

The Economics of China

Transformation Part 1



Fall 2020

Market Transition: Strategy and Process



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¹ PRC's leaders since 1949, n.d. photograph, viewed 19 September 2020,
< <https://i0.wp.com/chinahandsmagazine.org/wp-content/uploads/2018/11/November-12.jpg?resize=800%2C768&ssl=1> >.

Market Transition: Strategy and Process

- In 1978, the new leadership in China decided to move towards adopting capitalist/market-based economic policies.
- Problems/challenges facing this kind of transformation:
 - "There were virtually no private businesses".
 - "Individual prices were meaningless, and profit was therefore meaningless as well" ...
 - Economic openness to the rest of the world was still limited.

Market Transition: Strategy and Process

- What is (economic) reform?
 - "A reform is a type of deliberate policy measure that changes the rules under which economic actors operate".
- "Reforms are intrinsically difficult to carry out":
 - In particular, "there is a fundamental asymmetry between the position of current incumbents (the winners in the status quo) and that of potential beneficiaries of reform".
 - In addition, some reforms "cause immediate disruption and deliver benefits only with a lag".

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- Transition between 1979 to 1992: promoting economic growth and development through gradual and controlled transitions.
 - "Early reforms created pockets of unregulated and lightly taxed activity within the system".
 - "The reformers allowed such pockets to grow because they were seen as contributing to developmental objectives".
 - "For example, rural communities were permitted to run township and village enterprises outside the plan because that would contribute to local investment and economic growth".
 - "Foreign businesses were allowed to operate freely in Special Economic Zones (SEZs) because that would increase investment in China and might persuade foreign corporations to transfer technology to China.
 - "Such policies were seen as contributing to growth while not initially threatening the overall ability of the government to manage and direct the economy".

Market Transition: Strategy and Process

- Early Rural Transitions: 1979-1982.
 - While agricultural collectives remained in place, the government decreased procurement targets and increased monetary incentives.
 - Initially, as a result, China had to increase its grain imports at a time it was "desperately short of foreign exchange".
 - However, when China was finally able to achieve "increased availability of modern inputs, such as chemical fertilizers", domestic agricultural output increased to a point that "there was enough grain for every body".
 - "The decades in which China's industrialization had been repeatedly held back by agricultural weakness were over, and the centuries of a food-short China were over as well".
 - Also in rural areas, township and village enterprises (TVE's) turned out to be successful.

Market Transition: Strategy and Process

- Initial "success" in Rural Transitions meant the following:
 - "China's reformers gained confidence to persist in the reform project and push forward".
 - "rural reforms supplied ideas that could be used in further reforms, notably the practice of signing contracts to stabilize essential relationships while liberalizing 'above-quota' transactions. This was arguably the origin of the "dual-track" approach to reform".
 - "rural success relaxed the constraints imposed on policy-makers by scarcity, most immediately by easing access to foreign-exchange".
 - Since people in rural areas initially benefited from these transitions, "reforms had gained the support of the majority of the population".

Market Transition: Strategy and Process

- Accelerated Transition 1: 1984–1989.
- The nature of China's policy in the 1980s as a strategy of transition can be shown by focusing on two main characteristics:
 - Dual-track system.
 - Macrostability.
- "put together they added up to a simple package: introduce markets and then use your remaining capabilities to keep the macroeconomy on track".

Market Transition: Strategy and Process

- Dual-Track System:
 - "The core meaning is the coexistence of a traditional plan and a market channel for the allocation of a given good".
 - "Rather than dismantling the plan, reformers acquiesced to a continuing role for the plan in order to ensure stability and guarantee the attainment of some key government priorities".

