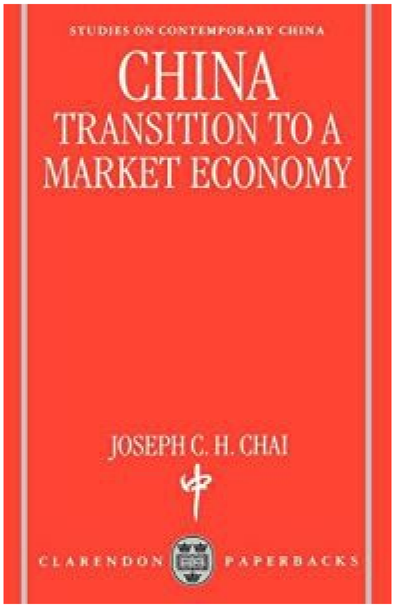

Book China

Transition to a Market Economy

Joseph C. H. Chai
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Recommendation

China is still an enigma to many business people and investors who wonder about the extent to which the country really will participate in a market economy. This book provides a strong, yet concise, review of the history and results of China's transition from a planned economy to a market economy. Author Joseph C. H. Chai covers the Chinese government's reform efforts across several economic sectors, including agricultural, industrial, financial, trade liberalization and foreign direct investment. The chapter on non-state sector business fully rounds out Chai's portrait of the current state of the Chinese economy. *BooksInShort.com* recommends this fascinating book to anyone who wants a scholarly review of the economic issues facing China before, during and after market economy reforms. The better your knowledge of economics, the more useful this book will be to you, but even so, it will intrigue any reader who has more than a passing interest in China.

Take-Aways

- Some experts see China's transition from a planned economy to a market economy as a model for other socialist countries.
- China's transition to a market economy has been smooth compared to transitions in Central and Eastern European countries.
- China has undergone three major economic reform stages since 1978.
- The "baogan" system was an agricultural reform designed to bring profit and loss responsibility down to the household level.
- Flattening the administrative hierarchy was an early reform goal in the industrial sector.
- Making state industrial enterprises more profit-oriented was a primary goal of industrial sector reforms.
- Price sector reforms centered on making prices more reflective of market conditions.
- Critical initial steps in modernizing the financial sector included creating a central bank and several regional commercial banks.
- Trade liberalization and foreign direct investment reforms were primary goals of China's open door policy.
- The non-state business sector was the greatest area of growth in the Chinese economy over the last 15 years.

Summary

Transition from a Planned Economy

China’s movement from a planned economy to a market economy is littered with good intentions. Compared to transitions in Central and Eastern European countries, it has been relatively smooth. Aside from the 1989 Tiananmen Square demonstrations, little serious political or social upheaval can be attributed to the economic transition. Yet, during similar transitions, the Soviet Union and Czechoslovakia disintegrated politically. The early stages of market economy transitions in Central and Eastern Europe saw a sharp drop in output and employment, and increased social and political instability. In contrast, the Chinese economy experienced an annual 9% rise in output during the past 15 years of transition. Given such results, some experts see China’s reform as a model for other socialist countries.

> “In the past China regarded trade as a necessary evil.”

The origins of China’s market reforms can be traced back to the decades from 1957 to 1978, when the centralized planning system averaged only 5% annual economic growth. The sluggish pace of growth eroded the government’s credibility for several reasons. One was the obvious and growing disparity between the Chinese standard of living and that of its neighbors with differing political and economic systems. Taiwan, Hong Kong and Singapore’s economies grew 10% per year and their consumption rates grew 6% to 9% a year, while Chinese consumption grew only 1% to 2%. Under its old system, China had difficulty importing technological and industrial equipment, lagging 10 to 40 years behind the rest of the world, particularly during its period of "self-reliance," coinciding with the western countries’ trade boycott.

Three Reform Stages

China has been through three major economic reforms since 1978. Only partial reforms were carried out during the first stage, from 1979 to 1984, which still emphasized the planned economy. The agricultural sector was the locus for these reforms, which targeted decentralization of property rights and the abolition of the commune system, and made only modest urban efforts. Foreign trade and foreign investment were still heavily regulated.

