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**Economic Transition: What Can Be Learned  
From China's Experience**

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**ECONOMIC TRANSITION: WHAT CAN BE LEARNED  
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## **ABSTRACT**

The last decade of this century has witnessed the transition of the formerly centrally planned economies of Europe and Asia to market economies, a process affecting some 1.7 billion people in 28 countries. While much agreement exists on the sorts of reform measures required, disagreement exists over their sequencing. The economic and social performance of these transition economies has varied considerably and for a variety of reasons, however China's performance, in particular, has been outstanding.

The paper reviews the reform measures required for economic transition, and alternative sequencing approaches to these reforms. It conducts an overview of the performance of the transition economies, with focus placed upon the experience of the Chinese economy. An analysis of China's approach to economic reform, its key components, major outcomes and outstanding issues are discussed. Key lessons to be derived for other transition economies from China's experience are also presented.

## ECONOMIC TRANSITION: WHAT CAN BE LEARNED FROM CHINA'S EXPERIENCE

**1. INTRODUCTION**

The period from 1917 to the early 1950s witnessed a number of countries, containing one-third of the world's population, reject the market as a mechanism for the allocation of resources and the determination of production, and instead embrace the so called Soviet model of central planning. This model contained a number of key features: material balance planning for allocating resources; collectivised agriculture; price, wage, interest rate and exchange rate control; emphasis on heavy industry dominated by large state owned enterprises (SOEs) with little priority given to the production of consumer goods; foreign trade control through state trading monopolies; emphasis on economic autarky;<sup>1</sup> and discrimination against the private sector. The model's dramatic collapse and rejection in Eastern Europe in the late 1980s and early 1990s, and the Soviet Union itself in 1991, created an unprecedented scale of transition<sup>2</sup> from planned to market economies and reintegration into the global economy, affecting some 400 million people in 26 countries. For economists the major challenge during the last decade of this century has been to advise how best this immense task could be accomplished, particularly given that there were few real world examples to draw upon and certainly none on the scale required.

While the achievements of the Soviet model were considerable, including: increased output, the attainment of industrialisation, the provision of basic education, health care, housing, jobs for the entire working population, an ability to avoid severe cyclical downturns, a relatively equal income distribution, and a welfare system which ensured access to basic goods and services, it was subject to intrinsic inefficiency. Planners were unable to acquire sufficient information to substitute for that supplied by prices in a market economy, particularly in the more advanced planned economies of

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<sup>1</sup> In practice most of the planned socialist economies were linked by trade to each other through the Council for Mutual Economic Assistance (CMEA). In Europe, however, Hungary and Poland in particular conducted considerable trade with the west, and China had been doing so for some time following the ideological split with the Soviet Union in the early 1960s. In the latter case though this still remained relatively modest.

<sup>2</sup> Transition means the movement from one economic system to an entirely different economic system. This involves replacing the framework and institutions of the old economic system with entirely new ones. It is therefore important to distinguish between economic transition and economic reform of an existing system.

Europe. The planning system became largely a personalised bargaining process, with connections being a key component. Firms had little incentive to use inputs efficiently and instead had a strong incentive to hoard both labour and raw materials. Lack of incentives stifled individual initiative, and a large bureaucracy allocating resources created serious sectoral distortions with some sectors, particularly heavy industry, massively overbuilt and others, light industry and services, severely repressed. Prices did not accurately reflect relative values, with energy, housing, public transport and staple foods being relatively cheap while consumer goods, if available, were often expensive and of very poor quality. Continual shortages enabled firms to operate in a seller's market reducing the incentive to improve quality, and state owned enterprises lacked the defined property rights that would stimulate work effort and profit making as in market economies.

Such deficiencies became increasingly intense in the centrally planned economies of Central and Eastern Europe as well as the Soviet Union itself by the late 1980s. During the 1950s and 1960s, however, impressive real growth rates of GNP had been achieved, with the exception of Czechoslovakia and East Germany. A more variable performance for these countries in the second half of the 1960s and first half of the 1970s is apparent, but by the latter half of the 1970s and throughout the 1980s these economies experienced continual economic stagnation.<sup>3</sup> In response, by the late 1980s and early 1990s, these economies rejected central planning and with the exception of East Germany, which was absorbed by West Germany in 1990, each independently embarked on a transition process towards decentralised market driven economies based upon predominant private ownership. A catalyst for the post 1989 economic reforms in these economies, was their political reform toward multi-party democracy during this period.

In the context of the planned developing economies of East Asia, China and Vietnam, the relevance of the system as a model for economic development had already been questioned. This occurred in China during the period of the Great Leap Forward in the 1950s and again during the ten year Proletarian Cultural Revolution of the 1960s and 1970s. The first of these had contributed to the ideological split with the Soviet Union in the early 1960s. The implementation of central planning went into decline in China from the mid 1980s. Similarly in Vietnam the Soviet model began to be questioned in the mid 1980s during which its already heavily dependent and moribund

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<sup>3</sup> See Harvie (1998a).

economy experienced further macroeconomic crisis and a deteriorating performance.<sup>4</sup> With its emphasis on capital intensive heavy industry the Soviet model was not appropriate in the context of very poor primarily rural economies, rich in labour resources but poor in capital resources. The adoption of a development strategy based on the tiger economies of East Asia, focusing, at least initially, upon labour intensive light manufactured goods for export, would have been more appropriate given their factor endowments. In addition, the early implementation of economic reform in agriculture produced impressive gains in output and productivity, in both China and Vietnam.<sup>5</sup>

With the demise of the planning system two approaches for attaining a market oriented economy, reintegration into the global economy, and improved long term growth and living standards for the transition economies came to the fore. These being the "big bang" or shock therapy approach and the gradual or pragmatic approach. Many countries, primarily in Central and Eastern Europe, adopted the big bang approach which advocated the need to destroy all remnants of the old planning system as rapidly as possible, and to replace it with a system based on a market allocation of resources with predominant private ownership. The social and economic costs of such an approach in terms of lost output, rising unemployment, rising poverty, increasing income disparities both between the rich and poor as well as across regions, deteriorating social cohesion and crime, at least in the short run, has been high for many of these countries. Occurring in conjunction with political reforms, in many instances, this has contributed to both greater economic and political instability.

On the other hand in China and Vietnam<sup>6</sup> major reform of the planning system had already been taking place during the period of the 1980s, and by the early 1990s each were committed to the attainment of market determined resource allocation while maintaining the "socialist" character of their respective economies. Unlike Europe the move towards a market oriented economy would occur with predominant state and not private ownership, and the transition process would be a gradual one. In addition, overriding political power would still reside with their respective

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<sup>4</sup> See Harvie (1998b).

<sup>5</sup> Both countries in the 1980s moved away from collectivised agriculture to the household as the basic unit of agriculture production.

<sup>6</sup> It should be borne in mind that central planning was not as pervasive in the context of these Asian countries as that for the Central and Eastern European economies and the Soviet Union itself. This can be partially explained by the different levels of economic development. The Asian countries were primarily very poor and heavily dependent upon their agricultural sectors.

Communist Parties. While economic and political reform was being conducted in Europe, only economic reform was on the agenda in Asia. However in both of the Asian countries there is considerable decentralisation of economic power, which has resulted in substantial difficulties for the centre in a number of areas and in particular with regard to macroeconomic management. For these authoritarian Asian economies political legitimacy and the maintenance of support in particular from the rural sector, required reform measures to produce rapid beneficial outcomes and a correspondingly higher priority, in comparison to their European counterparts, to the maintenance of social cohesion. Hence a more gradual and pragmatic approach was appropriate.

The remainder of this paper proceeds as follows. Section two identifies key issues involved in the process of transition from planned to market economies, not only in terms of the policies required but also more controversially the sequencing of such policies. Transition will involve fundamental change of institutions and the way in which society operates and imply profound social implications. Section three briefly analyses the economic performance of the transition economies of Europe and Asia, focusing upon that of economic growth and inflation. Section four analyses economic transition in China, focusing upon its key characteristics, phases and unfinished components. Section five highlights from China's economic reform experience some of the key lessons to be derived for a successful transition. Finally section six presents a summary of the major conclusions to be derived from this paper.

## **2. ECONOMIC REFORM - KEY ISSUES IN THE PROCESS OF TRANSITION**

During the last decade of this century economists have been called upon to advise on the major economic reforms required to take a planned economy to a market economy, as well as to the equally important issue of the sequencing of such reforms. There is general agreement over the sorts of reform measures which are required. The key areas for economic reform include: macroeconomic stabilisation; price and market reform (the latter emphasising trade reform, labour market reform and financial sector reform); restructuring and privatisation (focusing upon small and large scale privatisation of SOEs); redefining the role of the state with emphasis on market supportive measures including legal reform, institutional reform and building, and the provision of a social safety net. The provision of unemployment insurance, particularly during the early part of the

transition process, is seen as being essential. While there is general agreement on the need for such reforms, major dispute arises over their sequencing. There are those who would advocate a big bang approach to the implementation of economic reforms while there are others who would advocate a gradual approach to transition. The reality has been, however, that even for countries like Poland, regarded as a leading proponent of the big bang approach to transition beginning in 1990, that such reform has been limited to the implementation only of a rapid macroeconomic stabilisation program including that of price liberalisation, exchange rate reform, tax reform and trade reform. Progress in terms of the restructuring of SOEs and large scale privatisation, banking and finance reform, as well as social security reform, have been much slower.

