, the increase in the M2/GDP ratio from 33 percent in 1978 to 190 percent in 2004 is, we argue, as much an indicator of financial repression as it is of financial deepening. The M2/GDP ratio in China is exceptionally high, indeed higher than in almost any other country, precisely because repressive financial policies have limited access to nonbank saving instruments and forced households and businesses to accumulate large savings account balances to meet the cash-in-advance constraint they face due to restrictions on their access to credit. In addition, the increase in the stock market capitalization/GDP ratio is less than impressive when one takes into account the fact that only one-third of outstanding stock is tradable. While government bond issues have grown rapidly, they are almost entirely placed and traded in the interbank market. The corporate bond market hardly deserves the term *market*, since the right to issue bonds is severely restricted and the price of corporate bonds is administratively determined. In the banking sector, interest rates are also controlled, with ceilings on deposit and lending rates at artificially low levels, resulting in an enormous

implicit tax on financial saving and non-SOE investment.<sup>10</sup> Thus, we conclude, in chapter 4, that in spite of some positive developments, China's financial system remains highly repressed with deleterious consequences for economic growth.

Why does China repress its financial system? In chapter 4, we argue that the reason is the same as for other countries that pursued a heavy-industry-oriented development strategy and repressed their financial systems, because measures that repress the financial system serve the government's development strategy by maximizing the flow of resources to the government and the industrial enterprises it owns. While financial repression serves the government's development strategy, by discouraging financial saving and misallocating scarce capital resources, it does so at a high cost, a cost that is rising dramatically as a result of structural changes that have made the private sector the main engine of industrialization and growth in China. Financial development is crucial for sustaining growth in the future, whereas it was less so in the past, precisely because of this fundamental transformation in China's economy.

We develop this thesis in the following chapters by examining the sources of growth and the role of investment in particular (in chapter 2), the determinants of saving and sources of investment financing (in chapter 3), and the causes and consequences of financial repression (in chapter 4). Chapters 5, 6, and 7 examine the current situation and ongoing reforms in the banking sector, the bond market, and the stock market, in that order. In the final chapter (chapter 8) the focus shifts from the long run to the short run, analyzing the ups and downs of the economy over the past 25 years. We argue in chapter 8 that investment is not only the engine of long-term growth, but also the source of "boom-bust" cycles in China. Furthermore, we argue that the underdevelopment of the financial sector is not only an obstacle to long-term growth, but also a source of short-term instability and an impediment to effective macroeconomic stabilization policy.

<sup>10</sup> The ceiling on lending rates was abolished in October 2004, but this measure has yet to have a significant effect on credit allocation in China.