> “The experiences of the Central and Eastern European countries show that the costs of transition from a planned economy to a market economy can be substantial.”

During the second stage, from 1985 to 1991, the reform’s focus shifted to the urban sector, where it tried to change China’s economic system so that resource allocation would be done by markets and the government would exercise control only indirectly. Chinese reforms established market mechanisms simultaneously in urban areas and the countryside, including reduction in the scope of planning, the strengthening of enterprise autonomy and accountability, the liberalization of product and factor prices, the creation of both product and factor markets and the further liberalization of foreign economic relations.

> “The Chinese reform model is very often considered superior to other transition models and extolled as the model for other socialist countries.”

The third stage began in 1991, when the government set aside the planned economy concept. This reform’s objective was to create a full-fledged market economy by the year 2000.

The Chinese Reform Model

The Chinese reform model differs from other reform models in several ways. First, the Chinese model had no overall blueprint. Chinese officials described this lack of a blueprint as "crossing the river while groping for the stone." Second, China instituted reforms sector-by-sector and location-by-location. Reforms started in sectors of weak resistance and spread to more complex, less popular sectors. Thus, economic reforms preceded political reforms. Third, China used a two-steps-forward, one-step-backward strategy. When problems arose, the government halted or reversed the reform. Then, once the implementation problem was solved, a new wave of reforms, each more radical than the last, was introduced. Finally, China adopted a populist approach, implementing reforms from below, not above. The central authorities accepted provincial and local results. Often, by the time reforms were legitimized by the central government, they had been adopted at the local level for some time.

Agricultural Sector Reforms

Introduction of the household responsibility system (HRS) launched agricultural sector reforms. The most popular was 1978's "baogan doahu," which directed everything to the household level. By 1982, 70% of rural communes had adopted this system, which was developed at the grass roots level and spread without official party sanction. Establishing another trend, this system grew out of the search for a better agricultural incentive system. The baogan system worked by fixing animals, tools, specific quotas and taxes to the household. Once the quotas and taxes were met, the household could retain anything left. This system eliminated all the transaction costs associated with the work-point system and, thus, gave households the incentive of keeping net income.

> "Since human labor is inalienable from its body, individual freedom in the Chinese countryside has been immensely enhanced under the baogan daohu system."

The HRS system's efficiency was mixed. Net efficiency was positive, in that agricultural productivity grew 6% annually during the first reform stage and 3% annually during the second. But, baogan reform adversely affected the rate of investment in Chinese agriculture. Shifting income rights to farmers also shifted savings from the government to the farmers.

Industrial Sector Reforms

Industrial sector reforms centered on administrative streamlining and industrial reorganizations. These goals were addressed by a four-stage series of reforms in the early 1980s. First, the number of units at the bottom of the industrial hierarchy was reduced through enterprise consolidation. Second, branch associations were formed. Third, the number of levels in the hierarchy was flattened. Fourth, detailed supervision of the sector was transferred from the top government economic organs to branch administration.

> "Looking into the future, it is expected that the new collectives will play an important role in agricultural production in China."

The early 1980s reforms were not particularly effective. There was great resistance. A second, more comprehensive and successful reform movement was implemented to create increased enterprise autonomy. State-owned industrial enterprises gained considerable autonomy. However, enterprises still lacked decision-making authority in the areas of pricing, the appointment of management personnel and pay for managers and workers.

> "Starting in the mid-1980s the government had to introduce more radical reforms to revitalize Chinese industry."

The third round of industrial sector reforms closed the decision-making gap. The incentive system was changed to help motivate enterprise managers and workers to strive for greater industrial efficiency. Reforms included implementing fines and adding the profit-retention system, the profit-contract system, the tax-for-profit system and the contract responsibility system, all attempts to add profit incentives for privatization. State industrial enterprises have become increasingly profit-oriented and workers' pay is often tied to their productivity.