Figure 1 presents a summary of the major reform areas as well as their proposed sequencing, as originally advanced by Fischer and Gelb (1991).<sup>7</sup> A clear message from this is that economic transition in reality will require a gradual approach. Short term focus should be placed on the need to attain macroeconomic stability, including the containment of inflation and the reduction of interest rates, essential for the development of a private oriented market economy. Other key areas for early reform include that of: price liberalisation to enable market signals to play a crucial role in determining resource allocation; trade reform, including that of current account convertibility to enable rapid integration into the global economy; small scale privatisation; legal and institutional reform to provide the framework essential for the development of an increasingly market oriented economy; and finally the establishment of a social safety net, particularly that of unemployment insurance. These would be representative of a minimum "big bang" menu of measures. Only later on in the transition process would it be possible to implement reform of the labour market, the banking and finance sector, and the privatisation of large scale SOEs. However initial conditions for the transition economies varied considerably, influencing the urgency of implementation of economic reforms. In the case of Poland, for example, with major internal and external macroeconomic imbalances on the eve of transition, there was a pressing need for a macroeconomic stabilisation program.<sup>8</sup> This was also the case in Russia and the Newly Independent States (NIS) which faced a highly unstable macroeconomic environment combined with a disintegrating economy, collapsing

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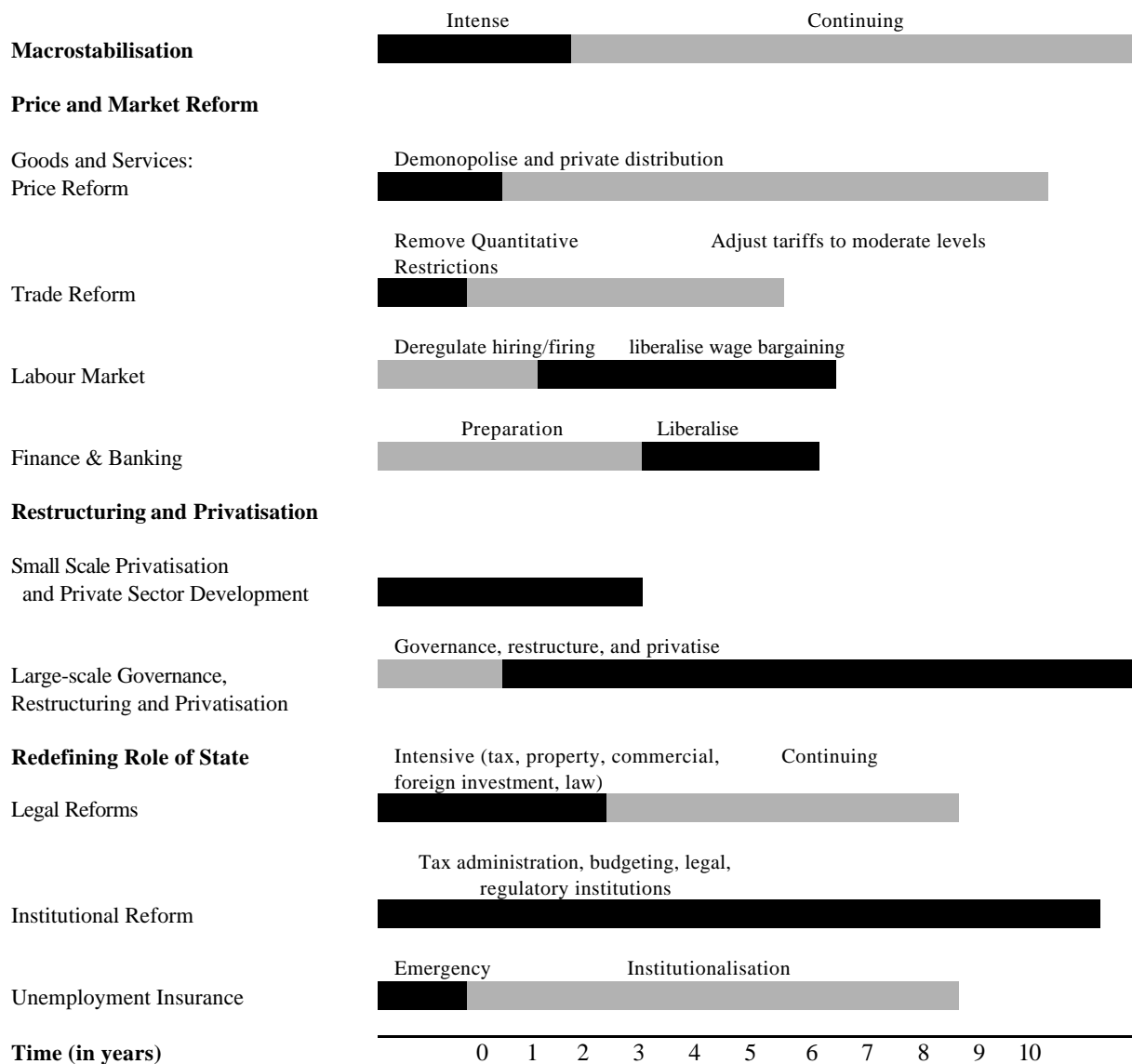
<sup>7</sup> As mentioned previously there would be broad consensus over the major areas of economic reform, but there would be disagreement in regard to Figure 1 over the timing and sequencing of such reform. Figure 1 contains the viewpoint of Fischer and Gelb (1991).

<sup>8</sup> (see Harvie 1998a)



trade, a monetary overhang and weak government. In addition, other noneconomic factors such as politics, history, culture, and geography can exert an important influence upon the reform strategy adopted. In the context of such an environment of rapid change, major economic and social upheaval is likely to arise.

**Figure 1: Economic Transition Phases of Reform\***



Source: Fischer and Gelb (1991), p. 102.

\* The darker areas imply greater intensity of reform measures.

The alternative gradual or phased approach to economic transition, focuses upon local experiments which, if successful, are expanded to include the rest of the economy. A few repressed sectors, such as agriculture, are liberalised almost immediately. After these initial steps, markets are slowly but steadily extended to other parts of the economy as the institutional building blocks of a market system are gradually put in place. This strategy relies on there being scope to reap large productivity gains from the first, partial reforms. These, in turn, raise incomes, so building momentum for further more difficult reforms in a self reinforcing process. Such a gradual approach to reform requires sustaining the reforms over an extended period, and containing adverse side effects arising from selective liberalisation of the economy. Since the market and the plan must coexist for an extended period of time, individuals and companies will have a strong incentive to seek economic rents by shifting goods or financial resources from the low priced controlled segment of the economy to the high priced liberalised segment. The government is required to keep tight control on both the macro and the micro economy, supervising those activities still covered by the plan and imposing stiff penalties for non compliance. This phased approach is essentially the path being followed by China and Vietnam.

### **3. REFORM PROGRESS AND ECONOMIC PERFORMANCE IN THE TRANSITION ECONOMIES**

A recent report compiled by the World Bank (1996) conducted a comparison of reform progress in the transition economies,<sup>9</sup> and this was appraised in terms of four criteria: degree of economic liberalisation, property rights and private ownership, institution building and development, and social policies.

Economic liberalisation was measured in terms of developments in domestic markets and prices, foreign trade and currency convertibility, and openness to new business entry. By 1995 it was found that many countries in Central and Eastern Europe and the NIS were essentially market economies, with open trade, current account convertibility, and liberal policies toward new entry and private business.<sup>10</sup> However some still retained extensive price and export controls and state trading monopolies, despite reform programs in these areas having been announced. The East Asian countries, with more extensive controls on foreign trade and entry, were found to be less liberalised

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<sup>9</sup> For the countries identified, see Table 1.

<sup>10</sup> See World Bank (1996), *World Development Report*, Figure 1.2, p.14.

than the more advanced reformers in Europe. However on average over a longer period of time 1989-95, with their earlier start the East Asian countries have been almost equally as exposed to market forces as the Central and Eastern European countries. Since 1989 Russia's economy was found to have had about half the exposure to market forces as the leading European reformers, while a number of other transition economies were found to have barely emerged from the planning system (e.g., Azerbaijan, Belarus, Tajikistan, Turkmenistan, Ukraine and Uzbekistan in particular).

