

3. Reform and Opening

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Topics

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List of reform tasks

- Pursue self interests with utility and profit maximization.
- Restore private properties and enterprises.
- Let price signals to guide resource allocation
- Free trade and free movement of productive factors
- Monetary, financial and fiscal systems
- Social insurance that takes care of the unemployed, the sick, and the old
- Delineate the boundary between markets and the government
- Delineate the boundary between the government and the party?

1 Expand the market economy: 1978-1993

Agricultural reform: 1978-85

- The commune system and stagnation of agricultural production in late 1970s
- Household responsibility system was introduced in 1979-84
- Food procurement prices were raised by about 20%

- Free markets for food were allowed to expand
- As a result, agricultural production expanded significantly and rural income rose by 7-8% a year in 1979-84

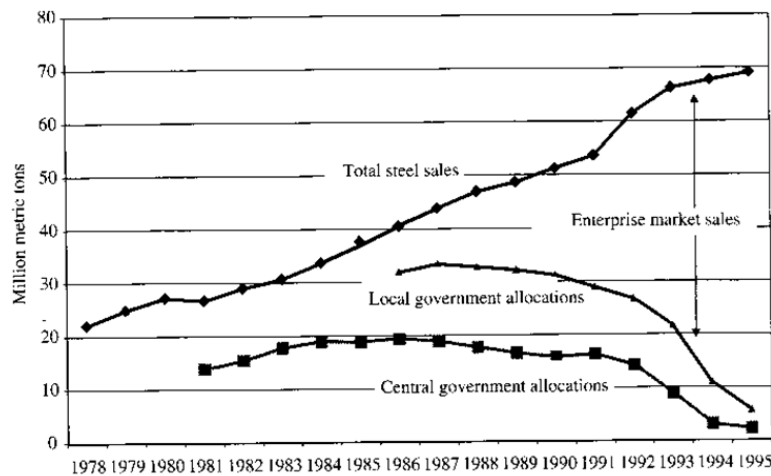
Profit retention

- Profit retention was experimented to provide incentive
- Later it was formalized into the managerial responsibility system
- Retained profits are split into three funds: accumulation, collective welfare and bonus
- Enterprise managers were given more power relative to party secretary
- Enterprises were encouraged to produce more for markets beside planned production

The dual-track system

- Planned production was frozen in absolute size
- State enterprises were permitted to sell residual/incremental output in free markets and acquire inputs there as well
- Market production was further boosted by the entry of town and village enterprises (TVEs), foreign-invested enterprises, joint-ventures
- By 1993, the transition to the market track was completed for most products

Steel market



Open to the world

- Break the monopoly of the central government over foreign trade
- Local governments and other ministries were allowed to set up their own trading companies
- Dual exchange rates: the use of the internal settlement rate for foreign trade
- Set up special economic zones to attract FDI and experiment with a market-friendly government.

Develop a banking system

- The People's Bank was broken up into four specialized banks
- In 1985, the PBC became the central bank
- Bank branches were encouraged to attract more deposits for lending
- There was a credit explosion for lack of centralization
- The M2/GDP ratio rose rapidly from 37% in 1980 to 50% in 1984, and 84.9% in 1993
- Inflation appeared in 1985, and again in 1988-89

Monetary and credit expansion



Key points

- The market track largely displaced the planned track for most products, especially consumer goods
- The Chinese economy became open to foreign trade and FDI, and exports expanded from \$20 billion in 1980 to \$86 billion in 1993
- Many coastal cities set up SEZs
- The banking sector became a major intermediary between saving and investment
- Money and wealth have replaced devotion to the Party as the fundamental motivation

2 Build up market infrastructure: 1994-2012

Freedom and chaos

- An intriguing question about the Chinese people is whether they can be given freedom
- With profit-retention and responsibility system, chaos appeared everywhere:
 - Multiple prices
 - Insatiable demand for bank loans
 - Extensive losses everywhere
 - Smuggling
 - Corruption
 - Runaway inflation in 1993

What are the new challenges?

- There lacks effective reign over the supply of aggregate credit and money.
- The soft budget constraint problem is acute, resulting in widespread losses and bad bank loans.
- The central government lost revenue to local governments and enterprises.
- Market discipline and a social infrastructure needs to be installed to weed out failed enterprises.

Critical new tasks

- To restore effective central control through monetary policy over the aggregate supply of money and credit.
- To set up a filtering mechanism, especially through the financial system, for weeding out failing enterprises.
- To foster a fair playground with uniform taxes and the exchange rate.
- To develop a fiscal system that redefines the role of central government, local government, and enterprises.

Macroeconomic reforms

- Monetary and financial reforms to centralize monetary policy and separate policy lending from commercial lending
- The formation of a national foreign exchange market.
- Fiscal reform to implement the VAT and corporate income tax system and to regain central government's control over fiscal revenue.

