

Political Economic Digest Series 19

Dear Political Economic Digest Series Participant,

Welcome to the nineteenth issue of Political Economic Digest Series. In the last issue of Political Economic Digest Series we discussed about how the economic reforms in India made an impact in the economic growth of India, in this issue we will be discussing about economic reforms in China after Mao Zedong.

The first reading "Why China is Growing So Fast?" Is an extract taken from a paper originally contained in IMF Working Paper 96/75, "Why Is China Growing So Fast?" by Zuli Hu and Mohsin S. Khan of the IMF's Research Department. This reading gives an overview of the Chinese economy from past to present.

The Second reading "Reformer with an iron fist" is a report by CNN published in 1999. This article is about Deng Xiaoping the person behind the economic reform in China.

The third reading "The Chinese Economic Reform" is written by Juan Antonio Fernández. In this article the author discusses about the special features of the changes initiated during 1978 which brought about economic reform in China.

"Whether a cat is black or white makes no difference. As long as it catches mice, it is a good cat." Deng Xiaoping

Why Is China Growing So Fast?

Zuli Hu & Mohsin S. Khan

In 1978, after years of state control of all productive assets, the government of China embarked on a major program of economic reform. In an effort to awaken a dormant economic giant, it encouraged the formation of rural enterprises and private businesses, liberalized foreign trade and investment, relaxed state control over some prices, and invested in industrial production and the education of its workforce. By nearly all accounts, the strategy has worked spectacularly.

While pre-1978 China had seen annual growth of 6 percent a year (with some painful ups and downs along the way), post-1978 China saw average real growth of more than 9 percent a year with fewer and less painful ups and downs. In several peak years, the economy grew more than 13 percent. Per capita income has nearly quadrupled in the last 15 years, and a few analysts are even predicting that the Chinese economy will be larger than that of the United States in about 20 years. Such growth compares very favorably to that of the "Asian tigers"--Hong Kong, Korea, Singapore, and Taiwan Province of China--which, as a group, had an average growth rate of 7-8 percent over the last 15 years.

Curious about why China has done so well, an IMF research team recently examined the sources of that nation's growth and arrived at a surprising conclusion. Although capital accumulation--the growth in the country's stock of capital assets, such as new factories, manufacturing machinery, and communications systems--was important, as were the number of Chinese workers, a sharp, sustained increase in productivity (that is, increased worker efficiency) was the driving force behind the economic boom. During 1979-94 productivity gains accounted for more than 42 percent of China's growth and by the early 1990s had overtaken capital as the most significant source of that growth. This marks a departure from the traditional view of development in which capital investment takes the lead. This jump in productivity originated in the economic reforms begun in 1978.

Measuring Growth

Economists studying China face thorny theoretical and empirical issues, mostly deriving from the country's years of central planning and strict government control of many industries, which tend to distort prices and misallocate resources. In addition, since the Chinese national accounting system differs from the systems used in most Western nations, it is difficult to derive internationally comparable data on the Chinese economy. Figures for Chinese economic growth consequently vary depending on how an analyst decides to account for them.

Although economists have many ways of explaining--or modeling--economic growth, a common approach is the neoclassical framework, which describes how productive factors such as capital and labor combine to generate output and which offers analytical simplicity and a well-developed methodology. Although commonly applied to market economies, the neoclassical model has also been used to analyze command economies. It is an appropriate first step in looking at the Chinese economy and yields useful "benchmark" estimates for future research. The framework does, however, have some limitations in the Chinese context.

Original data for the new IMF research came from material released from the State Statistical Bureau of China and other government agencies. Problematically, the component statistics used to compile the Chinese gross national product (GNP) have been kept only since 1978; before that, Chinese central planners worked under the concept of gross social output (GSO), which excluded many segments of the economy counted under GNP. Fortunately, China also compiled an intermediate output series called national income, which lies somewhere between GNP and GSO and is available from 1952 to 1993. After making appropriate adjustments to the national income statistics, including adjusting for indirect business taxes, these data can be used to analyze the sources of Chinese economic growth.

