The Chinese reforms

But from 1978……


From 1978……

“stabilize, privatize, liberalize”

China’s reform is puzzling: viewed as an anomaly not appreciated by mainstream economists

China's reform succeeded without complete liberalization, without privatization, and without democratization.

Table 1. **The Washington Consensus**

Original Washington Consensus
1. Fiscal discipline
2. Reorientation of public expenditures
3. Tax reform
4. Financial liberalization
5. Unified and competitive exchange rates
6. Trade liberalization
7. Openness to foreign direct investment
8. Privatization
9. Deregulation
10. Secure property rights

Source: Rodrik (2006) Development Lessons for Asia from Non-Asian Countries

China's reform defies the policies advocated by mainstream economist

Table 3. **A People's Republic of China Counterfactual (1978)**

Problem	**Solution**
Low agricultural productivity	Price liberalization
Private incentives	Land privatization
Fiscal revenues	Tax reform
Urban wages	Corporatization
Monopoly	Trade liberalization
Enterprise restructuring	Financial sector reform
Unemployment	Safety nets

The actual experience of the PRC is instructive because in fact none of the recommendations in the second column of Table 3 was undertaken (at least not quite in the form shown).

Transition / Structural Change

- From planned economy to market economy (CCP in control)
- From Autarchy to interdependence
- From a Rural society to an Urban one

(with CCP in control)

The goal of all reforms is not the marked economy but the economic growth.

"Crossing the river by feeling for the stones"
(*Mo shitou guohe*)

Characteristics of China's transition strategy

Gradual

Incremental

Piecemeal

Absence of blueprint

Experimental

Pragmatic

Evolutionary

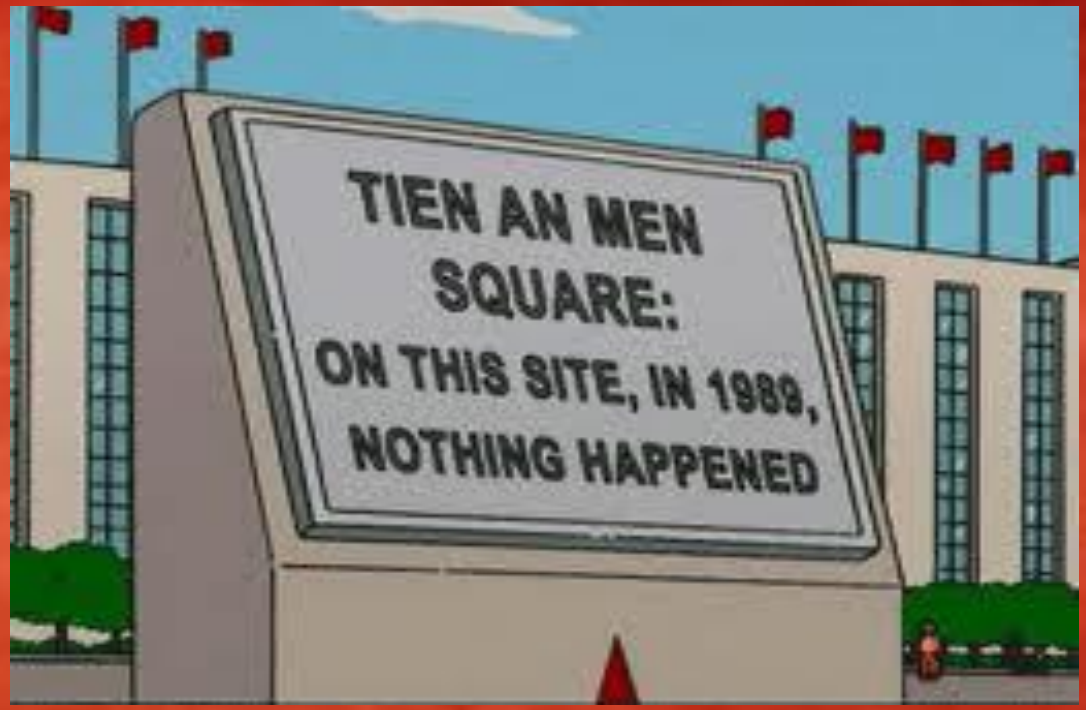
Ad hoc

Elements of China transition 1978 1992

- Dual track system (planned economy + market economy)
- Growth out of the plan
- New contracts
- Opportunities for Smes
- Price more and more market oriented
- Incremental managerial reforms instead of privatization
- Disarticulation (out of the plan - special economic Zones mainly export oriented)
- Controlled openness
- Macroeconomic stabilization achieved through the plan
- High saving and **investment**

1978 1992: notes

- Quite successful reforms
- Steps forward and steps back
- The more market economy you have the more is difficult to control the economic cycle (need of new instruments)
- Still fight between reformist and orthodox
- When things go bad there is social unrest
- 1988 1989 strong tensions due also to high inflation. (particularly harmful for urban salaries)
- Hu Yaobang's death starts demonstrations in Tiananmen square
- 1989 1991 years of new isolations with conservative orthodox that control power.