Price System Reforms

Price system reforms addressed the need for stability in the pricing system. Although there were four types of prices in China, the first two prices - industrial ex-factory and agricultural purchase - formed the basis for the other two - wholesale and retail prices. The government changed prices by manipulating taxes and/or profits at the wholesale and retail levels. The reforms attempted to link the two sets of prices to reflect market conditions.

> "The number of obligatory targets for most enterprises was practically reduced to just one, namely, profit."

By 1993, these reforms increased the industrial ex-factory price by a factor of three. This increase corrected the government's low pricing of consumer goods. Agricultural prices also increased, spurred by a decline in government fixed-price purchases. By 1992, 85% of all agricultural purchases were at market prices. Finally, retail prices were decontrolled during this period. To adjust for the increase in retailing prices of industrial products, the government lowered the prices on industrial raw materials.

Financial System Reforms

Financial system reforms were aimed at enhancing the efficiency of banks by increasing competition between them and improving their management. The first reform created a two-tiered banking system. China's only bank, the People's Bank of China (PBC), became the central bank. Nine regional commercial banks and four new specialized banks were established to take over PBC's commercial activities. China decentralized bank management and turned banks into independent enterprises responsible for their own profit and loss. The reforms failed to produce. The PBC remained an organ of the government. The money supply was not controlled and inflation was the worst in the country's history. Low personal savings rates didn't increase, and investment efficiency didn't improve.

Trade Liberalization and Investment Reform

Trade liberalization and direct foreign investment were among the six stated objectives of China's 1978 open door reform policy. Historically, China saw international trade as a necessary evil. The key to open door trade liberalization was stripping away multiple layers of insulation and state monopoly.

> "Chinese state-owned industrial enterprises gained considerable autonomy to organize their production and investment activities under the reforms."

The past 15 years have brought significant progress toward trade liberalization. China's domestic market is no longer isolated from foreign markets. From 1979-1993, trade grew at an annual average rate of 16%, almost twice the economic growth rate of the country. Exports grew significantly; China became the world's tenth largest exporter in 1996.

> "The profit-contract system is essentially a rental system."

The implementation of direct foreign investment, primarily export-oriented, started with encouragement but tight regulation (1979-86), reduced government regulation and intervention (1986-1992) and opening new areas to foreign investment (1992-present). The success of foreign direct investment reform is difficult to calculate in economic terms. These investments accounted for only 6% of China's total fixed asset investment from 1980-1993. These investments were made primarily in coastal regions and some social problems, namely worker abuse, were reported. However, success has created a positive climate from which further, more dynamic foreign investments can be made over time.

The Non-State Sector

The non-state sector consists of the collective and private sectors. Collective enterprises include urban collectives and township and village enterprises (TVEs). The private sector comprises individual and private enterprises (IEs and PEs). The non-state sector was the most important contributor to the country's economic growth over the last 15 years.

> "The reform of agricultural purchase prices since 1985 was meant to reduce state price subsidies for the marketing of agricultural products as well as to increase the role of the market in agricultural price determination."

By 1994, the non-state sector accounted for more than half of China's industrial output, retail sales, and exports. This sector serves several complimentary roles in the economy. It fills production and service gaps that the state sector cannot cover. It provides jobs for surplus labor, private investment opportunities and healthy competition for state enterprises.

But the non-state sector has also had several negative effects on the state economy. The state cannot compete with this sector's salaries for skilled labor. In zones where head-to-head competition exists, there is a significant income disparity. China also found a measurable increase in illegal activities associated with non-state sector business, particularly tax evasion (mostly by unregistered IEs) and bribery (to gain access to rationed goods).

China's Transition: A Final Thought

The success of China's transition from a planned to a market economy is mixed. Even though China has had a longer transition time, a smoother development and a more favorable environment than Central and Eastern European countries, China's transition is less advanced than theirs. The evidence does not yet support the belief that China is the model for other countries desiring to make a similar transition.

About the Author

Joseph C. H. Chai is senior lecturer in economics at the University of Queensland. Previously, a Research Fellow at Centre for Chinese Studies, Oxford University, and the Harvard-Yenching Institute, Harvard University, he has also been senior lecturer in economics at the University of Hong Kong.