A Surprising Find

Much previous research on economic development has suggested a significant role for capital investment in economic growth, and a sizable portion of China's recent growth is in fact attributable to capital investment that has made the country more productive. In other words, new machinery, better technology, and more investment in infrastructure have helped to raise output. Yet, although the capital stock grew by nearly 7 percent a year over 1979-94, the capital-output ratio has hardly budged. In other words, despite a huge expenditure of capital, production of goods and services per unit of capital remained about the same. This pronounced lack of capital deepening suggests a constrained role for

capital. The labor input--an abundant resource in China--also saw its relative weight in the economy decline. Thus, while capital formation alone accounted for over 65 percent of pre-1978 growth, with labor adding another 17 percent, together they accounted for only 58 percent of the post-1978 boom, a slide of almost 25 percentage points. Productivity increases made up the rest.

It turns out that it is higher productivity that has performed this newest economic miracle in Asia. Chinese productivity increased at an annual rate of 3.9 percent during 1979-94, compared with 1.1 percent during 1953-78. By the early 1990s, productivity's share of output growth exceeded 50 percent, while the share contributed by capital formation fell below 33 percent. Such explosive growth in productivity is remarkable--the U.S. productivity growth rate averaged 0.4 percent during 1960-89--and enviable, since productivity-led growth is more likely to be sustained. Analysis of the pre- and post-1978 periods indicates that the market-oriented reforms undertaken by China were critical in creating this productivity boom.

The reforms raised economic efficiency by introducing profit incentives to rural collective enterprises (which are owned by local government but are guided by market principles), family farms, small private businesses, and foreign investors and traders. They also freed many enterprises from constant intervention by state authorities. As a result, between 1978 and 1992, the output of state-owned enterprises declined from 56 percent of national output to 40 percent, while the share of collective enterprises rose from 42 to 50 percent and that of private businesses and joint ventures rose from 2 to 10 percent. The profit incentives appear to have had a further positive effect in the private capital market, as factory owners and small producers eager to increase profits (they could keep more of them) devoted more and more of their firms' own revenues to improving business performance.

China's recent productivity performance is remarkable. By comparison, productivity growth for the Asian tigers hovered around 2 percent, sometimes slightly more, for the 1966-91 period. China's rate of almost 4 percent simply puts it in a class by itself.

Why the Productivity Boom?

Exactly how did China's economic reforms work to boost productivity, especially in an economy still burdened by extensive government controls? In the important rural sector the story is particularly interesting.

Prior to the 1978 reforms, nearly four in five Chinese worked in agriculture; by 1994, only one in two did. Reforms expanded property rights in the countryside and touched off a race to form small nonagricultural businesses in rural areas. Decollectivization and higher prices for agricultural products also led to more productive (family) farms and more efficient use of labor. Together these forces induced many workers to move out of agriculture. The resulting rapid growth of village enterprises has drawn tens of millions of people from traditional agriculture into higher-value-added manufacturing.

Further, the post-1978 reforms granted greater autonomy to enterprise managers. They became more free to set their own production goals, sell some products in the private market at competitive prices,

grant bonuses to good workers and fire bad ones, and retain some portion of the firm's earnings for future investment. The reforms also gave greater room for private ownership of production, and these privately held businesses created jobs, developed much-wanted consumer products, earned important hard currency through foreign trade, paid state taxes, and gave the national economy a flexibility and resiliency that it did not have before.

By welcoming foreign investment, China's open-door policy has added power to the economic transformation. Cumulative foreign direct investment, negligible before 1978, reached nearly US\$100 billion in 1994; annual inflows increased from less than 1 percent of total fixed investment in 1979 to 18 percent in 1994. This foreign money has built factories, created jobs, linked China to international markets, and led to important transfers of technology. These trends are especially apparent in the more than one dozen open coastal areas where foreign investors enjoy tax advantages. In addition, economic liberalization has boosted exports—which rose 19 percent a year during 1981-94. Strong export growth, in turn, appears to have fueled productivity growth in domestic industries.

In one final area, price reform, the Chinese have proceeded cautiously, granting a fair amount of autonomy to producers of consumer goods and agricultural products but much less to other sectors. Several bouts of inflation have buffeted the Chinese economy in the past two decades, deterring the government from implementing full-scale price liberalization. High rates of growth also raise inflationary worries. Inflation may pose the single greatest threat to Chinese growth, though thus far it has been largely contained.

A More In-Depth Look

As with any national economy, China has unique characteristics that the researcher must properly account for.