Another key component of transition is ownership reform and here too the World Bank found considerable change in the transition economies, with a shift to a private economy reflecting both the entry of new firms and the privatisation of state firms. In Central and Eastern Europe and the NIS, nine countries were found to have private sectors accounting for over half of economic activity. Even though sizeable involvement by government in firms classified as private widely exist, this is offset by the unmeasured unofficial economy. Such an allowance is likely to put many countries over the halfway mark. Ownership developments in the economies of East Asia show a diverging trend. In China ownership has been diversifying substantially toward a wide variety of forms, including that of collectives, joint ventures between state and foreign private enterprises, foreign funded enterprises and domestic private enterprises. The growth of this so called nonstate sector has been increasing rapidly since the initiation of economic reform, and is now larger than the share of the formal state sector in the country's GDP. On the other hand Vietnam was found by the World Bank to be the only country in this sample where the state sector's share had risen since 1989, but many enterprises classified as state firms in this country are in fact joint ventures with private (mainly foreign) partners.

A third key component of economic transition is institutional reform and building. The old institutions operative under the planning system are no longer relevant in the context of a market oriented economy. For the latter to operate effectively it requires its own requisite institutional framework. The rapidity with which such a framework is developed will be strongly correlated with the extent and duration of economic liberalisation, since macroeconomic as well as ownership reform will create intense pressure for institutional reform. However despite such pressure the reality is that institutional reform is likely to be slow, and the successful transition to a market economy is correspondingly likely to be slow. A number of difficulties with institutional reform have become apparent in the transition economies:

- Progress in legal framework reform has varied between countries, with reform of judicial institutions and enforcement mechanisms lagging far behind other reforms and corruption remaining an acute concern in some countries;
- Reform of the banking sector has remained difficult, with many banks still lacking the necessary expertise to operate on a commercial basis and with many having non performing loans in their asset portfolios. In addition the old relationships between the SOEs and the banking system during the period of central planning is still pervasive. Serious conflicts of interest plague many financial systems, and in most countries the scope of market based finance is limited by poor debt recovery mechanisms;
- While most governments have substantially reoriented their roles to meet the needs of a market economy, there are still a number of key areas such as tax administration, public administration, and fiscal decentralisation where reforms are still at an early stage in many countries. This can have an adverse impact upon an economy and in some cases has adversely affected regional equity. The power and administrative authority of central governments have diminished in some countries with the considerable, and sometimes chaotic, decentralisation of revenues and functions to subnational governments. There is frequent confusion over the roles of the executive, the legislature, and the constitutional courts.

Institutional development is also a key component for sustaining the momentum of reform in the Asian transition economies. China's banks, for example, are less market based than those in Central and Eastern Europe because many loans are still allocated through a central credit plan. However the authorities have established three policy lending banks, with the objective of separating these from the other banks which are to function on a solely commercial basis.

Social policy reform is another key area but one which has tended to be politically difficult in most of the transition economies, apart from the introduction of unemployment benefits, and has typically not been a major focus early on. The World Bank has found that where such reform has taken place it has often been reactive, impelled by fiscal shortfalls. In the future, however, social policy reform is likely to become of increasingly higher priority. Central and Eastern European and NIS governments are increasingly facing pressure to develop policies to deal with both increased

labour mobility as well as increasing poverty within the framework of tight budgetary constraints. A similar situation also exists in the context of the East Asian transition economies, which must find ways to respond to an increasingly mobile and industrial rural population that is still outside the formal system of social benefits. China's urban enterprises still bear the burden of pensions, medical care and housing - partly because reforms have yet to resolve many difficult problems of the state sector. A number of measures, however, are being implemented to take such responsibilities away from the SOES, as attempts are made to put these on a more financially independent footing.

### *Economic and social outcomes*

An analysis of the major economic and social outcomes for the transition economies to date would suggest that there are three features which are most apparent. The first of these is the disparity in performance between three sets of countries. That between the more advanced reformers in Central and Eastern Europe and the NIS, the less advanced reformers in this region, and the East Asian reformers.<sup>11</sup> Secondly, that sustained and consistent reform pays off irrespective of which category the transition country falls under. Third, that both economic and social reform is required if the social outcomes of transition are to be addressed.

In Central and Eastern Europe and the NIS, the rapid implementation of liberalisation and stabilisation policies have produced the major immediate effects. The freeing of prices rapidly contributed to an elimination of shortages, and the phasing out of subsidies by governments to reduce overspending subjected firms to financial discipline and forced some initial restructuring. As indicated by Table 1 the freeing of prices in the early 1990s produced very high inflation in all countries except Hungary, where most prices had already been liberalised before 1990. As indicated by Table 2 the implementation of macroeconomic stabilisation programs, involving tight monetary and fiscal policies, contributed to large declines in output and especially in countries exposed to severe regional tensions involving economic blockades or war. However there is likely to have been an offset to this from expanded output from the informal sector, and some of this lost output consisted of goods no longer wanted. Hence using measured output changes may not necessarily give a good indication of actual developments and economic well being.

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<sup>11</sup> Tables 1 and 2 classify the transition economies into four groups. These groups are based upon the extent of their economic liberalisation over the period 1989-95 as identified in Figure 1.2, p.14, World Bank (1996), *World Bank Development Report*, with a separate grouping for the East Asian economies.

Referring again to Tables 1 and 2 it can be observed that for the more advanced reformers, primarily those countries in Group 1 and to a lesser extent those in Group 2, that their tough initial stabilisation programs have contributed to declining inflation and a resumption of growth, as the results of such a program in conjunction with other liberalisation measures began to have an impact. Underlying this recovery has been the entrance of many new and competitive firms into the market, and many state firms have been rationalised or been allowed to go bankrupt. There have been major structural adjustments as production has shifted away from industry to the previously repressed services sector, exports are playing an increasingly important role as they become reoriented toward world markets and FDI inflows to these countries has risen considerably. For example in the case of Poland, its growth rate was 6.5% in 1995, led by a 15% growth rate of the private sector. The state sector in this year also declined by some 3% of GDP.

A different picture emerges when the experiences of the less advanced, or less decisive, reformers in Central and Eastern Europe and the NIS, those classified in Groups 3 and 4 in Tables 1 and 2, are identified. Although the nature and extent of the reforms in many of these economies is impressive by conventional standards, their adjustment to these reforms has been much more sluggish. As indicated in Table 1, inflation has remained high although in most cases it has fallen substantially from earlier levels. The decline in output which they have experienced has also been much more than for the advanced reformers as can be seen from Table 2, and for many of these countries output was still declining well into their transition process. Despite their reforms, for many they have not yet managed to achieve a critical policy mass needed for sustained macroeconomic stability and a resumption of growth.

The final group of transition economies to be considered is that from East Asia, classified as forming Group 5 in Tables 1 and 2. In marked contrast to both the rapid reformers and the less rapid reformers in Europe, both China and Vietnam have enjoyed spectacular growth throughout their reform periods. The case of Vietnam is quite remarkable with the country having to adjust to the demise of the CMEA and the loss of Soviet aid, with no replacement from overseas in any substantive form until 1993, and doing so without a reduction in output. Also impressive has been China's average annual real GDP growth of just under 10% throughout its period of economic reform from 1978-96. This growth was substantially assisted by exceptionally high savings rates, and by large gains in productivity that were primarily due to labour reallocations from lower to

higher productivity activities. During the initial stage of reform this reallocation of labour was primarily from agriculture to industry. Much of China's growth, as in Europe, has arisen from formerly repressed sectors under planning. This in particular includes agriculture, at least during the initial stage, the foreign trade sector, services sector and the nonstate industrial sector.

A number of factors can be advanced to account for the variable performance of the transition economies. These include the following:

1. The speed, intensity and consistency of implementation of economic reform policy and liberalisation;
2. The implementation of a vigorous and effective macroeconomic stabilisation program with the objective of reducing inflation and budgetary deficits;
3. The extent of liberal entry and competition in markets both from domestic sources and foreign, the imposition of hard budget constraints on state or formerly state enterprises, appropriate fiscal incentives for local governments;
4. Degree of openness of the domestic economy to foreign trade and competition, as well as that to FDI and foreign technology;
5. Initial conditions as opposed to policy - some countries started with more favourable macroeconomic, structural, infrastructural and institutional conditions, including that of lower inflationary pressures, less interdependence with the CMEA system, a more recent history of a market economy, a more favourable location for developing new trade links, good physical communications, pre-existing contacts with the west in the form of trade, investment and finance. The willingness and ability for the government to play a supportive role in institution and infrastructure development is also important;
6. Each economy's initial level of development, degree of industrialisation, and income also varied significantly;
7. Many of the NIS countries and Albania, in particular, were less developed and more rural than others. In the case of China and Vietnam, however, this turned out to be an advantage. With agriculture repressed under the planning system the potential for improvements in productivity arising from labour reallocation and rural incomes was substantial. This sector turned out to be highly dynamic resulting in major gains in output, and providing a basis for reform in other

sectors of the economy because of its success. The shedding of labour in this sector led to a reallocation of labour to higher productivity industry usage;

8. Availability of domestic savings, and the provision of a pool of funds for desperately needed domestic investment;
9. Availability of natural resources such as oil and gas;
10. Some countries achieved independence for the first time, mainly for the NIS, and needed to construct the basic elements of statehood;
11. Some countries arose out of internal conflict, such as those of the former Yugoslavia, or upon achieving nationhood were involved in conflict with their neighbours such as between Armenia and Azerbaijan.

