1

Conditions and prospects for sustaining China's economic growth

Dilemmas of economic growth

Ligang Song

Sustaining economic growth has been of paramount importance for securing social stability in China while the economic system has been undergoing fundamental transformation. Growth not only creates more employment opportunities, but relatively high growth rate for a sustained period of time during the transition, largely through raising the standard of living, has demonstrated convincingly that the gradualist approach to reform adopted in China since the late 1970s has worked.¹ This success provides confidence and assurance for the government in silencing resistance to reform and overcoming difficulties in the reform process.

Yet, various dilemmas of economic growth exist in the context of reform and transformation. Some are more transitory and likely to be resolved with deepening reform and ongoing structural change, such as the dilemma of decontrolling prices while preventing inflation from rising as in the early period of reform.² Similarly reforms such as the liberalisation of interest rates and the capital account, which is yet to be materialised, falls into this category of dilemmas. Some dilemmas are more deep-seated and likely to have some long-term implications in that they are unlikely to be resolved easily with the progression of the reform and in some cases may become major obstacles to reform if not be dealt with well. Thus, failure to resolve these dilemmas may pose serious threats to the reform process itself and the long-term growth prospects of the Chinese economy. Some stem from the dynamic change in the reform process, shifting institutional settings, and changing macroeconomic environment.³

Dilemma 1: to balance the goal of efficiency with that of equity to maintain a sustainable growth in the process of reform.

Dilemmas of China's Growth in the Twenty-First Century

- Can economic growth with per capita income growing over time be sustainable from the standpoint of social stability with increasing and widening regional and income disparities?
- What does the government need to do to strike a balance between efficiency and equity in the context of reform?
- Do measures such as high income taxes, increased government expenditure on social welfare and transfer payments across provinces to reduce regional and income disparities at this stage of development affect incentives and therefore undermine the current growth momentum?

Dilemma 2: to ease unemployment pressures while deepening the reform programs especially with regard to the restructuring of SOE, opening up more domestic industrial sectors to foreign competition, and in the likelihood of slowing down of rural industries:

- To what extent does rising urban unemployment hold back the pace and depth of SOE reform?
- In what ways can productivity growth resulting from reform and industrial restructuring lead to job creation?
- Will increased foreign competition adversely affect domestic employment?
- What are the long-term solutions to the problem of a large rural surplus labour force, and what are the major constraints?
- What are conditions for maintaining stability while deepening the structural reform?

Dilemma 3: to achieve the goal of quality growth while pursuing growth targets amid growing structural problems in the economy.

- How to achieve the goal of quality growth against the background of an oversupply of manufactured goods on a large scale?
- How to deal with the situation in which demand becomes satiated with a relatively low per capita income?
- Is the government's investment-driven growth strategy against domestic deflation sustainable on efficiency and fiscal terms in a long run?
- What conditions are needed to revive non-government investment?
- What needs to be done in order to realise an optimal economic (industrial) structure by which quality of growth can be achieved?

Dilemma 4: to transform the widespread informal business practice into more rules-based business behaviour and operation without negatively affecting business transactions in the transition.

- Will the shift to formality required by conforming to WTO rules affect business transactions, and negatively affect growth?
- What are the compromises needed in society where doing business through informal means, through connections, is the norm?

Conditions and prospects for sustaining China's economic growth

- Can traditional networks and social relations be transformed and institutionalised in new forms needed for a market economy?

Dilemma 5: to overcome the existing ideological and institutional barriers to allow the dynamic private sector to play a more important and wider role in reforming SOEs and SOBs and sustaining growth.

- Is more dramatic reform of ownership required for deepening the structural changes for the next crucial stage of reform?
- What institutional reforms are needed to accommodate the rise of the private economy?
- What conditions are needed for the private sector to become the new source for growth?
- What are the consequences of delaying reform measures aimed at dismantling the existing institutional barriers for private sector development?

Dilemma 6: to build market compatible institutions against the remaining legacy of the former planning system, which still affects the behaviour of government and the way in which it functions at different levels.

- What are the discrepancies between the substantial and procedural rules required by the WTO and current institutional settings in China?
- In what way does China's extant legal and regulatory system and associated political and institutional restrictions constrain the development of open market competition?
- What are the most effective and practical ways of reducing the discrepancies and dealing with consequent adjustment costs?
- What are the political and economic implications of building market-compatible institutions for sustaining China's long-term growth?