TIEN AN MEN
SQUARE:
ON THIS SITE, IN 1989,
NOTHING HAPPENED

In 1992 reforms start again

- Deng visits the southeast provinces pushing Sez
- “Development is the only hard truth” – “it doesn't matter if the cat is black or white as long as it catches mice” – “to be rich is glorious”
- 1992 14° PCC congress: “Socialist Market Economy”

Deng Xiaoping the pragmatist

"Try it out! If it doesn't work, you'll do a self-criticism,
and that'll be the end of it.
If it works, and you can produce an extra 500,000 tons of grain,
that will be a great thing"
(on contracting land to households, March 1961)

"As long as we can bring about a rapid restoration,
it doesn't matter how we do it"
(on the need to prioritise production, February 1962)

"It doesn't matter if a cat is black or white,
so long as it catches mice"
(on contracting land to households, July 1962)

From 1992 to 2012

- Market reunification: end of dual track (1993)
- Recentralization: Tax reform – new equilibrium between local and central authorities.
- Macroeconomic austerity: strong control on credit to Soe – tight control on money supply

Regulatory Approach and Administrative Restructuring

- Fiscal and tax system: Vat 17%. Larger Tax bases, rule sharing between local and central authorities
- Banking and financial system: People Bank of China reform (like Fed «same same but different»). First attempt to tackle the non performing loans problem
- Corporate governance: Soe restructuring development of Shanghai stock exchange. More regulations and controls.
- External sector: trade reform. Beginning to prepare foe WTO admission.

Achievement

- Inflation under control
- Soes are less important: from 1978 to 1993 the Public sectors (including Soes) lost % points on GDP but grew in absolute terms both considering output and employees. since 1993 Public sector shrink also in absolute terms.
- Privatizations: called often Soes restructuring. Very often management by out of Soes e Tves.
- For the first time we have reforms where someone has to lose: Soes employees.

Table 4.1
Contrasting styles of economic reform

1980s reform	1990s reform
Zhao Ziyang: cautious, consensual decision-making	Zhu Rongji: Rapid, personalized decision-making
Introduce markets where feasible; focus on agriculture and industry	Strengthen institutions of market economy; focus on finance and regulation
Dual-track strategy	Market unification, unite dual tracks
Particularistic contracts with powerful incentives	Uniform rules: "level playing field"
Competition created by entry; no privatization	State-sector downsizing; beginnings of privatization
Decentralize authority and resources	Recentralize resources, macroeconomic control
Inflationary economy with shortages	Price stability, goods in surplus
"Reform without losers"	Reform with losers

Table 1.2. **Chronology of economic reforms in China**

Year	Policy change
1978	"Open door" policy initiated, allowing foreign trade and investment to begin
1979	Decision to turn collective farms over to households
	Township and village enterprises (TVEs) given stronger encouragement
1980	Special economic zones created
1984	Self-proprietorships (*getihu*) encouraged, of less than 8 persons
1986	Provisional bankruptcy law passed for state owned enterprises
1987	Contract responsibility system introduced in state owned enterprises
1988	Beginning of retrenchment of TVEs
1990	Stock exchange started in Shenzhen
1993	Decision to establish a "socialist market economic system"
1994	Company law first introduced
	Renminbi begins to be convertible on current account
	Multiple exchange rates ended
1995	Shift to contractual terms for state owned enterprise staff
1996	Full convertibility for current account transactions
1997	Plan to restructure many state-owned enterprises begins
1999	Constitutional amendment passed that explicitly recognises private ownership
2001	China accedes to the World Trade Organisation (WTO)
2002	Communist party endorses role of the private sector, inviting entrepreneurs to join
2003	Decision to "perfect" the socialist market economic system
2004	Constitution amended to guarantee private property rights

Source: OECD (2005)

Later on….

- Franchising / distribution
- Private property
- Taxation
- Fdi
- Vat reimbursement (lower or zero for more than 2800 products)
- Monopoly law

Why China is growing?