Separating the individual contributions of initial conditions, economic reform policies, macroeconomic stabilisation programs and other factors to the diverging economic performance of the transition economies is extremely difficult. However research conducted by the World Bank on this group of countries suggests that favourable initial conditions do play a significant part in determining cross country differences in outcomes. However, regardless of the starting point, vigour and constancy in the implementation of reforms has also been vital for restoring growth and containing inflation.

While focus to this point has been given to the variable economic impact of transition, the social impact of transition has also shown great variability among the transition economies. In Central and Eastern Europe and the NIS many people have gained from the transition process, with imports and consumption of high quality consumer goods from the west booming. But a combination of falling output, rising unemployment and income inequality, both between the rich and poor and across regions, has led to a large increase in poverty and growing insecurity in many countries. Indicators of social progress suggest that life expectancy has actually deteriorated in countries primarily in Groups 2, 3 and 4 including such as Romania, Azerbaijan, Kazakstan, Kyrgyz Republic, Latvia, Tajikistan, but most noticeably in Lithuania, Russia and the Ukraine. All the countries in Group 1 saw an improvement in life expectancy during their transition processes. Infant mortality rates have fallen in all countries in the post transition era, with a few experiencing a deterioration in the immediate aftermath of transition. By contrast living standards have risen sharply in the Asian



reformers. For example during the first stages of reform in China almost 200 million people were lifted out of absolute poverty, a quite remarkable achievement. However rising urban-rural differences and increasing regional inequality have now weakened the link between economic growth and poverty reduction. This has led to rising concern about the distribution of gains from reforms, requiring deliberate policy action by government to resolve or ameliorate.

From the discussion to this point it can be observed that the East Asian economies have performed remarkably well in comparison to most of the Central and Eastern European countries and the NIS, both in terms of sustained economic growth and the maintenance of relatively low rates of inflation. However they have obviously started their transition processes from a much lower economic base. But their proven ability to sustain high growth and relatively low inflation makes them unique among the transition economies. A particularly interesting issue is identifying why China, in particular, and Vietnam have been able to reform in a primarily partial and phased manner and yet still grow rapidly, whereas even vigorous reformers in Central and Eastern Europe and the NIS have suffered large declines in output. A number of possible reasons have been advanced to explain this in the context of China, including the fact that its policymakers did not have to confront some of the serious obstacles that proved very difficult to overcome in Central and Eastern Europe and the NIS. However for China over the period 1978-96 it has been able to successfully devise and implement a set of market oriented reforms that have given growth promoting incentives to farmers and workers, while maintaining macro-economic control and redirecting the interests of the bureaucracy toward supporting reform. These were and remain major achievements.

In the remaining sections of the paper focus is placed upon an analysis of economic reform in China, the most successful transition economy to date.

**Table 1**  
**Economies in Transition - Average Annual Inflation Rates (CPI)**  
**(per cent) 1990-1996**

Country	Average Annual Inflation Rates (per cent) <sup>a</sup>						
	1990	1991	1992	1993	1994	1995	1996
Group 1 <sup>12</sup>							
Croatia*	135.6	249.5	938.2	1,516.0	97.5	1.6	3.5
Czech Republic	10.8	56.7	11.1	20.8	10.0	9.1	8.8
Hungary	29.0	34.2	22.9	22.5	18.8	28.2	23.6
Macedonia, FYR*	120.5	229.7	1,925.2	248.0	126.5	16.1	-0.7
Poland	586.0	70.3	43.0	35.3	32.2	27.9	19.9
Slovak Republic	10.8	61.2	10.1	23.0	13.4	9.9	5.8
Slovenia	549.7	117.7	201.0	32.0	19.8	12.6	9.7
Group 2							
Albania	0.0	35.5	225.9	85.0	22.6	7.8	12.7
Bulgaria	22.0	333.5	82.0	72.8	96.0	62.1	123.0
Estonia	23.1	210.6	1,069.0	89.0	47.7	28.9	23.1
Latvia	10.5	124.4	951.3	109.1	35.9	25.1	18.8
Lithuania	8.4	224.7	1,020.5	410.4	72.1	39.5	24.7
Mongolia	0.0	20.2	202.6	268.4	87.6	56.8	49.3
Romania	5.1	174.5	210.9	256.0	136.7	32.3	38.8
Group 3							
Armenia*	10.3	100.0	825.0	2,732.0	5,273.4	176.7	18.6
Georgia*	3.3	78.5	887.4	3,125.4	15,606.5	162.6	40.2
Kazakstan	4.2	91.0	1,381.0	1,662.3	1,879.9	176.3	39.1
Kyrgyz Republic	3.0	85.0	854.6	772.4	228.7	52.5	30.4
Moldova	4.2	162.0	1,276.0	788.5	329.6	30.2	23.8
Russia	5.6	92.7	1,353.0	699.8	302.0	190.1	47.8
Group 4							
Azerbaijan*	7.8	105.6	912.6	1,129.7	1,664	411.7	19.8
Belarus	4.5	83.5	969.0	1,190.0	2,220.0	709.0	53.0
Tajikistan*	4.0	111.6	1,156.7	2,194.9	350.4	610.0	443.0
Turkmenistan	4.6	102.5	492.9	3,102.4	1,748.0	1,005.0	992.0
Ukraine	4.0	91.2	1,209.7	4,734.9	891.0	376.0	80.2
Uzbekistan	3.1	169.0	645.2	534.0	1,568.0	304.6	54.0
Group 5							
China	2.1	2.7	5.4	13.0	21.7	14.8	6.1
Vietnam	67.0	68.1	17.5	5.2	14.5	12.8	6.0

Source: World Bank, *World Development Report 1996*, Table A.3, p.174.

World Bank, *World Economic Outlook*, October 1997, Statistical Appendix Tables A.12 and A.13, pp. 163-164.

a. For many countries, inflation for the earlier years is measured based on a retail price index. Consumer price indices with a broader and more up to date coverage are typically used for more recent years.

\* Countries affected by economic blockades or war.

<sup>12</sup> Each group is based upon the World Bank (1996), *World Development Report*, Figure 1.2, p. 14 classification of transition economies categorised by the extent of economic liberalisation over the period 1989-95.

**Table 2**  
**Economies in Transition - GDP Growth Rates (per cent), 1971-96**

Country	1971-80 (average annual)	1981-89 (average annual)	1990	1991	1992	1993	1994	1995	1996
Group 1 <sup>13</sup>									
Croatia*	na	na	na	-15.1	-12.8	-4.2	1.1	2.4	4.7
Czech Republic	na	1.8	-1.2	-14.2	-6.4	0.6	2.7	4.8	4.1
Hungary	4.6	1.8	-3.5	-11.9	-3.1	-0.6	2.9	1.5	1.0
Macedonia, FYR*	na	na	na	-9.8	-12.4	-8.4	-4.0	-1.4	1.1
Poland	na	2.6	-11.6	-7.0	2.6	3.8	6.0	6.5	5.5
Slovak Republic	na	2.7	-2.5	-14.6	-6.2	-3.7	4.6	6.8	6.9
Group 2									
Albania	na	1.7	-10.0	-28.0	-7.2	9.6	9.4	8.9	8.2
Bulgaria	na	4.9	-9.1	-11.7	-7.3	-1.5	1.8	2.1	-10.9
Estonia	5.1	0.2	-7.1	-7.9	-21.6	-8.2	-1.8	4.3	4.0
Latvia	4.7	3.7	-1.2	-11.1	-35.2	-16.1	2.2	0.4	2.8
Lithuania	4.6	1.8	-3.3	-13.1	-51.9	-24.2	1.0	3.1	3.6
Mongolia	na	5.7	-5.6	-9.2	-9.5	-3.0	2.3	6.3	2.6
Romania	7.6	1.0	-5.6	-12.9	-8.8	1.5	3.9	7.1	4.1
Group 3									
Armenia*	14.5	3.5	07.2	-12.4	-52.6	-14.1	5.4	6.9	5.8
Georgia*	6.8	1.2	-14.8	-20.6	-44.8	-25.4	-11.4	2.4	10.5
Kazakhstan	4.4	2.0	-4.6	-9.8	-2.9	-10.4	-17.8	-8.9	1.1
Kyrgyz Republic	4.4	4.0	6.9	-7.9	-13.9	-15.5	-20.1	5.4	5.6
Moldova	na	na	-1.5	-17.5	-11.9	-24.1	-31.0	-3.4	-8.0
Russia	6.5	3.0	-3.6	-5.0	-14.5	-8.7	-12.6	-4.0	-2.8
Group 4									
Azerbaijan*	21.5	2.9	-11.7	-0.7	-22.1	-23.1	-18.1	-11.0	1.3
Belarus	6.6	5.0	-2.8	-1.2	-9.7	-7.6	-12.6	-10.4	2.6
Tajikistan*	4.9	3.3	-2.4	-7.1	-28.9	-11.1	-21.4	-12.5	-7.0
Ukraine	na	na	-3.8	-11.9	-17.0	-16.8	-23.0	-12.0	-10.0
Uzbekistan	6.2	3.4	2.0	-0.5	-11.1	-2.3	-4.2	-0.9	1.6
Group 5									
China	5.5	11.1	3.8	9.2	14.2	13.5	12.6	10.5	9.7
Vietnam	na	4.4	4.9	6.0	8.6	8.1	8.8	9.5	9.5

Source: World Bank, *World Development Report 1996*, Table A.2, p.173.