These dilemmas result from a gradualist and complex process of reform. At the heart of the economic transformation is structural change and the best way to deal with the structural problems in the economy is to reform the entire economic system. But there are the impracticalities in carrying out all reform programs at the same time. When pushing for a reform in one area, the gradualist approach tends to leave other parts of the economic system unattended thereby producing various kinds of discords and conflicts during the process. Frictions caused by such an approach usually lead to the identified dilemmas, exacerbated by other factors such as institutional incompatibility, demographic structure, macroeconomic instability, and social, custom and culture influences.

Dealing with these dilemmas requires skilful management of the reform process in terms of the sequencing and depths of the reform program. Adjustment costs have to be minimised in order to keep reform on track against the backdrop of the resistance to reform. It is evident that incremental changes resulting from the implementation of such an approach can gradually pave the way for further reform in the system. This is the key consideration in implementing the gradualist

Dilemmas of China's Growth in the Twenty-First Century

reform approach. In so doing, various kinds of compromises and adjustments have to be made, affecting ongoing structural changes and incentives, and consequently the efficiency and growth potential of the Chinese economy.

Structural change is required in order to create those conditions in which incentives can be raised and macro and microeconomic efficiency can be improved. Dealing with structural change, especially its side effects such as rising unemployment, is an important component of the reform strategy. China has managed to make the necessary compromises and adjustments to overcome different kinds of impediments to reform and in doing so to maintain the growth momentum in the past. However, the economic imperatives at the turn of the century, such as the binding commitments and the changes required by China's accession to the WTO, have made it more difficult for the government to manoeuvre in dealing with some of the key dilemmas facing the economy. It is also anticipated that China's accession to the WTO will produce some significantly positive impacts on the structural adjustment and reform (Drysdale and Song 2000).

In the past, the government could simply delay the reform program in certain areas when tensions resulting from the reform became so great that they had the potential to derail the reform process. But, the reality now is that the government has less degree of freedom because of binding constraints imposed by its accession to the WTO. Apart from the commitments China has made for its accession, requiring a comprehensive reform of the economic system in a timely manner, there are also areas of domestic reform where more radical reform programs need to be carried out to enable the government to overcome bottlenecks to further reform.

The remaining reform agenda involves those parts of the economic system which have been most difficult to tackle. For example, much-needed reform of banking sector has been tied up with the progress in reforming state-owned enterprises (SOEs), which in turn has been subject to unemployment pressures, the development of a social security system as well as some political constraints on ownership reform. Government attempts to slash state-owned banks' (SOBs) bad loans by converting a large amount of bad assets into equity have lessened the problem of bad debts for major SOBs, but not resolved it in a fundamental way.

There has also been macroeconomic shift from China being 'a seller's market to a buyer's market' taking place during the reform period of the 1990s. The resulting over-supply of manufactured goods has made the task of structural change even more difficult. The situation has worsened because of stagnant domestic demand and weak external markets, which have plunged the economy into a persistent period of deflation from the last quarter of the 1990s and into the new century.

The reform programs implemented in the earlier period of reform especially in the 1980s tended to be more inflationary such as freeing up the price control

Conditions and prospects for sustaining China's economic growth

and decentralisation. In contrast, reform programs put into practice since the mid 1990s have had a propensity to be more deflationary including increased taxation, strengthened financial regulation and supervision, rising unemployment from SOE reform, and housing and pension system reform. These reforms and associated uncertainties, coupled with the slow growth of rural incomes in recent years are the main causes for China's persistent deflation.

Under these circumstances, the government has no other choice but to rely primarily on fiscal means to boost domestic demand and to offset external shocks in order to reach growth targets. Such requirement is particularly pronounced when China faces weak external markets for its exports as it experienced in the aftermath of the Asian crisis in the late 1990s and the recent slowdown of the global economy. However, it is doubted that whether this kind of debt-driven growth strategy is sustainable given the fiscal capacity it has and possible distortion it might create. It is generally accepted that the real hope lies at the revival of non-governmental investment especially from the private sector, but again this requires further changes in policies and institutions.

