ECONOMIC REFORM IN CHINA

By

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Economic reform in China has deeply transformed its old central planning system, replacing it with market mechanisms as the motor for development. Through these reform measures, China has achieved impressive growth and productivity in agriculture, industry and other sectors. Still, while important gains have been made, the reform process has not been without its own share of problems. This paper aims to review and reflect on the reform experiences of China; it will look into the specific measures undertaken specially during the 1990s, and draw out the general features of the reform process. Towards the end, this paper will examine some recent developments in China's economy particularly along the areas of trade, investment and overseas employment.

HISTORY OF ECONOMIC REFORM

Economic development in China before 1978, which was under the old central planning system, was very volatile and erratic. Political movements and mass campaigns often interrupted the regular flow of economic activities, while the overheated investment climate sometimes caused serious austerity and retrenchment. Because of these problems, the Chinese government felt compelled to search for a new mechanism by which its economy could operate more efficiently, thus paving the way for economic reform.

China's economic reform, which started in 1979, was first directed on the rural (agricultural) sector. Three major programs were implemented along this line: the agricultural reform, which was considered as the "trial area"; the village/township industrial

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development, and the price system reform. It is important to review these programs which may be considered as the forerunners of economic reform in the 1990s.

Rural Reform

Baochan Daohu ("to fix farm output quota for each household") was the first step in rural reform. Implemented at the start of the 1980s, this entailed the assignment of lands to families based on their productive capacities. These families were then tasked to produce a fixed quota of agricultural products to be sold to state procurement agencies at official prices. Households that were able to produce more than their quota were allowed to keep the excess harvest or sell them at market prices. All these sparked more enthusiasm in agricultural production. However, fearing that the new system would be short-lived or changed in the near future, peasants tried to maximize the fertility of the land at the shortest possible time. This problem was remedied by extending the contract term between the townleaders and villages, and by allowing the two parties to negotiate with regard to the required quota. On the other hand, to address the growing demand for land, amid an over-abundance of labor, more land was allocated to key-point households, which were more skilled in farming, while other peasants were encouraged to engage in small and medium-scale livelihood activities such as animal husbandry, forestry or fishpond management.

Rural Township Industries

In 1985, as much as one-third of the total rural labor force was idle, while in the eastern coastal provinces, surplus labor amounted to almost one-half of the provincial labor force. Neither the cities, which were already crowded, nor the special and key-point households, which had limited resources, could absorb this idle and surplus labor force. To address this problem, rural and township enterprises started to industrialize by: 1) collecting money from the peasants and using it to buy machines or build factories; 2) inviting retired skilled workers and technicians from the cities to work in these industries with high pay; and 3) tapping the urban markets which have been experiencing shortages in consumer goods for a long period. The advantages of developing rural and township industries was described in the saying, "let peasants leave earth not leaving hometowns, let them do industries not forget to do agriculture (as seasonal workers)." In 1984, 52 million or 14 percent of the idle labor force in the rural areas were employed in these industries. In 1985, this increased to 60 million, and by 1992, 100 million, with an industrial output value of 1,250 billion yuan (nearly $210 billion).

As typical Chinese inventions in rural reform, these rural and township enterprises created more job opportunities, delayed the migration of the surplus population from the countryside to the urban areas, and increased the income of the peasants. Their emergence as competitors in the Chinese economy, however, meant that the state-owned enterprises had to share the limited resources with them, thereby distorting the price system further. Faced with unreasonable relative prices, the price system reform was placed on the agenda.

Price System Reform

The two-tier (dual track, parallel) price system, whereby goods were sold at both planned (lower) and market (higher) prices was a by-product of rural reform. From 1978-1987, the two-tier price system was extended to the industrial sector. The raw materials and products of these industries were then priced at 2-3 different levels. Gradually, however, the higher free prices became more dominant than the planned prices. This led to a high inflation rate and the Chinese leaders were urged to either stop or postpone the price reform. A vicious cycle in the price reform thus ensued: distorted price system caused shortage → inflation → sudden stop of reform → more distorted price system.