World Bank, *World Economic Outlook*, October 1997, Statistical Appendix Tables A.6 and A.7, pp.155,157.

\* Countries affected by economic blockades or war.

#### 4. OVERVIEW OF CHINA'S REFORM PROCESS

Despite the industrialisation efforts of the 1950s and 1960s, China was very poor and primarily rural at the start of its reforms in 1978. Agriculture employed 71% of the work force, most

<sup>13</sup> Each group is based upon the World Bank (1996), *World Development Report*, Figure 1.2, p. 14 classification of transition economies categorised by the extent of economic liberalisation over the period 1989-95.

of the population lived in rural areas, and it was heavily taxed to support industry. The country therefore started its transition largely as a peasant agrarian economy with substantial scope for reallocating labour and attaining major productivity gains. Poverty rates were high by international standards and average per capita income was very low. Social safety nets extended only to the state sector - about 20% of the population. Poor infrastructure and an emphasis on local self sufficiency led to low regional specialisation and large numbers of small and medium sized firms. While the economy was less centrally planned and administered than in the Soviet economy, it was relatively centralised with the central government controlling key production and allocation decisions. Local governments had greater power and developed considerable management capacity, preparing them for a more decentralised economy. Chinese industry also received subsidies, but cross subsidisation was less pervasive. In addition, most prices, including those for foreign exchange, were administratively controlled. As a result of an extremely inward looking approach, foreign trade and investment were relatively insignificant and the economy was, to a large extent, "closed". Unlike many of the other transition economies, however, China did not face severe macroeconomic imbalances at the start of reforms, nor was it undergoing the kinds of political transitions many of these countries simultaneously embraced.

Since the initiation of economic reforms in the late 1970s, China has achieved impressive economic growth coupled with significant structural transformation. During 1978-96, real GDP grew on average by 9.7% a year, contributing to a near quadrupling of per capita income and the lifting of millions out of poverty. Over the same period, many of the distortions and rigidities of the former central planning system were eliminated and market forces came to play an increasingly important role in economic decision making. The state's role in the economy was gradually reduced and a dynamic non state sector has emerged that now accounts for almost two-thirds of GDP.<sup>14</sup> In addition, as part of the normal process of economic development, employment in agriculture has declined substantially while a thriving manufacturing sector has emerged. However, despite the rapid growth of the past two decades, China has some way to go to achieve income levels comparable

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<sup>14</sup> The non state sector in China comprises urban and rural collectives (including township and village enterprises), joint stock companies, private businesses, joint ventures, and foreign funded enterprises. While collectives represent a form of public ownership, they differ importantly from state enterprises in that they typically have faced harder budget constraints and less direct involvement from government ministries. In addition, in recent years, many collectives have been effectively privatised while retaining their original classification.

with those in the newly industrialising economies of East Asia such as Indonesia, Malaysia, and Thailand.<sup>15</sup>

### *Key features of China's economic reforms*

China's economic reform process contains a number of key features which are similar to that being followed in other transition economies, but at the same time contains elements which are quite unique:

1. the approach can best be described as incremental and experimental with considerable responsibility assumed by local governments,<sup>16</sup> unlike the "big bang" reforms implemented elsewhere. The country embarked on reforms in the late 1970s without a detailed blueprint of the ultimate goals or the steps that would be taken. Reforms were often introduced on an experimental basis in some localities on many occasions at the initiative of local governments - and then applied more widely after they were judged successful. Such a pragmatic approach to economic reform was designed to avoid major disruptions to the economy,
2. the reform process utilised intermediate mechanisms to enable the transition from one economic system to another to be as smooth as possible, thereby avoiding major disruptions that could arise from an abrupt shift. The use of such mechanisms was a means of encouraging economic agents to behave in a way compatible with a market system prior to the phasing out of central planning, and typically followed a two track approach under which existing allocation mechanisms were retained while new ones were adopted at the margin and came to assume an increasingly important role.<sup>17</sup> Specific examples of this process include: the dual-track pricing system to improve the allocation of resources at the margin, where firms were permitted to sell increasing amounts of output at market determined prices as the proportion sold at controlled prices was progressively reduced; in the external sector establishing a swap market in foreign

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<sup>15</sup> At market exchange rates, China's per capita income is currently estimated at about US\$600. Purchasing power parity measures suggest a significantly higher per capita income of between US\$2,000-US\$3,000, roughly 30% below comparable estimates for Indonesia, 60% below Thailand, and 70% below Malaysia (World Economic Outlook (1997), May, Table 18, p. 81). The estimates of per capita income for China are subject to a considerable margin of uncertainty owing to incomplete information on the structure of domestic prices.

<sup>16</sup> For a discussion of China's reform experience, see Bell et al. (1993), Wanda Tseng et al. (1994). See also Australian Department of Foreign Affairs and Trade (1997), East Asia Analytical Unit.

<sup>17</sup> The two track approach was adopted in virtually all areas including agriculture, price liberalisation, exchange markets, and the opening of the economy to foreign trade and investment. See Sachs and Wing Thyee Woo (1994).

exchange retention rights to improve the use of foreign exchange was permitted alongside the existence of official rates. The share of transactions at market determined rates was gradually increased before the rates were ultimately unified in 1994; establishing open economic zones to introduce foreign capital and technology to the country; using the contract responsibility system to encourage economic agents to behave in a market oriented fashion; and authorising some local governments to enact and experiment with market oriented legislation.

3. the Chinese leadership has attempted to maintain the socialist character of the economy, focusing public ownership on key sectors of the economy whilst encouraging the development of the non state sector,
4. the reforms have produced unexpected outcomes, most notably the development of the non state sector and more specifically township and village enterprises. These have managed to create some 100 million new jobs in the rural economy since the beginning of the reform process, absorbing surplus labour in the agricultural sector as well as contributing to a diversification of the economic base of the rural economy. A similar role is envisaged for the tertiary sector during the late 1990s with the shake out of jobs from the urban SOEs.<sup>18</sup>

#### *Phases of economic reform (1978-present)*

The process of economic reform in China can be usefully broken down into a number of phases. The first phase covered the period 1978-84, the second phase from 1984-88, the third phase from 1988-91, and finally the fourth phase from 1992 until the present.

#### **Phase 1—Agricultural and rural reform (1978-84)**

Economic reforms began in agriculture in the late 1970s.<sup>19</sup> Because this sector had been so heavily repressed under central planning, its liberalisation had immediate payoffs. Between 1981 and 1984 agriculture output grew on average by 10% a year, largely because the shift to family farming substantially improved incentives. Key measures in this sector included: the leasing of land to farmers under the household responsibility system; higher procurement prices for key crops, the introduction

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<sup>18</sup> The State Commission for Restructuring the Economy (SCRES) anticipates that further reform of the economy will lead to the loss of 18 million jobs in SOEs over the period of the Ninth Five Year Plan (1996-2000).

<sup>19</sup> See Naughton (1996) for an alternative viewpoint that they began in the industrial sector.

of a dual (two track) price system for agricultural produce; encouragement of diversification and specialisation of crops; and restrictions on rural markets (trade fairs) were relaxed. The reforms led to: major gains in agricultural production and productivity; higher rural savings and investment; and the release and reallocation of labour for employment in the emerging rural industries, the so called township and village enterprises. Reforms also began in other areas of the economy, but were not as dramatic in scope and effect. In the industrial sector the bonus system was reintroduced, the retention of depreciation allowance was permitted and the retention of profits by state owned enterprises on an experimental basis began, and experiments initiated to link bonuses more closely to performance and to establish tighter links between wages and productivity. Open economic zones were established in coastal regions to attract foreign investment and promote exports, and to serve as laboratories for bolder market oriented reforms.

### **Phase 2—Broadening of reforms (1984-88)**

The initial success of the rural reforms encouraged the authorities to broaden reforms to include the urban-industrial sectors in 1984, and to gradually dismantle the central planning system. In the industrial sector important reform measures implemented included: experiments to grant state enterprises more autonomy in production and employment decisions (the contract responsibility system); the extension of the dual track system to industrial prices; and the introduction of enterprise taxation. Encouragement was also given to enterprises to borrow from the banking system for their investment requirements rather than depending upon funds through the state budget. This period also witnessed the growth in significance of other types of enterprises, most notably that of TVEs. In the financial sector, the monobank system was dismantled and the People's Bank was established as the central bank. In the fiscal area, reforms in 1984 allowed enterprises to retain a larger share of profits, and an enterprise tax system was introduced to replace profit transfers to the budget. Revenue sharing arrangements between the central and local governments was revised in favour of the latter, resulting in macroeconomic control problems. The trade and exchange system was further liberalised arising from an increase in the number and scope of open economic zones, and the foreign trade plan was further reduced. Fourteen major cities were "opened up" to encourage foreign trade and investment, including the accumulation of technical know how. Many of these measures were further expanded and revised in 1986 to include: the establishment of swap centres

for trading in retained foreign exchange earnings<sup>20</sup> and a decentralisation of trade through the establishment of local foreign trade corporations.