The emergence and development of the private economy is the most significant outcome of reform in that the sector has been most responsive to changes in market prices and market-oriented institutions with respect to incentives and efficiency. Despite constraints, the private sector has become the most dynamic sector in the economy, and has, since the early 1990s, made important contributions to growth and reform. It increases employment, creates competition, nurtures entrepreneurship and instigates innovation. It helps channel an increasing proportion of investment into more efficient uses and hence increases the overall efficiency of the economy. It helps derive the regulatory and institutional framework into becoming more compatible with a market system. It also accelerates growth with less risk to macroeconomic stability than would expansion of SOEs since private enterprises are subject to budget constraints (Garnaut *et al.* 2001).

However, there still exist some institutional barriers, which prevent the government taking full advantage of the developing private economy. It is evident that the emerging sector has had the greatest impact on the process of marketisation and played an increasingly important role in reforming SOEs and SOBs through purchasing and holding the share of state assets and increased competition. Nevertheless, there is still not an unreserved endorsement of the role of the private sector in restructuring the economy. Many issues of reform with respect to the development of the private economy remain. Some are structural in nature. For example, the formally registered private enterprises receive only less than one per cent of the total state bank lending while having produced more than one-third of industrial outputs by the end of the 1990s (Song 2002).⁴

The private sector genuinely needs a level-playing field, which put enterprises on an equal footing in competing with other firms, including foreign firms. In this sense, the building of market-compatible institutions is the most important factor for the continued development of the private sector. Right institutions

Dilemmas of China's Growth in the Twenty-First Century

reduce the transaction costs for business activities by reducing frictions and uncertainties. Specifically, ownership and property rights need to be formalised and made more secure. Regulatory policies that affect, among other things, entry, exit, markets (especially financial markets) and government functions need to be enhanced. Reform in these areas will help overcome the remaining constraints on the development of the private sector, leading it to make an even greater contribution to the reform and growth of the Chinese economy (Song 2002:101).

The commitments on accession to the WTO are presenting the new challenges for China. In particular, WTO entry requires transparent and formal procedures in the conduct of business and trade, property rights to enhance incentives and facilitate business transactions, level-playing fields to fulfil the obligation for 'national treatment' and ensure fair competition, and rule of law to provide a legal environment in which businesses can operate. Informalities widely practised in China are therefore in principle inconsistent with the WTO requirements. The challenges thus stress the role of institutions and formalities in determining economic outcomes, through among other ways, their effect on transactions costs, and the societal benefits that flow from the use of property rights in a competitive marketplace.

Hence, it is safe to say that the biggest challenge facing China's entry to the WTO is not its sectoral impact, but its impact on the institutions of government itself. The task is to build a modern, open and transparent, and efficient system of government management in line with the requirements of the WTO and the broader objectives of the economic transformation. Failing to accomplish this objective will not only impede the reform process in China, but will also undermine the functioning of the WTO itself given the size and increasing influence of the Chinese economy.

This book describes some of the main features of China's economic growth in the context of reform at the turn of the new century. The main message is that the prospects for China's economic growth will, to a great extent, depend on how the authorities can successfully handle the key dilemmas it faces given the constraints that both internal and external environments have imposed. The first 5–10 years of the twenty-first century will be crucial for testing whether China's growth and reform strategies will work well through this difficult and complex period of transition. A key criterion is whether these strategies are capable of producing sustained growth.

Conditions to be met

None of the dilemmas mentioned in the previous section are likely to trigger an immediate crisis, nor is the failure to resolve them in the short term likely to put the reform on hold indefinitely. However, because of their potential long-term consequences, these dilemmas do require solutions by which conditions for

Conditions and prospects for sustaining China's economic growth

a sustainable growth and development can be met. In particular, solutions to some of the key dilemmas do demand the political commitments and determination as well as skilful management in guiding the economy going through the uncertain path of the ongoing reform and economic transformation. Chapters in this book discuss some of these conditions from different angles.

Chapter 2 focuses on China's legitimate worries about its WTO membership by discussing its implications for continued high growth and for internal security. Based on the 'convergence school' of thought,⁵ Woo argues that WTO-induced acceleration in the convergence of Chinese economic institutions to those in rich market economies will sustain China's economic growth in the twenty-first century, as long as severe political instability does not occur. But the view is premised on the maintenance of domestic stability dependent on whether the increase in China's exports and the increase in foreign direct investment into China can offset enough of the temporary negative unemployment created by import liberalisation. Woo concludes that this occurrence will improve the tradeoff in the state enterprise sector between restructuring and job losses.