- Institutional changes (decentralization, corporate law, legal system reform, from planned economy to “quasi” market economy or socialist market economy etc.)
- Economic policies (fiscal policies, interest rates, exchange rates, one child policy, Hukou, financial reforms, etc
- Industrial policies (vertical, horizontal, regulation, etc.)
- Focus on **investment** and export

Table 1.3. **Share of transactions conducted at market prices**

Per cent of transaction volume

	1978	1985	1991	1995	1999	2003
Producer goods						
Market prices	0	13	46	78	86	87.3
State guided	0	23	18	6	4	2.7
State fixed	100	64	36	16	10	10.0
Retail sales						
Market prices	3	34	69	89	95	96.1
State guided	0	19	10	2	1	1.3
State fixed	97	47	21	9	4	2.6
Farm commodities						
Market prices	6	40	58	79	83	96.5
State guided	2	23	20	4	7	1.6
State fixed	93	37	22	17	9	1.9

Source: National Reform and Development Commission and Price Yearbooks.

Growth and structural changes

Economy: data

Never ask how statistics and sausages are made. This is true everywhere, even more in China

- Market research are usually not very reliable. Difficult to cross check.
- Gdp is estimated in different ways but remember statistical offices are under the control of the Govern/Party. Still lack of standards.
- Retail data can be even worse because China mix investment and domestic consumption (plus government spending)
- Deflation difficult to define especially in services
- Difficult to calculate gdp when products change so much

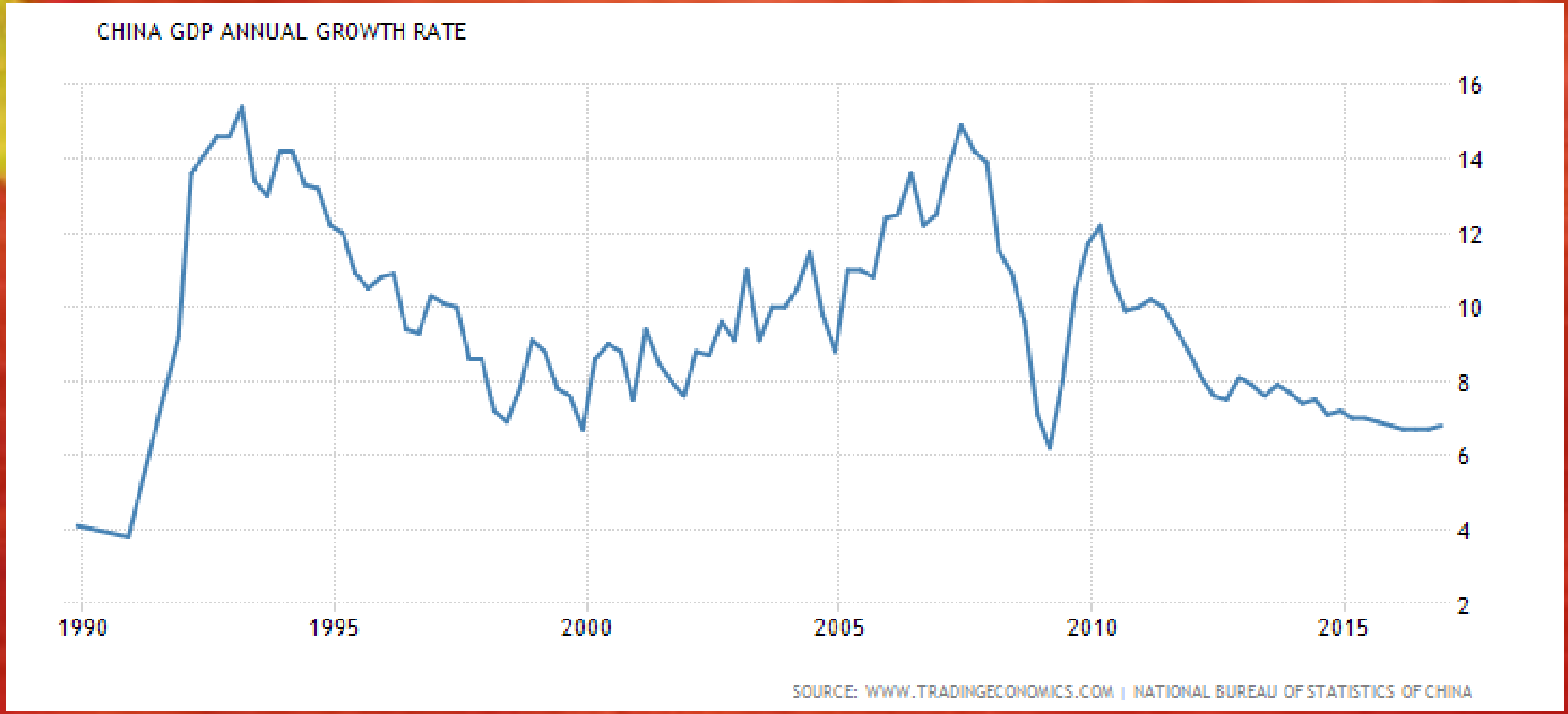
Growth and structural changes

Table 7.1
Growth of per capita GDP (average annual growth rates, percentage).