The reform of the price system was not as successful as the other reforms undertaken by the government for two reasons: 1) price reform involved more complicated relations such as benefit distribution, the relation between input and output, the stability of the whole society, etc. 2) procedural design programs were lacking and the importance of some preconditions were not realized by Chinese leaders.

REFORM EXPERIENCE IN THE 1990S

The Reform of State-Owned Enterprises (SOEs)

At the core of the entire transition from a centrally planned to a market economy was the reform of the SOEs. Originally expected to play the leading roles in economic construction, the

SOEs instead suffered huge losses. By the end of 1993, it was estimated that one-third of all SOEs nationwide were incurring losses. The SOEs were deemed as one of the hallmarks of socialist societies because they were publicly owned. However, it was also this public ownership which prevented the adoption of measures needed to change the SOEs' legal personality as government agencies often interfered in such processes.

The reform of the SOEs may be divided into four phases.

1983-1985: Instead of remitting their profits to the central government, the SOEs paid income taxes and shared profits with their supervising authority, which consisted of agencies in local government. This retention of profits greatly increased the initiative and motivation of the SOEs. A target output was assigned to the SOEs and production below the target had to be sold at lower planned prices, while those above could avail of higher consultative prices. The effect of this scheme was to stimulate more serious bargaining between the government and the SOEs as to what the target output should be. The profit distribution mechanism encouraged the SOEs to seek a reduction of the target output and increase its actual production in order to generate more profits.

1986-1991: At this stage, the enterprise output responsibility system, which was derived from earlier reforms in agriculture, was introduced into the SOEs. This system fixed the profit remittance quota of every local government to the central government for a given period. The local government, however, negotiated with the SOEs under their supervision for the allocation of the profit remittance quota. If the remittance quota collected by the local government from the SOEs was larger than the profit quota to be remitted to the central government, the local government could keep the excess funds. If it was smaller, more profits could be kept in the SOEs as consumption or investment funds. Here, it will be noted that three entities shared the profits: the central government, local governments and SOEs. The managers of the SOEs tried to increase their consumption and investment funds by reducing the profit remittance quota while producing more output and selling them at the highest price.

1991-1992: During this period, the reformists of China recognized a "negative effect" as the managers of the SOEs who signed responsibility contracts with government agencies began clamoring for shorter contract terms. Since their income depended on the total output of the SOEs during their term, the managers wanted to achieve maximum production levels at the shortest possible time. They, however, ignored the potential costs of such demands, like the rapid wear and tear of equipment and depletion of scarce resources. This problem was remedied by extending the contract term.

1993-1994: Despite the longer contract terms, managers still resorted to short-term practices because they continued to operate under the old profit-sharing system. A new management system for the enterprises was thus needed. The shareholding system, whereby enterprises will be owned by different stockholders, seemed to pose a better alternative but the security market could not allow too many companies to list their shares in the secondary markets. Hence, in the first half of 1994, the modern enterprise system was introduced in order to revive the SOEs instead of privatizing them.

Although important reform measures have been put in place, a number of steps still have to be taken to improve the economic status of SOEs in China. One, there is a need to further reduce interference from government agencies in the operations of SOEs. The SOEs also need to be released from the debt chain or what is known in China as triangle debt. On the other hand, the Chinese government must provide a better legal environment that will allow SOEs which are losing money to declare bankruptcy. Likewise, it must promote an industrial policy which can offer enough financial support to upstream industries which produce important raw materials, energy and transportation services. Finally, SOEs must be freed from the responsibility of providing for the housing, education and welfare of their employees. In short, the SOEs should be treated as an enterprise, not a sub-unit of government agencies.

The Labor System Reform

The "iron rice bowl" is a Chinese term which means that no one can be denied an employment opportunity and a person can keep his or her job under any condition. As the prevalent labor system before the reform, the "iron rice bowl" encouraged complacency and low productivity among workers, resulting in substandard incomes which in turn led to greater inefficiency.

At the risk of offending the masses and losing their support, Chinese leaders decided to reform the labor system and break the "iron rice bowl" concept. To do this, they introduced the contract labor system which required workers to sign a contract with their employers. By 1986, when the enterprise output responsibility system was implemented in the urban areas, 20 percent of all state workers were already employed on a contractual, rather than permanent basis, as previously offered by the "iron rice bowl." Later, the contract labor system was extended to more employees. This system, however, still left one question unanswered: how to create conditions that would promote the mobility of employees across industries, regions and firms.