First, many researchers cite the periodic political crises that seized China before 1978 as a factor obscuring pre-1978 economic strength. Because the political climate in China was so much in flux, these commentators argue, the economic pictures before and after 1978 cannot be compared with any accuracy. This proposition was evaluated by dropping from the analysis the 1958-70 subperiod, which encompasses the Great Leap Forward and the Cultural Revolution. The result is that pre-1978 productivity increased only modestly as a result, from 1.1 to 1.6 percent.

Second, in the 1953-78 period Chinese central planners invested heavily in the urban industrial sector and restricted migration from the country into the cities. Could the abandonment of this policy after 1978 itself explain the strong performance of the economy? Did these sectoral shifts drive growth, or did productivity? In the event, although these sectoral shifts are important, they do not eliminate the independent rise in productivity associated with the reforms.

Third, some commentators maintain that if the productivity growth was a one-time shot of adrenaline to the body economic, it is certainly not sustainable. In fact, productivity gains have been steady throughout 1979-94 and even increased during 1990-94. If the post-reform period is broken into three distinct phases, each associated with a different set of reforms, sizable productivity gains are evident in

each subperiod. This indicates that the Chinese were able to carry over initial productivity gains to other parts of the economy.

Finally, one can scrutinize the analysis for measurement problems. In particular, are the capital-stock data calculated properly and were there any measurement errors relating to the input data? Regarding the capital-stock measurement, since the Chinese national income statistics exclude the value of residential housing and since outlays for new housing rose during 1978-94, the investment figures should be adjusted accordingly. When this is done, there is no change to the pre-1978 productivity growth estimate and a modest increase in the post-reform productivity growth rate, which corroborates the general story. Could an overvaluation of the initial capital stock have biased the findings? More conservative estimates of the capital stock were used to re-analyze the data, but there is no strong evidence to refute the findings. Although the pre-1978 productivity gains become negative, the post-reform productivity rate is unaffected.

Another more significant problem with capital-stock data is that Chinese asset surveys do not produce capital stock estimates consistent with the investment data in the national accounts. The difficulties of bridging this statistical gap are considerable. The analytical findings of this study were compared with those obtained by economists who had computed the data somewhat differently. On the productivity side, the studies differed in emphasis but not in essence: as a body, the available evidence corroborates productivity improvements as a significant source of post-1978 growth, even when divergent capital-stock calculations are employed. The outside estimates of productivity growth vary from about 2 percent to nearly 4 percent for the 1979-94 period.

Regarding other input data, a study was made of the potential for a differential bias that might overstate the post-reform growth relative to the pre-reform period. This problem might arise because centrally planned economies are prone to the overreporting of output and the underestimating of prices. As it happens, although enterprise managers have traditionally tended to overreport output in an effort to meet production targets set by the government, the incentives to do so have probably declined in the reform era as managers have faced less strict state control. It is unlikely, therefore, that performance in the post-1978 era has been overstated relative to earlier eras.

The underdeflating of nominal output could be a more serious source of bias. The piecemeal character of price reform--with some sectors liberalized and others not--means that selecting an appropriate deflator for the post-1978 period is difficult. Yet, the central planning period may also have seen an underdeflation of output, since repressed inflation was probably widespread (as manifested in shortages, black market trading, and long waits for certain goods). Thus, the measurement problem, while real, probably does not much alter the basic conclusion about substantial productivity gains after 1978.

Conclusion

Although China occupies a unique niche in the world's political economy--its vast populace and large physical size alone mark it as a powerful global presence--it is still possible to look at the Chinese experience and draw some general lessons for other developing countries. Most important, while capital

investment is crucial to growth, it becomes even more potent when accompanied by market-oriented reforms that introduce profit incentives to rural enterprises and small private businesses. That combination can unleash a productivity boom that will propel aggregate growth. For countries with a large segment of the population underemployed in agriculture, the Chinese example may be particularly instructive. By encouraging the growth of rural enterprises and not focusing exclusively on the urban industrial sector, China has successfully moved millions of workers off farms and into factories without creating an urban crisis. Finally, China's open-door policy has spurred foreign direct investment in the country, creating still more jobs and linking the Chinese economy with international markets.

China's strong productivity growth, spurred by the 1978 market-oriented reforms, is the leading cause of China's unprecedented economic performance. Despite significant obstacles relating to the measurement of economic variables in China, these findings hold up after various tests for robustness. As such, they offer an excellent jumping-off point for future research on the potential roles for productivity measures in other developing countries.