Chapter 3 provides an analysis of the dynamics of incremental reform with special respect to the relationship between the growth of the non-state sector, the change of the ownership structure of the economy as a whole and the reform process of the state sector. In particular, Fan discusses the issue of sustainable growth in the context of gradualist reform by asking whether the problems of the SOEs have dragged the whole economy down and to what extent the development of the non-state sector lessens the burden of SOEs. His model suggests that as long as the non-state sector keeps growing, the conditions for reforming the state sector will improve and the institutional transition will be achieved in the long run. The major risk is however that the state sector may use its state power to control income redistribution and the allocation of resources and consequently slow down the structural change in ownership. Viewed from this angle, he points out that the worsening financial situation is actually the ultimate driving force for the reform program.

Chapter 4 looks at China's WTO issues in the context of domestic reform particularly with respect to the reform of the SOEs and private sector development. Apart from the gains from trade, China's WTO membership may help the government to break through political, economic and ideological deadlocks and set up the ultimate goal and road map for economic transition. In particular, pressures from internal and external economies may push China to complete the last and most difficult stage of reform—ownership reform.

Chapter 5 discusses the impact of foreign entry in Chinese banking based on the experience of the Central European transition economies and taking account of the current situation in China and the prospects for reform. The key message is that competitive pressure from foreign entry evolves only gradually and depends on foreign banks' share of credit markets becoming significantly large. This suggests

Dilemmas of China's Growth in the Twenty-First Century

that domestic banks in China do have a window of opportunity to adjust to competition. They point out that the more quickly the government removes restrictions from the credit and deposit markets, the more likely it is that domestic banks will learn how to price risk appropriately, leading to a significant improvement in the quality of their assets.

Chapter 6 discusses the legal implications for regulation of trade in service sectors. Under the General Agreement on Trade in Services (GATS), any treatment afforded to foreign service suppliers by China under any bilateral arrangement will have to be offered on the same terms to service suppliers from any WTO member. However, whether the theoretical opportunities to compete using a joint venture by foreign suppliers actually result in competitive markets will depend to some extent upon the way that the government sets and administers domestic regulations. Williams and Cass pointed out, that depending on the extent to which the GATS commitments actually achieve increases in competition, it is possible that the rent accruing to the existing producers in the more restricted markets will increase. There is the possibility that in some areas the commitments may not result in a significantly more competitive environment.

Chapter 7 deals with income distribution issues using a macroeconomic approach to examine the causal linkage between macro factors and income disparity in China in a dynamic context. The estimation results show that unemployment/population growth and the dispersion of fiscal spending across different provinces played a prominent role in widening income inequality in China while monetary factors had a less significant role. Interestingly, the findings do not support the view that income disparity will prevent further economic growth. A policy implication of the results is that a sound macroeconomic environment is crucial to reducing income inequality in China.

With an impressive record in raising its agricultural production, it is not entirely clear to what extent China can, or should, maintain food self-sufficiency, and whether eventual imports should consist of meat or feed grains. Chapter 8 tries to lay the ground work for dealing with these issues by adopting a Land Use Change (LUC) approach that seeks to identify alternative options for agricultural policy through a spatially explicit intertemporal model. Their findings show that the marginal value of labour is high in the Northern regions and low in densely populated areas of the Central and Southern regions where marginal returns to land are relatively high for both irrigated and rain-fed land. It also appears that the marginal productivity of agricultural labour is usually higher in the neighbourhood of large urban areas.

Grain storage is an integral component of the food system. The area of household grain stocks is particularly pronounced in China since it is estimated that some 60–70 per cent of China's annual output of grains are held as household stocks in rural China having profound implications for the design and implementation of domestic policies. And yet, the area has received little attention.

Conditions and prospects for sustaining China's economic growth

Chapter 9 tries to fill in this gap by analysing the determinants of household grain stocks in China based on household survey data. Wan's main finding is that price does matter, suggesting that rural farmers in China do engage in speculative activities by storing grains.