Ownership reform and restructuring

- Losses in the state sector
 - Competition
 - Tightening of monetary policy
 - Lagged ownership reform
- Grasp the large and release the small
 - Privatize most small and medium-sized SOEs
 - Convert large SOEs into corporations, and let them sell shares to the public later.
 - Reduce excess capacities

Restructure SOEs and government

- Sever the link between government agencies and armed forces and the commercial enterprises they used to control and operate.
- Most industry ministries were eliminated and government staff was cut by half.
- The debt-for-equity swap. Layoffs and closures.
- More than 20 million workers were laid off in the three years.

Set up the social safety net

- Socialize the pension system
- Set up the unemployment insurance, although layoffs from SOEs in 1998-2000 were processed separately.
- Set up a 3-tier health care insurance system.
- Housing reform: stop employer-provided housing

Towards a WTO-compliant market economy

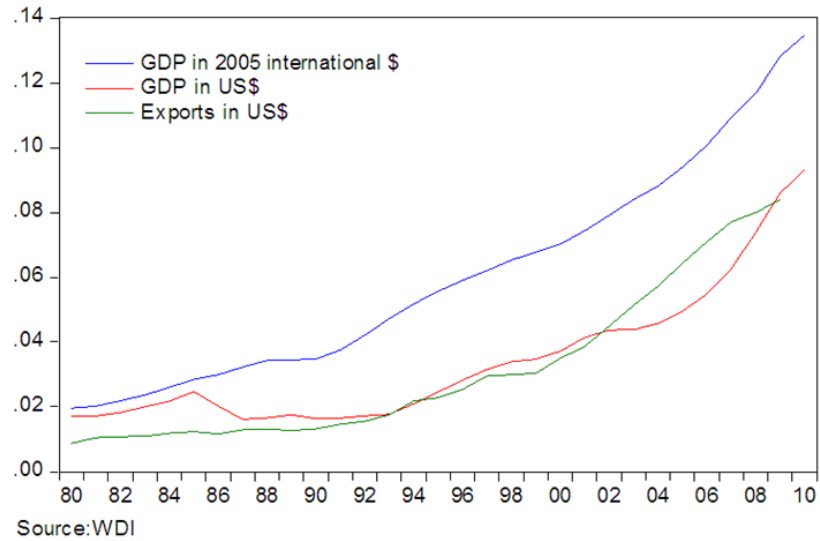
- Trade barriers are lowered below the average of developing economies. In terms of effective import tariff rates, China is close to a free trader.
- Trade policy and market environment become more transparent and stable, though US and Europe reserve the right not to recognize China as a market economy until 2016.
- The role of government shifts from directing production to regulating markets and managing aggregate demand.

Emerging as an economic superpower

- China has become the biggest exporter of merchandise, and the second largest economy.
- China has become the decisive driver in commodities markets, especially in those of oil and iron ore.
- China has accumulated the largest stock of foreign exchange reserves and the largest creditor to the US government.

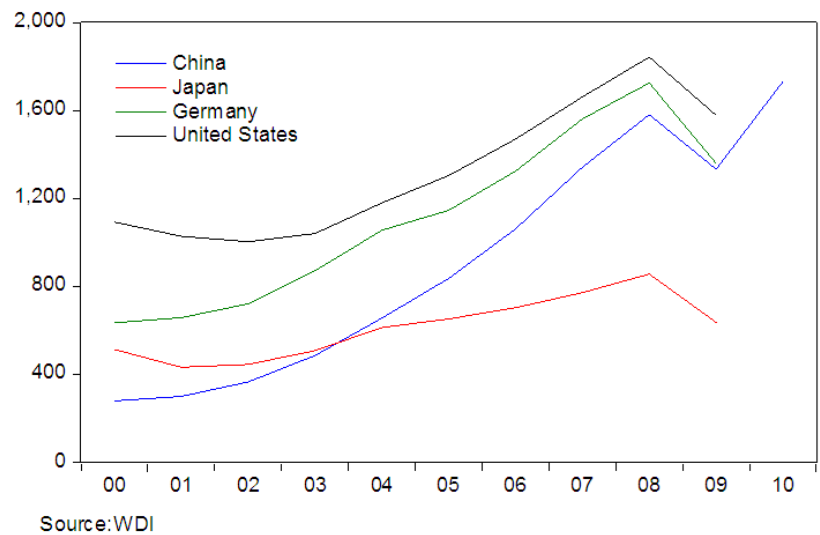
China's share in the global economy

China's Share in the Global Economy



Export giants

Export Giants, US\$ billion



But China is constrained by

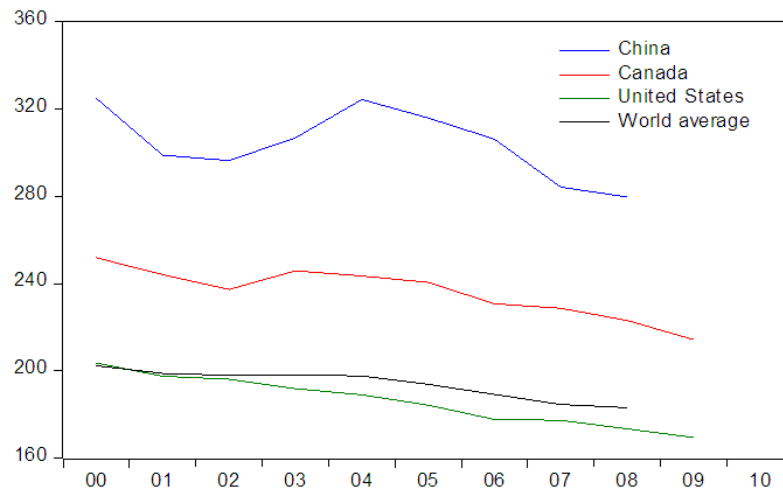
- On the one hand, the production machine is bumping against the constraints of:
 - resources