To enhance the mobility of employees, it was necessary to establish a labor market. Initially, only technicians or skilled laborers could find new employment in the labor market (then called the qualified personnel market) while most of the unskilled with low education levels had little chance of being tapped for work. However, after several years of expansion and upgrading from the late 1980s up to 1994, the labor market was reoriented so that anyone can enter and look for a job. After a test and an interview, workers can resign from their work and sign a new contract with another firm.

Nonetheless, workers in China today continue to face several difficulties which impose constraints on their mobility. Some of these are the following:

[] *limitation in moving across regions.* Since the urban areas, particularly the coastal cities are already crowded, migrants from the hinterlands can no longer move into them. Shanghai, the biggest and most commercialized city in China, attracts nearly two million migrants from the inland provinces every year. Some of them are desperate enough to seek employment of any kind, while others are required to organize as construction teams. Once they are issued licenses by the local governments, these migrants can be hired for contract projects such as the construction of buildings, roads, etc. A Shanghai newspaper reported that, of the millions who applied, only a hundred received blue cards (permanent employee card issued by the Shanghai Public Security Bureau) in the spring of 1994. Beijing recently required firms located in the capital which intend to employ workers from outside, to pay 100,000 yuan ($16,000) to government agencies; this effectively discourages most firms from hiring migrants from the inland provinces. Indeed, the number of new residents in the cities is much too small compared to the huge inflow of migrants from the rural areas.

[] *limitation in crossing firms.* As mentioned earlier, many SOEs in China are losing money. The economical way of solving this problem is to allow the SOEs to declare bankruptcy in order to reduce the government's burden of providing subsidies. This is different from the political method, wherein the stability of the whole society is considered the priority of the Chinese Communist Party and the government. If the SOEs are allowed to declare bankruptcy through the Bankruptcy Law, more workers will lose their jobs; this is viewed as a threat to the stability of society.

[] *lack of re-training opportunities that will enable workers to shift to other forms of work in developing industries.*

Aside from these obstacles to labor mobility, other problems hound the labor system in China. One of these is the rapid increase in wages as compared to GNP growth. According to the *Beijing Review*, since the introduction of economic reforms and the open-door policy 15 years ago, China's annual GNP has grown at an average of 9.6 percent. Statistics also show that in 1993, the per capita disposable income of rural and urban residents, taking inflation into account, was three times more than it was 15 years ago. This means that wages are rising at almost the same rate as GNP. From 1984-1990, the average annual wage increase was 14.6 percent, which was higher than the average GNP growth rate for the same period. This does not take into consideration other non-wage incomes such as bonuses, allowances and various forms of subsidies as well as non-monetary benefits such as low rent apartments, a public health system and free gifts given before festivals. Thus, reformers in China must take steps to convert non-wage and non-monetary incomes into wages and monetary rewards, and at the same time slow down their rapid growth.

Banking and Financial System Reform

After several years of undertaking preparatory measures, reforms were implemented in the banking and financial sector in 1994. Though far from complete, these reforms have helped a lot in making China's financial sector more dynamic and efficient. Some of the more significant steps undertaken were the following:

Transformation of the People's Bank of China (PBC) into a real Central Bank

Prior to 1978, the only bank in China was the PBC which, aside from being the state treasury, also served as a center for credit, settlement, cash receipt and payment and monetary issuance. Realizing the need to reduce its non-Central Bank activities, the Chinese government set up several specialized banks to assume some of the functions previously performed by the PBC. These include the Agricultural, Industrial and Commercial Bank of China, which was established in 1979; the Bank of China, which handles international settlements and foreign trade credits; and the People's Construction Bank of China, which provides credit and other support services for construction projects, separate from the Ministry of Finance. From 1986-1993, nine more commercial banks, including the Bank of Communication, and some regional development banks were opened in the country. Meanwhile, the PBC was officially designated as Central Bank.

Despite the presence of these specialized and commercial banks, the PBC still engaged in policy based lending and managed various investment and trust companies. In this sense, there was no significant difference between the PBC and the other banks. At the same time, the PBC failed to implement state and monetary policy and supervise national financial activities as expected of a Central Bank.