Market Transition: Strategy and Process

- Macroeconomic Stabilization: Traditional “planned” instruments used to stabilize the economy.
 - Unlike the “big-bang” transition that occurred in Russia and other countries, “the Chinese used the instruments of the planned economy to shift resources toward the household sector and relieve macroeconomic stresses at the very beginning of reform”.
 - In particular, planning instruments were used to fight inflation, “reduce unemployment and increase the supply of consumer goods”.
 - In turn, this “tended to preserve stability and solidify support for the reform orientation”.
- “Reform without losers”: Maintaining a dual-track system and intervening to minimize macroeconomic disruption meant that “almost no major social group had suffered significant economic losses during the 1980s”.

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- Macroeconomic (De)Stabilization: Macroeconomic cycles.
- Early transition was not problem-free.
 - "Inflation spiked in 1980, 1985, and 1988–1989, with consumer price inflation peaking at 28% in 1988–1989".
 - Inflation at this level caused significant hardship to workers on relatively fixed incomes and introduced bouts of uncertainty".
 - "Macroeconomic cycles were also reform-policy cycles".
 - "Reforms advanced strongly in certain years (1979–1980, 1984, 1987–1988) but in each case were accompanied by increased imbalances and inflation".
 - "These 'political business cycles' were similar to those in the socialist economy, except that the expansionary phases corresponded to accelerated reform rather than to political mobilization".

Market Transition: Strategy and Process

- The economic crisis in 1988-1989 (with 28% inflation) led to a political crisis.
- As a result, economic transition was put on a short break in 1989-1992.
- However, a more radical phase of transition was about to start.

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² Zhu Rongji, n.d. photograph, viewed 19 September 2020,
< https://cdn.theatlantic.com/static/mt/assets/damien_ma/ma%20sep15%20p.jpg >.

Market Transition: Strategy and Process

- Accelerated Transition 2: 1993–1999. "Reform with Losers".
 - The main features of this phase are moving toward a "wild" form of capitalism and focusing on economic growth above anything else.
 - This meant that while some groups benefited from economic growth, others suffered from changes that occurred during this phase.
 - Economic and social problems during this phase:
 - Declining state capacity along with a decline in health and education spending and social safety net deterioration.
 - High inflation and growth slowdown.
 - Continued privatization and downsizing of state-owned enterprises resulted in millions of job losses without government intervention to alleviate the direct consequences.

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- 1993–1999: Inflation and crisis of state capacity.
 - "Inflation, previously tamed, came roaring back, accelerating through 1993 and remaining above 20% throughout 1995".
 - "It took a prolonged period of monetary restraint to put an end to the inflationary surge, and price stability was not achieved until 1997".
 - In addition, "during 15 years of reform, budgetary revenues as a share of GDP dropped from 33.3% of GDP in 1978 to only 10.7% at its low point in 1995".
 - "It was feared that this decline threatened the government's ability to achieve its most basic goals".

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- 1993–1999: From planning to regulating.
 - End of the dual-track system. Economy "grown out of the plan".
 - "Movement in the direction of a regulatory state, with a focus on regulating competition, reduced government intervention and direction management of enterprises".
 - "three important measures were adopted that became effective during 1994: a new fiscal system, a new foreign-trade system, and a new Company Law."

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- 1993–1999: New Fiscal System.
 - "broader tax base by implementing a 17% value-added tax and other business taxes".
 - "establishing a set of rules for sharing revenues between central and provincial governments".
 - These fiscal changes "provided a new, broader tax base for the economy and led to a steady revival of government budgetary collections".
 - "The reforms restored robust growth to fiscal revenues, which increased every year until 2015, when they reached 22.1% of GDP".

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- 1993–1999: New Monetary/Financial System.
 - The People's Bank of China (PBC), the central bank in China, was restructured and given a "new mandate to conduct monetary policy and with a monetary policy board established as a governance and advisory body".
 - "In 1999, four asset-management corporations were established to take over some of the nonperforming loans of the four big state commercial banks and begin to liquidate them for as much residual value as possible".
 - "Securities Law in July 1999".