– environment.

- On the other hand, income and wealth disparities are widening. The benefits of strong economic growth have been reaped mainly by foreign investors and consumers, domestic elites. The working poor has been lagging behind.

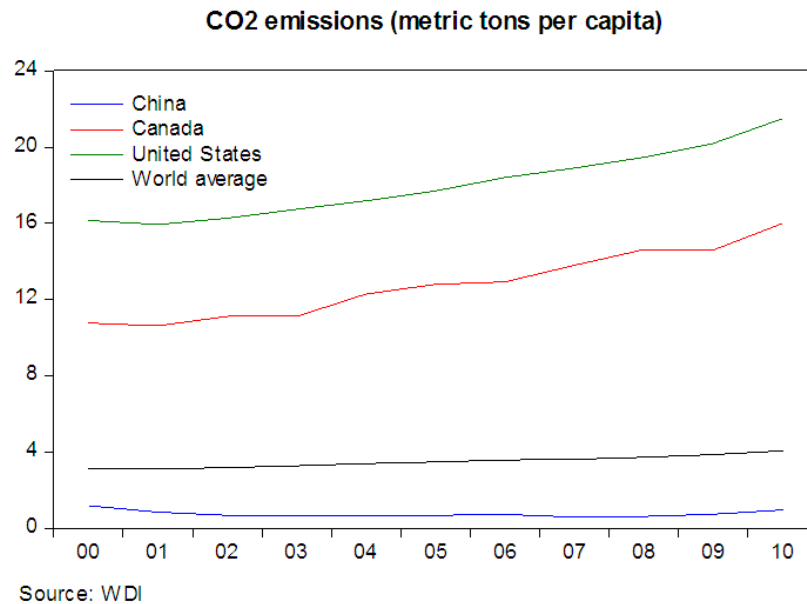
Energy use comparison

Energy use (kg of oil equivalent) per \$1,000 GDP (constant 2005 PPP)



Source: WDI

Emission comparison



Key points

- A half-baked market economy resulted in chaos and inflation
- A new round of reforms was carried out in 1994-2011 under the stress of a crisis that started in 1989
- Fundamental reforms are designed to:
 - Strengthen the aggregate control over money and credit
 - Level the play field for firms of various ownership
 - A filtering mechanism for rewarding profitable firms and winding down loss-making firms
 - Sever the bond between SOEs and government
 - Set up social safety net
 - Commercialize the housing sector
 - Join the WTO

3 A new round of reform: 2013-present

Current challenges

- Demand engine must shift from foreign to domestic sources.
- Industrial production have to slow down due to rising environmental and resource and labor costs.

- The key is to turn migrants from workers to urban consumers in a new style of people-centered urbanization.
- Politically, government must be held more accountable and the rule of law strengthened.

Let the market (or the Party) play a “decisive” role

- Scale down government approvals.
- The negative list approach for foreign investment as experimented in Shanghai free trade zone.
- The mixed ownership approach to reform SOEs and expand the access to NSEs.
- Reform the *hukou* system and rural land system.
- Reform the fiscal system.

Govern the country according to the law

- The 4th plenum of the 18th CCP passed a resolution on the rule of law
- This objective is to constrain party bosses and strengthen market order
- But the Party leader such as Xi still wields supreme power
- The rule of law complements the “decisive role” played by the market

Xi’s dream of China’s rejuvenation

- He is more powerful than the US president
- A less corrupt CCP that is willing to carry out his orders
- A firm grip on the military, police and court, financial institutions, and state-owned enterprises through the CCP
- He can wield global influence (a global community with a shared destination (人类命运共同体)) through military power and financial aids, particularly through the BRI initiative
- He tolerates no dissent and criticism with iron-fist repression and an internet Great Wall

Key points

- Where China should be heading became a widely shared concern both inside and outside China when Xi Jinping took over the control of the Party in 2012
- It was wished then when a new round of deep reforms would push China further towards a true market economy and enable a new growth engine
- For a while, this view was also adopted by the third plenum of the 18th CCP central committee in 2013
- But Xi's dream of rejuvenating China and a G2 world has turned China in another direction of more Party control and repression

Review questions

- How was China “reformed and opened” in 1978-93?
- How was a socialist market economy shaped in 1994-2012?
- What reforms remain ahead?