Extracted from <http://www.imf.org/EXTERNAL/PUBS/FT/ISSUES8/INDEX.HTM>

Reformer with an iron fist- Deng Xiaoping (1904-1997)

CNN

Deng Xiaoping's greatest contribution to modern China came when this veteran revolutionary was well into his 70s, and the backlash against the Cultural Revolution had propelled him to the top of China's ruling elite.

Ascending to power in 1978, Deng ridiculed the Cultural Revolution slogan that held it was "better to be poor under socialism than rich under capitalism." The blunt, practical Deng offered instead: "Poverty is not socialism." He encouraged the creation of a market economy and capitalist-like enterprises, and by the early 1990s his reforms had helped lift an estimated 170 million peasants out of extreme poverty.

Yet he refused to abrogate, either because of temperament or politics or both, the power of the Communist Party over the lives ordinary Chinese citizens. To do so would have meant abandoning the Marxist-Leninist-Maoist ideology on which the People's Republic of China was founded in 1949. Such inflexibility is believed to have been behind Deng's apparent approval of the brutal suppression of unarmed demonstrators in Beijing's Tiananmen Square in June 1989.

A political conversion and a new name

Born in 1904 to a prosperous landowner in a village 65 miles from Chongqing in the south-central province of Sichuan, Deng turned to revolutionary thought early, and his résumé as a Communist is almost as long as Mao Tse-tung's.

While studying in France in the early 1920s, Deng joined a movement of young Chinese leftists led by Chou En-lai. In 1924 he changed his birth name, Xiansheng, to Xiaoping (Little Peace) to mark an important new phase in his life, a Chinese custom. Years of guerrilla war followed. Short (5 feet 2 inches)

but physically tough, Deng joined the Red Army's legendary Long March of 1934 and helped lead the military campaign of 1948-49 that overthrew the Nationalist regime of Chiang Kai-shek.

Deng rose quickly through the party ranks once the Communists seized power in 1949, becoming general secretary in 1955. Deng's pragmatic ideas for economic development, however, often put him at odds with Chairman Mao, who emphasized egalitarian policies and revolutionary zeal.

Deng's remark about the irrelevance of color to a cat's mice-catching ability came during one of their feuds over economic policy in the early 1960s. Mao once complained that Deng treated him "like a dead ancestor" and later quipped, "Which emperor authorized that?" when Deng ordered the turnover of collective lands to individual peasants to help relieve the famines of 1959-62 that resulted from Mao's failed Great Leap Forward that began in 1958.

'Capitalist roader'

Perhaps the most remarkable turns of Deng Xiaoping's career were his amazing comebacks from three political purges. Fellow revolutionaries ousted him in 1933, but he was back in good standing a year later. His 1966 fall from grace would last far longer. Responding to the famines induced by the Great Leap Forward during which an estimated 30 million people died, Deng proposed major reforms, such as free markets for farmers and incentive bonuses. In short order he was denounced as a "capitalist roader," held under house arrest for two years, paraded in a dunce cap through the streets of Beijing and forced to wait tables at a Communist Party school.

In 1969 Deng, his wife Zhuo Lin and several of his five children were exiled to Jiangxi province in southeastern China. The Cultural Revolution was in full swing, and Deng later said only a personal security team supplied by Mao protected him from being killed.

Deng meets with U.S. President Jimmy Carter in January 1979. Deng's goal was a wealthy, modern, powerful China, and he opened the door to new relations by establishing ties with the West.

Premier Chou En-lai brought Deng back into the party leadership in 1973. Turmoil at the top increased after Mao's death in 1976 and Deng was briefly purged for a third time. By late 1978, however, Deng and his supporters held a working majority in the party's leadership. Although Deng never assumed the title of Communist Party chairman, he did take the title of chairman of the party's Central Military Commission, which gave him control of the People's Liberation Army. It had been Mao's most important title, the key to controlling a nation of diverse cultures that now numbers more than 1.2 billion people.

One of Deng's first reforms was to abolish Mao's rural agricultural communes and allow peasants to cultivate family plots. Grain harvests quickly increased, and other reforms followed. City dwellers were allowed to start small-scale businesses, ordinary Chinese were allowed to buy consumer goods, and Deng actively courted international investors. He also imposed tough population controls that included forced abortions to limit families to one or two children.