Hence, to transform the PBC into a real Central Bank, the Chinese government adopted the following measures:

[] *establishment of a Central Bank macroregulation and control system* by granting the PBC the right to issue money, manage basic monetary policies, regulate and control total credit, and regiment the bench mark interest rate. This was needed to guarantee the consistent operation of monetary policies throughout the country.

[] *reform and improvement of monetary policies*. The ultimate goal of monetary policy is to maintain currency stability for economic growth. The policy tools that were put in place to achieve this were the legal deposit reserve rates, rediscounting rates, open market operations, Central Bank foreign exchange operations, loans and credit lines. These were needed to regulate and control the money supply.

[] *strengthening of the Central Bank's supervision and management of the national banking industry.*

Transformation of specialized banks into commercial banks

One of the goals of the banking sector reform in China was to separate policy related finance from the commercial banks during the whole transformation period, while letting the state-owned commercial banks, which used to be specialized banks, become the main body among China's financial institutions. Along this line, the specific measures adopted were the following:

[] *founding of three new policy related banks in the second half of 1993.* These were the State Development Bank which funds key state construction projects; the Agricultural Development Bank which provides loans for the production of grains, cotton and edible oil, the purchase of farm products, and agricultural development; and finally, the Bank of Import and Export Credit.

[] *increasing competition in China's financial network by encouraging various forms of ownership among banks and other financial institutions.* After this policy was implemented, China's financial climate became more vigorous, playing host to nine non-state and four state-owned commercial banks, 12 insurance companies, 387 financial trust and investment firms, 87 securities and 29 financial houses, 11 financial and leasing concerns, and 59,000 rural and 3,900 urban credit cooperatives. Another measure adopted was to invite more foreign banks and non-bank financial institutions to invest in China.

Introduction of a new tax system in 1994

For the first time, China evenly divided its tax revenues between the central and local governments. This new tax sharing system sought to increase the total tax revenues and improve the administration of the central tax organization. Moreover, the old consolidated industrial and commercial tax was replaced with the value added tax (VAT), consumption and business tax. So far, the new tax system has been operating smoothly; according to a report by the State Administration of Taxation in September 1994, taxes collected by the central government increased by 25.2 percent while those by the local governments climbed by 30.8 percent.

Reform of the foreign exchange system

In January 1994, China abolished the official exchange rate of the *reminbi* (Chinese currency) by merging its dual exchange rates. China introduced a unitary and controlled floating exchange rate system that was based on market supply and demand. In addition to the merging of exchange rates, other reforms included the following:

- [] introduction of a banking system for exchange settlements and sales.

- [] opening of the China Foreign Exchange Transaction Center in Shanghai on April 4, 1994.

- [] abolition of the stipulation whereby an enterprise can retain a portion (retention quota) of foreign exchange and remit the rest to the government.

- [] setting up a nationwide inter-bank foreign exchange trading market by linking the Foreign Exchange Adjustment Centers previously scattered in some cities with the Shanghai Foreign Exchange Trade Transaction Center.

- [] improvement of exchange rate formation mechanisms.

- [] prohibition of valuation, settlement, and circulation of foreign exchange.

- [] improvement in the collection, payment and settlement of foreign exchange.

- [] introduction of conditional and free conversion of the *renminbi* for regular transactions.

- [] cancellation of mandatory planning for the income and expenditures of foreign exchange.

The new exchange system has been doing well with the *renminbi* remaining stable against the US dollar, at 8.7 yuan to $1. However, the foreign currency reserve has increased only slightly, and it will take some time before the *renminbi* becomes perfectly convertible to the dollar.

GENERAL FEATURES OF CHINA'S ECONOMIC REFORM

Economic reform in China has been characterized by the lack of systematic micro and macro economic theories to guide the process. Deng Xiaoping, the architect of China's economic reform captured this succintly in his famous words: "Crossing the river with tumbling and grouping the stones under the riverbed." Still, the reform experiences of China reflect a number of important and interesting features:

Gradualism

Unlike their Russian and Eastern European counterparts who tried to implement reforms overnight, China's leaders favored a more gradual approach to reform, primarily to maintain stability within society. To be sure, there are several advantages to the gradual approach: 1) severe shocks can be avoided; 2) it permits mid-course correction and rethinking of policies; 3) it gives cadres enough time to adjust to new policies and practices; and 4) it facilitates the growth of popular support as people experience a gradual improvement in their living standards.