The labour force that is in excess of farming requirements in China is estimated in the order of over 200 million. To sustain China's economic development, this labour force needs to be absorbed into non-farming activities. Chapter 10 deals with this issue by discussing part-time farming trends and their policy implications. Zhou, Summer and Lee point out that there are two major paths through which labour can be shifted out of farming activities: leaving the farm completely and moving to other industries; or remaining farm-based and where possible engaging in non-farming activities, which is referred to as part-time farming. Since any large-scale relocation of farm labour is not likely to happen in the near future, encouraging more farmers to engage in part-time farming may be a solution to lessen the employment pressure in rural areas.

Chapter 11 attempts an interesting question about whether China is abundant in unskilled labour. Ding's findings show that China is neither rich in all of its low-educated, unskilled labour, nor poor in its entire high-educated profession due to many constraints. The most abundant factor in China is manufacturing manual workers not the large number of agricultural workers. A trade-off is that low income in agriculture impedes the application of advanced technology to agricultural sectors because more labour needs to be employed instead of machinery. Another trade-off is that the rapid growth of the manufacturing industry leaves less room for development of agriculture because both sectors demand land and capital. For China, the real bottlenecks are highly skilled workers such as technicians and managerial personnel and physical capital.

Chapter 12 examines the role of foreign direct investment (FDI), exports and spillover effects in regional development in China. The study found that while FDI and exports have in general a positive and significant impact on economic growth in China, the role of export expansion varies across different regions. Export growth significantly contributed to economic growth on the most developed coastal region, while its impact was insignificant in the less developed Central region and negative or marginally significant in the poorest West. The results indicate that the role of exports in economic growth depends largely on the individual situation of each region such as the level of development, industrial structure, policy orientation and degree of openness.

Decentralisation can positively affect economic growth through its impact on the mobility and allocation of resources and the provision of local public goods. However, as Chapter 13 shows, fiscal decentralisation in China during the period 1979–93 had a positive impact on the provision of local public goods, but a negative impact on provincial economic growth. As Chen points out, the negative impact of decentralisation on provincial economic growth may be due

Dilemmas of China's Growth in the Twenty-First Century

to the inappropriate degree or the badly adapted form of the decentralisation. However, in terms of the government-enterprise relationship, decentralisation may not have gone far enough for enterprises to have true autonomy or hard budget constraints.

In finding out the determinants of regional economic growth, Chapter 14 provides some empirical evidence from a panel data of Chinese provinces. Wu found that the growth of physical capital, infrastructure, labour productivity, human capital and foreign investment is positively related to China's economic growth in the 1980s and 1990s. The study also confirms that China's economic reform and openness have made positive contributions to economic growth.

Chapter 15 discusses China's role in international action on climate change by analysing the bargaining power and set, and comparing emission tax and permit trading schemes. A key question to be addressed is whether a decentralised and differentiated emission tax scheme improves global welfare. Jiang's theoretical and numerical models show that the emission tax and tradable permit policies are different for a tradable permit policy allows cross-border income transfers while a tax does not. To achieve the Pareto optima, an emission tax policy should be accompanied by a net transfer of income from rich to poor countries, while a tradable emission permit policy requires that rich countries are allowed a negative number of permits. The second-best outcome lies at a differentiated tax system which can be justified by the fact that China and the rest of the world have different preferences about the environment and consumption, and different production technologies.

Notes

- 1 China experienced an average of 9 per cent annual growth rate in the twenty years of economic reform (1978–98) and only in recent years since the end of 1990s the average annual growth rate has been lowered to around 7 per cent.
- 2 Resolving this dilemma involved a series of government retrenchment programs leading to a stop-go cycle of the economic growth in the early period of reform. With the deepening of the reform programs, the 'dual price system', which was essentially a compromise in freeing up prices, has been gradually replaced by the unified market prices. Consequently, the cycle of macroeconomic movement has become less volatile over time.
- 3 The list does not mean to be complete. Major issues such as growth with environment degradation are not included.
- 4 See the share of the total non-state sector in the total bank credits over the 1997–98 period in Table 3.1.
- 5 See Sachs and Woo (1994), Sachs and Woo (2000) and Woo (2001) for a more detailed background of the debate between the 'experimentalist school' and the 'convergence school' about the different interpretations of the way in which institutional change has affected China's economic success.