'An entire generation of mental cripples'

Deng pushed to remake education in China, charging the Cultural Revolution had produced "an entire generation of mental cripples" by shutting down schools and sucking the student population into the ubiquitous Red Guards. Deng allowed students to go abroad for college, sparking a craze for learning English.

Perhaps Deng's most glorious year was 1984, when he reached 80 years of age. China's food supply hit 400 million tons of grain, making the nation self-sufficient in food. That same year Deng successfully negotiated an agreement with the British government to return Hong Kong to Chinese control in 1997, the year Britain's 99-year lease on much of the territory was to expire.

Throughout Deng's economic reforms, however, he kept an iron fist ready to crush any threats to the nation's Communist dictatorship. In Deng's final five years, virtually all of China's dissidents were imprisoned or exiled abroad. Deng also supported the use of tanks and guns to end the 1989 pro-democracy demonstrations in Tiananmen Square, where hundreds of students and bystanders were believed to have been killed. That same year Deng gave up his chairmanship of the military commission, and his influence over China's ruling elite steadily declined through the 1990s until his death in February 1997 at age 92.

Deng left China a more stable and prosperous nation than at any time in the 20th century, but its authoritarian government and one-party system were still firmly in place.

Extracted from <http://edition.cnn.com/SPECIALS/1999/china.50/inside.china/profiles/deng.xiaoping/>

The Chinese Economic Reform

Juan Antonio Fernández

China is passing through massive transformation; from a command to a market economy, from an economy based on agriculture to one based on manufacturing and services, from one with high fertility and low longevity to one faced with OCDE style low fertility and high longevity, and from an economy that was almost totally closed to one that, today, even before her accession to the WTO, is much more open than most countries at the same level of income. This vast movement of transformation started on a very simple principle frequently stated by Deng Xiaoping: "Poverty is not socialism". Prosperity was the new face of the socialism according to Deng Xiaoping's famous dictum: to get rich is glorious. In the past socialism used to mean government planning, for the new China, it means common prosperity.

China offers us a unique opportunity to explore the causal relationships among economic, institutional, political, and social forces in an important transforming economy. In China's economic transition important structural changes are occurring at the state and firm levels, and these changes have radical implications for the structure of economic and social life in China. Gradualism and stability were the foundations of the Chinese reform and continue to be so for the present leadership of the country. For

the Chinese leaders economic reform has priority over political reform. They acknowledge that it would be impossible to accomplish anything in an environment of political unrest. The premature introduction of markets where there was neither a culture nor the institutions for dealing with them can have catastrophic effects. And from the results obtained, we can consider the Chinese as one of the most outstanding social transformations in human history, all this within a long period of stable and peaceful social environment, except for the Tiananmen Square demonstrations in June, 1989.

We must consider the enormity of the task facing China. Some figures can give a glimpse of the burden of the scale. The country has a total population of circa 1,300 million people distributed among 23 provinces (24 with Taiwan), 4 autonomous regions, 4 municipalities plus Hong Kong and Macau; 18 of those provinces have a population between 90 and 35 millions and they could be considered big countries in their own. China has more cities of 1 million-plus population than the rest of the world combined. Among China's state-owned enterprises there are 500 that employ more than 100,000 people, and her economy must create 10 million to 15 million new jobs every year.

Given China's immense size and large population, the state structure is very complex. Authority is fragmented both horizontally (diverse departments) and vertically (diverse geographical levels) through the system has resulted in a negotiated state where local and individual institutions vary in nature depending on the relationship they have negotiated with other parts of the apparatus. Under the provinces, there is a three-level administrative network of prefectures, counties, and cities, and townships and districts. Government and party organizations paralleling one another. There are several levels of administrative levels for public enterprises: central government, provincial level and municipal level. Central and provincial government tend to preside over large, asset-intensive organizations, while medium and small companies tend to be under the control of municipal and district levels.

This complex administrative system of government organizations was set in place to mobilize firms and the individuals within them around directives issued from the central government. This system was an administrative decentralized governance structure that allowed the central government to promulgate policies down the hierarchy of government jurisdiction, relying on local government offices to mobilize organizations and thereby people. The result of these policies was a "nested hierarchy" of government organizations spread throughout the country, each with jurisdiction over a smaller sector of the population. It is a dispersed bureaucratic system in which individuals hold immense capacity to circumvent formal regulations. The political center does not control the system throughout and there is significant deviation from central policy across bureaucracies and at the local level. In some sense, real politics in China is local politics. It is at the local level that problems have to be solved concerning economic policy and social equity.