On the other hand, the gradual approach also has several disadvantages. For one, those parties who are threatened by the reform process will have more time to regroup, block and possibly reverse certain reform measures. Likewise, under the gradual approach, it will be very difficult to anticipate or predict the future economic environment; hence, some sectors may not be able to adequately prepare themselves for possible changes in the long term.

Decentralization

Decentralization refers to the release and transfer of administrative power from the central government to the provincial, municipal, county, township and village administrations. Traditionally, power was largely concentrated in the central government. The reformists of China adopted decentralization measures in the hope that these would spark interest in implementing reform, develop the local economy, increase people's incomes and reduce unemployment.

Despite its advantages, however, decentralization has several shortcomings, namely: 1) an overheat of investments always follows local actions aimed at attaining rapid regional development; 2) budget deficit and high inflation may occur; and 3) conflict between the upper and lower layers of government, official agencies and different local government bodies may take place in the course of decentralization.

Substituting Privatization with Marketization

Due to China's insistence on undertaking reforms along the social road, public ownership (which is divided into state and collective ownership) has been treated as characteristic of the social market economy. While Chinese reformers do not openly talk about privatization, they nonetheless encourage the growth of non-state or private economic sectors, including enterprises which are partially or 100 percent foreign-owned. This is deemed necessary to diversify ownership patterns and bring about competition, which in turn is expected to stimulate greater productivity and create more employment.

RECENT TRENDS IN CHINA'S ECONOMY

Influx of Foreign Capital

In 1993, over one-tenth of the world's $152 billion cross-border investments went into China, a figure surpassed only by the amount of investments which entered the United States. By the end of June 1994, China has approved nearly 200,000 foreign-funded enterprises and investments. With a lot of foreign capital coming in, China has become a stronger economic competitor compared to other East Asian countries. Its rapid economic growth (annual GDP growth rate was 12.8 percent and 13.4 percent in 1992 and 1993 respectively) and huge domestic market are only some of the factors which may have brought about the influx of foreign investments to China.

Growth in Foreign Trade

In 1993, China's foreign trade reached a total value of $195.7 billion as against a mere $10 billion in 1978. That same year, China became the 11th largest trading nation in the world even as it recorded a $10.39 billion deficit. In October 1994, however, the country registered a trade surplus with the two-way trading volume increasing by 16 percent. China's exports, which are mainly labor-intensive products such as textiles, toys and footwear, have to compete for the market with those from other Asian countries, notably Indonesia and the Philippines. China has to improve its export structure and produce more manufactured goods such as electrical machinery and other equipment, if it hopes to move ahead of its competitors. In this regard, the country's Special Economic Zones (SEZs) will play a major role in increasing its export of manufactured goods.

On the other hand, China's imports for the remaining seven years of the century will amount to $1 trillion, or equivalent to one-seventh of the world's annual trade volume. Most of the imports will be used by sectors such as transportation, energy, telecommunications, raw material production, agriculture, water control, natural resources exploration and development as well as the technical renovation of state-owned enterprises.

Organized Labor Force Exportation

China, which has an abundant labor force, has been increasingly sending its workers overseas in an organized manner. Other labor exporting countries, however, need not worry because the Chinese nationals who go abroad specialize in different business activities, and thus do not compete for employment. Likewise, Chinese workers and specialists are recruited for specific projects; hence, their stint abroad is considered only as temporary immigration. Indeed, Chinese leaders do not encourage their citizens to immigrate. Nonetheless, they realize that the pace of China's economic reconstruction will significantly influence the extent of Chinese immigration. Rapid development and improvement in living standards will encourage more people to stay in their homeland.

Economic reform in China will continue for several more decades. While new obstacles may emerge in the future, one thing is certain: the reform process can no longer be reversed. The new market mechanism is bound to become a reality in the first decade of the new century.

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