The reforms during this period provided the basis for broader and sustained growth, and led to the emergence of an increasingly important and dynamic non state sector. However they also created difficulties in macroeconomic control which eventually gave rise to inflationary pressures, and necessitated a tightening of macroeconomic policies in the late 1980s.

### **Phase 3—Rectification program (1988-91)**

The success of the earlier reforms contributed to rising demand, primarily through increased fixed investment, and production, but also contributed to a sharp increase in inflation. Under a rectification program plans for a new round of price reforms were postponed and there was a re-centralisation of price controls, in conjunction with other strong measures designed to reduce the inflationary pressures within the economy. The country entered a period from mid 1988 to 1991 of retrenchment, in which further reform measures were delayed. While the retrenchment measures were successful in reducing the inflationary pressures, they contributed to a major reduction in the growth of the economy. This was felt particularly strongly in the industrial sector where the SOEs experienced a major increase in losses, inter-enterprise debt increased substantially and stock levels increased sharply. They were also felt by the TVEs who were deliberately starved of access to credit as part of the rectification program. A major crisis developed compelling the authorities in late 1990 to stimulate the economy using monetary and investment policies. By 1991 the economy began to recovery. During this period, however, generally more stable prices encouraged the authorities to make substantial realignments in relative prices and liberalise certain other prices.

### **Phase 4—Deepening of reforms (1992-present)**

By early 1992 the authorities had declared an end to the rectification program, which had succeeded in reducing inflation but at the expense of slower growth and a partial reversal of reforms, announcing their intention to further accelerate the reform process and the opening up of the

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<sup>20</sup> While foreign funded enterprises were permitted to retain foreign exchange earnings, domestic enterprises were subject to a general surrender requirement but received "retention quotas" equivalent to a certain percentage of their foreign exchange earnings. Retained foreign exchange could be traded in swap centres at a market determined exchange rate.



economy. This message became clear during Deng Xiaoping's tour of the prosperous southern coastal cities at this time, when he called upon the whole country to accelerate growth and to vigorously pursue the policy of reforming and opening up the whole economy. Although Deng's exhortation led to a boom in fixed investment and the reemergence of inflationary pressures, he had prepared the ideological groundwork for the adoption of a more comprehensive reform strategy aimed at transforming the Chinese economy to a fully market based system by announcing that the market mechanism was a tool for economic development and was consistent with socialism. At the Fourteenth National Congress of the Chinese Communist Party in October 1992 his views were formally endorsed, setting the establishment of a "socialist market economy" as the national goal. This goal was later included in the country's constitution during the first session of the Eighth National People's Congress in March 1993. It culminated in a new reform strategy adopted during the Third Plenum of the Fourteenth Central Committee in November 1993.

At the Third Plenum the goal of creating a socialist market economy was seen as being one in which market forces, within the context of continued dominant state ownership, would play the primary role in resource allocation. The importance of strengthening institutions and infrastructure for control over the macroeconomy was emphasised as was the need to expand the influence of markets on the economy through reform in a number of key areas:

1. central banking and the financial sector,
2. the fiscal system,
3. the exchange and trade system,
4. state owned enterprises, with the objective of developing these into modern corporations with independent managers (corporatisation).

Attaining a secure and market oriented financial system is a key objective of the authorities' reform program. In this regard there has been legislation to strengthen the operational autonomy of the People's Bank of China, to commercialise the state banks and provide them with greater autonomy in lending decisions, to encourage the development of new market based financial institutions and deepen financial markets, and develop tools for indirect monetary policy management. Steps have also been taken to improve prudential supervision and oversight of the financial system. Recent

initiatives include the gradual shifting of policy directed lending to three newly created "policy banks", the development of a nascent interbank money market with market determined interest rates, and the initiation of open market operations on a limited scale. At the same time, China's stock market - opened early in the decade - has been developing slowly.<sup>21</sup> These measures will lead to a more efficient allocation of credit and facilitate the use of indirect monetary control instruments.

China's reform experience has been characterised by a marked weakening in budget revenues.<sup>22</sup> In common with many other economies that are emerging from central planning systems there has been a sharp and sustained decline in general government budgetary revenues since the initiation of reforms, from over 35% of GDP in 1978 to around 11% in 1996. The reduction has reflected not only the gradual separation of state enterprises from the budget, but also a worrying tendency to move genuine fiscal operations to extrabudgetary funds. In addition, the tax system has performed poorly on account of its heavy dependence on the declining state sector. Notwithstanding the weakness in revenues, however, China's fiscal deficit has remained relatively small (around 2% of GDP on average) as there has been a corresponding cutback in budgetary spending. As a consequence major reforms are being undertaken in the fiscal system to improve budget revenues through: improved tax administration; efforts to capture more fully the dynamic nonstate sector in the tax net, including through the scaling back of tax exemptions and concessions; and bringing extrabudgetary funds into the budget. A strengthening of the tax system is also under consideration through the introduction of stable and transparent tax rates. In addition, the system of intergovernmental fiscal relations has been improved by replacing the complex system of contract based revenue sharing arrangements with one based on a clearer delineation of tax assignments and tax sharing between central and local governments. A new budget law to streamline budgeting procedures and to limit local governments' ability to run budget deficits has accompanied the reforms. As a result, there have been some improvements in the fiscal system but difficulties remain, reflected in continued weakness in budget revenues and a large number of off budget fiscal activities.

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<sup>21</sup> Two broad categories of shares are traded on China's stock market: "A" shares are intended for Chinese residents, while "B" shares are reserved for foreigners. At the end of 1996, the total market capitalisation amounted to almost 15% of GDP.

<sup>22</sup> For an overview of China's public finances see Ahmad, Gao Qiang, and Tanzi, (1995), and World Bank (1993).

The last few years have also witnessed major reforms in the exchange system, including the unification of the exchange rate and lifting of remaining restrictions on payments for trade - and non trade - related current transactions, culminating in the establishment of current account convertibility at the end of 1996. Since the unification of the exchange market in January 1994, the exchange rate of the renminbi has been kept broadly stable vis a vis the US dollar, and China's strong external position has been reflected in a sharp rise in international reserves. Progress has also been made in lowering tariff rates, easing nontariff barriers, and expanding foreign trading rights, although further reforms in all three areas will be required to establish a liberal and open trade regime. Reflecting the further expansion in the number and scope of open economic zones, there has been a sharp increase in FDI inflows and significant increases in the number of foreign funded and joint venture companies. Other capital flows, however, have remained subject to controls and external debt has remained moderate.

An important outstanding issue in China's transition is the poorly performing state enterprise sector. Although the sector has accounted for a shrinking share of GDP, it continues to absorb a disproportionately large share of bank credit - around two thirds - and remains a major employer of urban labour.<sup>23</sup> Progress in other areas, notably in the financial sector, hinges importantly on a breakthrough in SOE reform and on tackling the chronic loss making enterprises that have placed a burden on the financial sector. Under the framework of the Third Plenum, state enterprise reform was moved to the top of the agenda with the current approach going significantly beyond earlier reform efforts by simultaneously addressing key issues such as corporate governance, alternative ownership forms, divestiture of social services, and mergers and bankruptcies. Moreover, the approach involves a potential downsizing of the overall scope of state activity to a limited number of areas that can feasibly remain under state control, and allows for a potentially significant increase in nonstate ownership especially in smaller enterprises. This overall strategy has subsequently been elaborated with the principle of "seizing the large and releasing the small". According to this approach, dominant, but not necessarily exclusive, state ownership is to be maintained for the 1,000 or so largest enterprises, while nonstate ownership and control will be permitted in the case of smaller ones.

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<sup>23</sup> The state sector's absorption of credit may be exaggerated by the official data, which do not take into account on-lending by state enterprises to the non state sector.

The aim of the reforms is to establish a modern enterprise system through a clear separation of the state's ownership of enterprises from their management, accompanied by greater autonomy and accountability and harder budget constraints on SOEs. Progress in the latter as well as the difficult area of dealing with loss making enterprises (especially larger ones) has, however, continued to be slow. Although increasing somewhat bankruptcies have remained limited and formal layoffs of redundant labour have been small. Finally, enterprises are being relieved of their heavy social functions<sup>24</sup> with the creation of local government social welfare units and unemployment and retraining programs.