Despite all the complications, several features of the Chinese economy in 1978 made it particularly ripe for change:

- The economic disruption of the Cultural Revolution, and that of the Great Leap Forward before, had undone many of the early economic benefits following the founding of the People's Republic.

- China enjoyed the advantages of backwardness. More than two-thirds of the population lived in the countryside. For them, the uncertainties of the reform were less alarming than the difficulties of the present system. Agriculture's surplus labor meant that rural industry could achieve rapid, uninterrupted growth for almost two decades without facing wage pressures.
- Planning was less entrenched in China than it has been in other transitional economies. So when commercial activities were legalized, Chinese entrepreneurs needed little encouragement to expand.
- China had always had a strong administrative capacity, especially at the provincial level. So, when reforms required administrative and financial decentralization, provincial governments were able to take on the new responsibilities.
- China had a skilled and disciplined labor force. The share of technicians and engineers in the industrial labor force was higher than in many newly industrializing economies of Southeast Asia.
- The Chinese diaspora extended to virtually all corners of the world. Chinese minorities in several Southeast Asian countries had considerable economic power, and they figured prominently in the explosive growth of foreign direct investment in China.

The economic reform started in 1979 with a combination of regulation by plans and regulation by the market, to be followed later by the implementation of the socialist market economy: reform of SOE, finance, taxation, pricing and foreign trade. As to the SOE reform, we can consider four stages: from 1979-83, some experimental initiatives were launched for SOEs: profit retention, performance related bonus and production outside the mandatory plan; from 1984-86, profit remittance was replaced by profit tax and SOEs were allowed to sell their output in excess of quotas on the free market; from 1987-92, the contract responsibility system was introduced with the objective to clarify the authority and responsibilities of the managers; finally, from 1993, the introduction of modern corporate systems has given SOEs further autonomy.

As a result of these reforms, there have been important changes in the state-firm relationship at the three levels: economic responsibility has been pushed down the hierarchy, administrative offices have become more economically oriented, and firms have independent budgets and self-responsibility policies. Managers are more responsible now for the economic health of the organizations over which they preside. However, the relatively easier reforms have now been completed. As the reform moves to the next stage and China integrates further into the world economy, there will be significant losers, including those workers and institutions that have formed the core of the CCP socialist system. We are witnessing the emergency of a new economic superpower, but still many questions remain open for the Chinese leaders.

The leaders of China face an enormous challenge. The country has survived remarkably well to date and has avoided the various doom-laden scenarios that have been offered abroad. There is no alternative but to move ahead. Still many challenges: transform the state-owned sector without encountering

major social unrest; provide a new framework for urban social welfare and rebuild the rural system; legislate for a growing private economy; find employment for some 200 million surplus laborers in the countryside. This list of challenges could overwhelm a government's capacity, yet the Chinese leaders must deal with all of them at the same time. In her favor, China has the following advantages: a very large domestic market with great potential, a gigantic amount of cheap labor, high rate of savings, and the Chinese community worldwide. The role of the Chinese government is to make full use of these advantages. Since the latter half of the 90s China's leadership has moved to a more comprehensive vision of the nature of reform and has begun to adopt a better sequencing for the reform program.

Impressive as China's strengths are, they do not guarantee success. Much will depend on the ability and resolve of the authorities to maintain momentum of reforms. The World Bank in its report on the future of China pointed out several risks ahead. First, the link between banks and state enterprises; as the performance of the state enterprises weakens so do the state banks. Second, the nexus between enterprise reform, labor markets and inequality. Rising unemployment may discourage the government from pursuing state enterprise reforms vigorously. Unreformed state enterprise will go on paying excessive wages to a redundant work force. Again, this will impose a large fiscal burden on society. Third, the delayed enterprise reform could hamper efforts to clean the environment. Lastly, without reforms a broad range of needed public expenditures in health, education, infrastructure, and the environment would be jeopardized.