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- 1993–1999: New Foreign-Trade System.
 - "Extraordinary steps were taken to open the economy in 1993".
 - "Foreign firms were allowed access to China's market through foreign direct investment".
 - "At the end of 1993, reforms unified China's foreign- exchange regime (eliminating the dual track in foreign exchange), devalued the currency, and established current-account convertibility.
 - Later, China joined the World Trade Organization (WTO) in 2001.
 - "WTO accession implied an important further step in the degree of openness of the Chinese economy and the extent to which foreign goods and companies could compete in China".

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- 1993–1999: "Company Law, effective July 1, 1994".
 - "The Company Law provided for all state-owned enterprises to gradually reorganize as limited-liability corporations, with clarified corporate governance institutions".
- In addition, "new central-government agencies were established to deal with other types of regulatory oversight, including, for example, the State Intellectual Property Office and the State Administration of Technical and Quality Supervision".

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- 1993–1999: "Reform with Losers".
 - "privatization...became common in the TVE, collective, and SOE sectors".
 - "Thus employment in all government-controlled enterprises declined by 33 million (or 43%) over 10 years".
 - "Reform after 1993 clearly imposed significant losses on substantial social groups".
 - "Most directly affected were SOE workers".
 - "Deprived of job security for the first time since the establishment of the PRC, some state workers suffered precipitous losses in income and social standing".
 - "Groups and individuals emerged from this phase of reform less sheltered from competition than in the past, and the shortcomings in China's social safety net were now glaringly obvious".
 - "The benefits of transition were more unequally spread among the Chinese population than had been the case in the 1980s, and inequality soared".

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- 1993–1999: "Reform with Losers".
 - "The transition strategy employed between 1993 and 1999 was more orthodox and less distinctively Chinese than the approach taken in the 1980s".
 - "There was a less stark opposition between 'big-bang' and 'gradualist' transitions".
 - "In both types of transition, there was a cost for change".

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- After 2003: From "Wild-West" to Moderate "State Capitalism".
 - "In 2002/2003, the new Hu Jintao–Wen Jiabao administration took over in China".
 - The new leadership, while continuing to place economic growth as a priority, added new policy priorities such as:
 - "rebuilding social services, such as health insurance".
 - "bolstering agriculture by cutting taxes and providing protection".
 - "developing robust industrial policies".
 - "initiating steps to reverse increasing environmental degradation".
 - "Policy-makers sought a broader definition of development...and showed a willingness to displace the unquestioned priority of GDP growth as a policy-making objective".
 - This trend has continued with the current leadership which took over in 2012-2013 (Xi Jinping and Li Keqiang).

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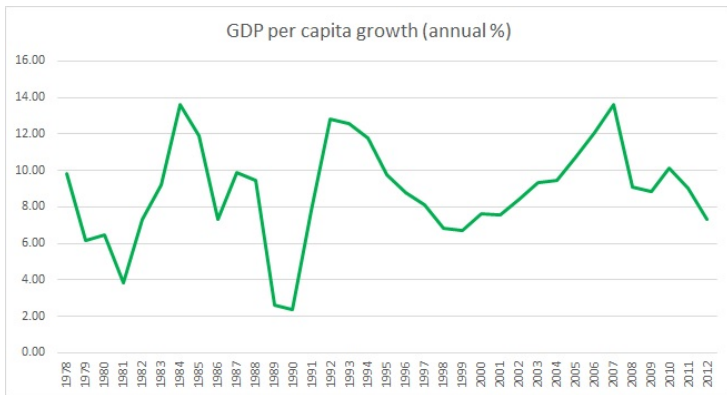
- China's "Growth Miracle": Between 1978 and 2012, China GDP annual growth³ average was approximately 10%.



³ Numbers for average calculation and below graph are from:
<https://databank.worldbank.org/source/world-development-indicators>.

Market Transition: Strategy and Process

- China's "Growth Miracle": Between 1978 and 2012, China GDP per capita annual growth⁴ average was approximately 9%.



⁴ Numbers for average calculation and below graph are from:
<https://databank.worldbank.org/source/world-development-indicators>.