### *Pressing outstanding issues*

Despite China's impressive achievements in terms of growth and structural transformation, its transition to a market based economy has been marked by:

1. recurrent cycles in economic activity and inflation;
2. widening income disparities between the rich and poor, rural and urban areas and across regions;
3. pressure to generate jobs and avoid social unrest;

These problems reflect the partial and gradualist nature of China's reforms. The economic cycles have arisen due to the lack of development of indirect instruments for macroeconomic control, requiring as a consequence the use of blunt administrative instruments. The lack of policy instruments arises from a poorly developed financial sector, which in turn reflects a lack of significant progress in restructuring the SOEs. The regional income and development disparities are a consequence of encouraging an uneven pattern of development, accentuated by the promotion of open economic zones. The latter has contributed to internal migration and the emergence of a "floating" population that is officially estimated at around 100 million. Addressing these urgent problems are among the key challenges facing the Chinese authorities.<sup>25</sup>

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<sup>24</sup> Dating back to the central planning system, many SOEs provide a broad range of social services that would tend to be provided by governments in a market based economy. These include housing, education, and medical care, and, less formally, the retention of redundant labour. For further discussion, see IMF (1996).

<sup>25</sup> For a discussion of the challenges China faces in its transition, see Naughton (1996).

The delay in restructuring the SOEs implies that the fall out in terms of job losses is likely to be substantial, now that it is being taken much more seriously.

Since the initiation of economic reforms China has undergone four major macroeconomic, characterised by a temporary rise in inflation to relatively high levels (see Figure 2).<sup>26</sup> However, the inflation rate throughout the period of economic reform has remained modest, particularly in comparison to a number of transition economies as identified previously. GDP growth has also remained impressive throughout its transition period, with unsustainable rates occurring in 1984 and 1985 and more recently over the period 1992-94. The boom part of each cycle corresponds closely to the initial part of each phase of reform identified previously, and tend to be generated by an increase in aggregate demand brought on by SOE fixed investment. This was primarily financed by credit creation through the state banks, in conjunction with further price liberalisation,<sup>27</sup> thereafter leading to a noticeable increase in inflation. The authorities would respond by tightening financial policies, especially through direct administrative controls, including ceilings on bank lending, direct prohibitions on investment, and price reregulation. The cycles experienced have been further exacerbated by difficulties of macroeconomic management due to: economic decentralisation and the resultant considerable influence of local governments over economic policies and the financial sector; and where indirect instruments of macroeconomic control have been inadequate or non-existent, requiring the use of other blunt instruments. As a result, success in slowing inflation has occurred in conjunction with a sharp reduction in economic growth, and on occasions in excess of that which would be regarded as desirable.

This cyclical pattern largely reflects the incompleteness of Chinese reforms, specifically in the SOE and financial sectors, as previously alluded to. SOEs face soft budget constraints and interest rates on bank loans frequently set below inflation. Enterprises and powerful local governments have attempted to capture for themselves the benefits of increased credit in the form of higher local investment, incomes and employment, expecting that any inflationary costs would be dissipated throughout the entire economy. Partial price reforms have increased the need for government subsidies to cover the losses of enterprises whose prices remained fixed at artificially low levels. In

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<sup>26</sup> Even though the cycles during the reform period have been relatively large by international standards, they have been smaller than the disruptions associated with the Great Leap Forward and the Cultural Revolution.

<sup>27</sup> For further discussion of the causes of China's macroeconomic cycles, see Wanda Tseng et al. (1994) and Naughton (1995).

addition, fiscal decentralisation and difficulties in developing an effective tax administration have contributed to large declines in government revenues. As a result, the government shifted more of its fiscal responsibilities to the banking system.

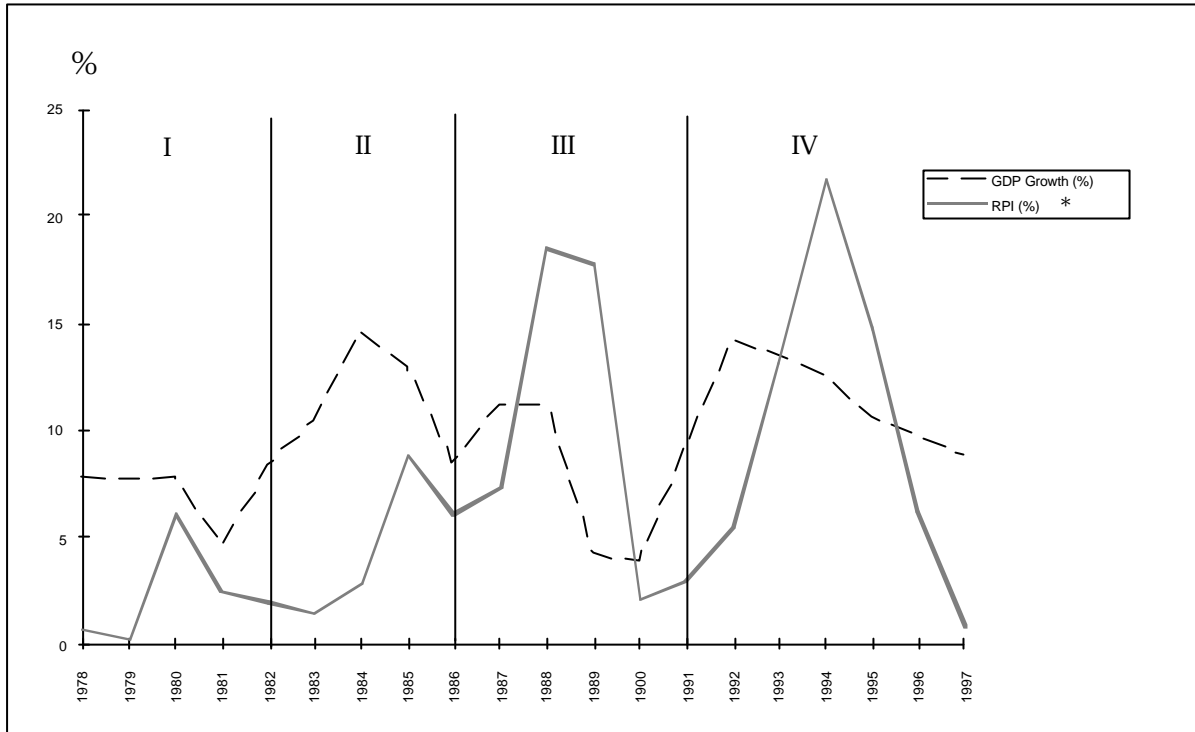
The institutional and economic reforms pursued in the last few years have sought partly to strengthen the effectiveness of the central authorities' control over macroeconomic policy and to broaden the range and increase the market orientation of policy instruments. Considerable progress has been achieved with this, as indicated by the recent success of Vice Premier Zhu Rongji<sup>28</sup> in reducing inflation from a peak of 21.8% in 1994 to only 0.8% by 1997 without causing a major disruption to growth (see Figure 2).<sup>29</sup> Nevertheless, this successful stabilisation program has contributed to SOEs experiencing rising losses in recent years and banks being called upon to support them with easy credit. Hence a major challenge still facing the authorities is the ability to implement tight macroeconomic policies when required, without the need for banks to be subject to implicit and explicit pressure to support loss making enterprises. Hence the significance of reform of the SOEs discussed earlier in this section of the paper.

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<sup>28</sup> Measures to reduce inflation were introduced in July 1993 as part of a 16 point austerity program.

<sup>29</sup> Attaining what has been called a soft landing for the economy, implying that the rate of inflation is less than the rate of GDP growth.

**Figure 2**  
**China's Consumer Price Inflation and Real GDP Growth Rates 1978-97**



Source: State Statistical Bureau (1996)  
 World Bank (1997), *World Economic Outlook*, October  
 \* Retail Price Inflation

During the initial stage of China's economic reform income disparities in the country showed a distinct improvement, however since 1984 these disparities have increased and most obviously between rural and urban areas and across regions. A number of factors have contributed to this: the relatively poor performance of agriculture following spectacular initial gains; the concentration in some poor rural areas and provinces of poorly performing state enterprises; restrictions on labour mobility; generous tax concessions and other incentives in open economic zones which has encouraged an uneven pattern of development and increased disparities between the coastal and inland provinces. Government concerns with these developments has led to the call for increased public investment in rural areas, in particular in transportation and infrastructure, and reducing preferential policies for the coastal provinces in order to redirect foreign investment to interior provinces. The government is also considering the development of a fiscal grants mechanism to redistribute income from richer to poorer provinces. In 1993 the government also announced a

major poverty alleviation effort, intended to lift the remaining 50-60 million rural poor out of poverty by the year 2000.

Finally, an issue of major concern to the government relates to the spectre of rising unemployment, and the associated social unrest. Even at the best of times unemployment pressures in China have existed. The country's official unemployment rate is low, only 3.6% in urban areas in 1996, but this statistic does not include an estimated 30 million surplus workers in SOEs or rural surplus labour which could be as high as 150 million. Also left out of the official statistics are some 70 million peasants who have headed for China's cities in search of employment, and form part of a 100 million floating labour force. Estimates of unemployment in China have been put as high as 20%, with many reports of the unemployed demonstrating in the country.