A key component for the success of the economic reform in general, and SOE reform in particular, is the restructuring of the banking and financial sector. In the 80s, financial reform was not really thought of as a part of economic reform. However, in the mid-90s reformers recognized the need for the overhaul of the sector and the necessity of cleaning up the banks' bad debts. This was given extra urgency, first by the Asian Financial Crisis and then by the impending WTO entry. With the main role of state banks to feed the SOEs sector, they built up a huge portfolio of non-performing loans. Zhu Rongji set in motion a series of reforms designed to free the state banks from local politics, to allow the Central Bank to play more of a regulatory role, and to get the non-performing loans off the books of the banking system.

In 1994, the banking system was divided into three types of banks: commercial banks, policy banks and cooperative banks, with a limited but increasing role for private banks. The four major banks remained under the authority of the state but were given greater capacity to make loans on a commercial basis. These four banks (the Industrial and Commercial Bank, the Bank of China, the China Construction Bank, and the Agricultural Bank of China) account for up to 70 per cent of the domestic banking business and they employ together with the Bank of China a total of 1,760,000 people. The Agricultural Bank of China alone has 510,000 employees which makes it the biggest company in the world in number of employees.

Capital markets still remain small, the banks being the main source of financing in China. In 1998, with the onset of the Asian Financial Crisis, the reformers were able to push ahead with financial sector reform. First, the reorganization of the branches of the People's Bank of China along regional lines to reduce political interference by powerful provincial party chiefs in lending decisions. Another measure was to move the non-performing loans off the books of the four major commercial banks and to recapitalize them. Asset Management Companies were created and the capital is provided by the

Ministry of Finance. The AMCs are to acquire at face value loans from SOEs. The AMCs, were expected to recover those loans through debt-for-equity swaps. However, AMCs have little power to reorganize the SOEs.

Separating state enterprises and commercial banks from government is arguably the most immediate and important of all ongoing reforms in China. Her future lies with competitive and private firms in industry and services. In the financial sector this means government at all levels should stop interfering in the lending decisions of state commercial banks. Banks must begin to build trust, relationships, and information channels with non-state firms. They must establish systems for management information, risk evaluation, creditworthiness analysis, and provision for bad debts. In addition, a developed capital market is needed to allocate resources, diversify risk and raise returns to investors. These reforms should be matched by continuing reform of labor markets: social security system, labor mobility, more information about employment opportunities, better retraining of laid-off workers, and gradually removing restrictions on migration. Similarly, the government could meet environmental objectives through greater use of market mechanisms.

More market does not mean less government. It means different government. Government energies need to shift away from direct involvement in productive activities and toward two areas in particular: first, more spending on such priority areas as education, health care, agricultural research, infrastructure development, environmental protection, and support for the disadvantaged groups in society; second, the development of transparent and participatory institutions that promote the rule of law, and a stable economic environment. The World Bank report on the future of China offers a positive vision for the country: China in the 2020 can be competitive, and confident, having eliminated poverty as it is known today and promising a bright and healthy future for its children. It would be engaged with the rest of the world as an equal and responsible in trade and finance, built on modern institutions and the rule of law. It would be a middle-income country that of the Republic of Korea, enjoying rapid and sustainable growth based on markets and private enterprise. As Mr. James D. Wolfensohn, President of the World Bank Group, recognized in his visit to China in 2002: "The progress since my last visit in 1995 is impressive, and remarkable in many sectors, and a strong signal to the world that with the right policies and determined leadership, real inroad could be made in reducing poverty. The simple fact is that more than 250 million people in the past 20 years have been lifted from poverty here. The problems confronting China have not been totally overcome – far from it – but the magnitude of this achievement in a single generation is such that other countries should learn from it."

The reality is that China's experiment with market reform has propelled her into the top 10 trading nations in the world. Over the past two decades, China has achieved the fastest economic growth of any national economy. If that growth continues, China could become the world's largest economy during the first half of the 21st century. The World Bank estimates that by 2020 China could be the world second largest exporter and importer and its consumers may have a purchasing power larger than all of Europe's. She is becoming the biggest economy in the planet with a population whose main objective in life is to become prosperous. The fact is that China is changing so fast that is difficult to keep abreast of developments. Furthermore, China is a maze of intricacies, complexities and contradictions. As Deng

Xiaoping declared in 1985: “(The Chinese reform) is a great experiment, something that is not described in books.”

Extracted from <http://www.ceibs.edu/ase/Documents/reform.htm>

A documentary has been made by BBC about economic reforms in China. You can watch the documentary and learn more about the economic reform in China from the link given below:

<http://youtu.be/Ku76TVslBGI>