As can be observed from Figure 2, the Chinese economy has experienced declining GDP growth rates since 1992, as austerity measures implemented in 1993 attempted to cool an overheating economy. By 1997 the economy's GDP growth was down to 8.8% and inflation to only 0.8%, and a soft landing had been achieved. However it is generally believed by economists that China requires growth rates above 7-8% to generate sufficient new jobs to absorb the unemployed. Hence the slower the growth of the economy, brought about through declining demand rather than tight credit, has generated greater weakness in the job market. It is forecast that China's growth will further slow to 8% in 1998 and to 7.7% in 1999. This will make it more difficult for China's leadership to go full ahead with the essential SOE reform identified previously. The revamping of the state sector over the past few years has been estimated to have already cost the jobs of up to 12 million workers by the end of 1997, with an estimated 30 million additional surplus workers remaining. China's leaders face the precarious task of deciding how best to achieve economic and employment growth without sparking an increase in inflation, in conjunction with the need to bring about reform of the SOEs. A very delicate balancing act will be required.



## **5. LESSONS FROM CHINA'S EXPERIENCE**

The process of economic transition in China can provide a number of interesting and important lessons for other transition economies, in terms of the reform strategy to be pursued - its pace, sectoral emphasis, sequencing and key ingredients.

Firstly, the initial starting point determines whether a more gradual or big bang approach is appropriate. China started its reform process in a relatively advantageous position. While the economy was not performing as efficiently as it could have, and many distortions existed from the planning system, it was already experiencing economic growth, it had low inflation, low budget deficits, high savings and low external debt. The reform process could therefore proceed in a gradual and incremental fashion. There was no need for the economy to start off the transition process with a stabilisation program. In addition China maintained centralised political control in the hands of the Communist Party, unlike other transition economies in Europe which saw the demise of their Communist governments. For China political reform was not on the agenda. Hence the starting point for economic reform was one in which there was both relative economic and political stability.

Secondly, the focus of reform was initially placed upon a sector of the economy where success was most likely. For China this was the agricultural sector. This was a key sector in the economy in terms of employment, and one which had been severely repressed during the period of central planning. It possessed considerable potential and likelihood of success with its reform, and therefore presented a good starting point upon which to build support for further reform. Its rapid growth during the early period of reform generated: considerable improvements in productivity through resource reallocation; increased output; and an increase in rural income. The latter generated considerable rural savings and funds for investment in township and village enterprises, which were to constitute the major dynamic component of the nonstate sector. After the initial success of these reforms focus was then placed upon the industrial sector by the mid 1980s, emphasising greater autonomy at the enterprise level. However SOE reform has been slow, and even by the late 1990s it is still incomplete.

Thirdly, there should be an opening up of markets to competition from various types of enterprise ownership. In the Chinese industrial sector the significance of SOEs has been steadily declining, brought about through the expansion of the nonstate sector. However public ownership still contributes around 90% of total output, when the production of collectives is added to that of

the SOEs. In the industrial sector China possesses a unique and dynamic ingredient - Township and Village Enterprises (TVEs) the responsibility for whose operation and development fell upon local governments in the mid 1980s.<sup>30</sup> For a variety of reasons,<sup>31</sup> including that of tax incentives, they developed rapidly after 1984. The TVEs act as competition for the SOEs, provide a major source of exports, assist in the increased marketisation process of the economy, have created some 100 million new jobs since the beginning of the reform process, as well as enhance rural industrial development. While aspects of the TVE phenomenon are specific to China, their experience holds important lessons for other transition economies: the importance of liberal entry into markets, the importance of competition, the need for enterprises to operate under hard budget constraints, and the need for appropriate incentives for local governments.

Fourthly, countries in transition should, as rapidly as possible, integrate their economies with that of the global economy. From the outset of economic reform China has been gradually opening and integrating its economy with the rest of the world, resulting in large increases in external trade and foreign investment and the recent establishment of current account convertibility. The experiences of its dynamic regional neighbours, played a major role in convincing the Chinese government to pursue such a strategy. In less than two decades, China's share in world export markets has nearly tripled. The Chinese economy has absorbed almost half of total FDI flows to developing countries in recent years and with the exchange rate of the renminbi kept broadly stable vis a vis the US dollar, the strong external position has resulted in a sharp rise in international reserves. In fact, China's foreign exchange reserves, amounting to more than US\$120 billion in June 1997, are now the second largest in the world. Unlike a number of other transition economies China was not part of the CMEA, and had for many years been trading with the west albeit at modest levels. The open door policy has enabled China to gain access to western technology and ideas through FDI, which has played a key role in its process of economic development. China with its cultural, family and historical connections to Hong Kong and Taiwan, however, is in a particularly advantageous position in this regard. With a relatively cheap, literate and adaptable workforce, China will remain an attractive destination for FDI from labour intensive industries in other countries.

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<sup>30</sup> In reality, however, approximately 40% of TVEs are effectively privately owned.

<sup>31</sup> See Harvie and Turpin (1997) for example.

Fifthly, by October 1992 China had made the clear decision to move towards a socialist market economy, and by 1994 more ambitious and comprehensive reforms of the economy were to be implemented in order to make this objective possible. The characteristics of such a socialist market economy will be: considerable decentralisation of economic decision making; the market will determine the allocation of resources and the market will be influenced by the state; the agriculture and services sectors are effectively privatised; public ownership of industry remains substantial and wholesale privatisation of "pillar industries is rejected; the economy is characterised by openness to both foreign trade and investment, where export led growth and the attraction of FDI is seen as important for economic development. The attainment and viability of such a socialist market economy in which there will remain extensive public ownership, will provide an interesting case study for the viability of such an alternative system to that of free market capitalism.

Finally, China's experience with a gradual approach to transition highlights the prospective problems with such an approach. There is likely to be a problem with macroeconomic cycles in an economy from a selective approach to reform. The inevitable incompleteness of reform makes it difficult to develop effective instruments for macroeconomic control, particularly where reform of the industrial and financial sectors are difficult and closely intertwined with each other. There is also likely to be a weakening of budgetary revenues which will require remedial measures. The case of China in this regard highlights problems where there is decentralisation of economic decision involving local governmental authorities. A gradual approach can also encourage corruption where a two track pricing system is operative. Where there is both a controlled price and a liberalised pricing system for identical products operating side by side, there is the likelihood of profit seeking behaviour by economic agents. Gradually, as the liberalised sector becomes more significant, the incentive for such behaviour will decline. A gradualist approach to economic reform can also contribute to rising income disparities, particularly where certain areas or regions are given preferential treatment as in the case of China.

## 6. SUMMARY AND CONCLUSIONS

The clear message from this paper is that there is no simple or singular blueprint for the successful economic transition from a planned to market economy. A number of key policy areas can be identified, however, including that of macroeconomic stabilisation, price and market reform, restructuring and privatisation and the need to redefine the role of the state. While there is general agreement on these basic measures, major disagreement relates to the sequencing of such reforms. The two major approaches are that of a big bang or gradual approach. However in reality the big bang approach has been primarily limited to the implementation of a rapid macroeconomic stabilisation program, with the process of restructuring the economy, including that of privatisation, and the development of institutions required in the context of a market economy taking a much longer period of time.

There is considerable variation in the economic performance of the transition economies since the beginning of economic transition. For the Central and Eastern European economies and the NIS the initial part of the process has been characterised by reduced production as well as a temporary, in most cases, dramatic increase in inflation. The extent and consistency of economic liberalisation has contributed to the difference between each country's performance, as well as other factors such as their initial starting point, history and culture. It was noticeable, however, that the East Asian economies of China and Vietnam have performed noticeably differently during their process of economic reform. Neither suffered the declines in GDP growth, nor the significant increases in inflation, observed elsewhere. The case of China was shown to be of particular interest.

China's performance during its period of economic transition has been remarkable. Over the period 1978-96 it achieved an average annual GDP growth rate of just under 10%. A number of key developments appear to lie at the heart of its success: a gradual and pragmatic approach to economic reform, with a logical sequencing of its major measures; elimination of market entry barriers and stimulation of competition between the state and nonstate sectors; the development of a dynamic nonstate sector with diverse ownership; adoption of an open door policy which encouraged resource allocation into areas of production, labour intensive light manufactured goods, in which China had a comparative advantage, and the attraction of FDI and western technology.

Despite its success in the post reform period, a number of difficulties for China still remain to be overcome. These include: the problem of loss making SOEs; the related problem of developing

the financial sector and setting the banking sector on a commercial footing; weak budgetary revenue for the central government; and growing urban-rural and regional disparities. Reform of the SOEs in particular will have major social consequences in terms of loss of jobs and this will be compounded by slower growth of the economy. As a consequence the tasks facing China's leaders are immense and precarious. There is the need to maintain growth and generate employment without increasing inflation, while bringing about much needed reform of the SOEs and financial sector.

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