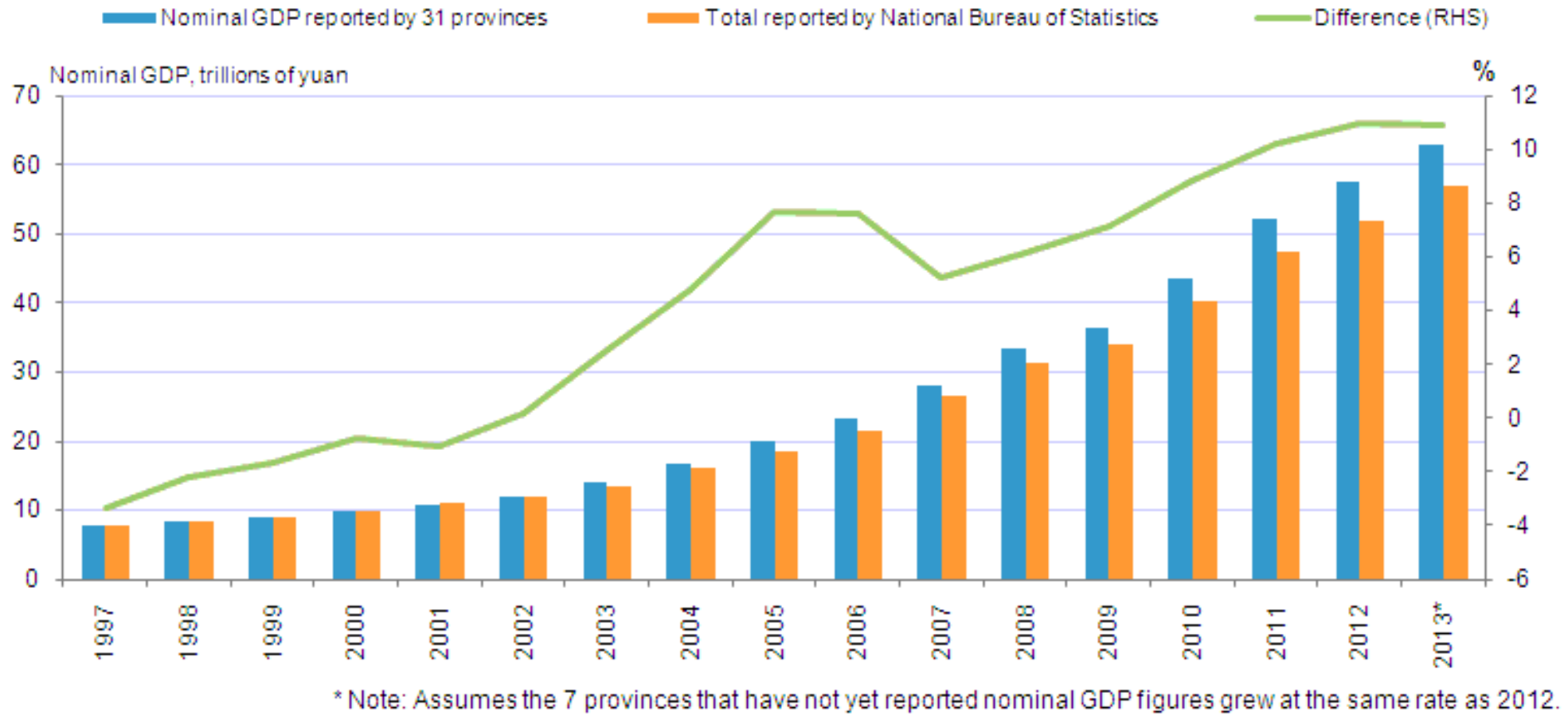
	GDP	Population	GDP per capita
1952–1978	6.0	1.9	4.1
1978–2000	9.7	1.3	8.3
2000–2010	10.5	0.6	9.9
2010–2016	7.7	0.5	7.1

Source: *SAC* (2017, 16, 21–37).

Chinese GDP growth rate



China's GDP: slower and more slippery



* Note: Assumes the 7 provinces that have not yet reported nominal GDP figures grew at the same rate as 2012.

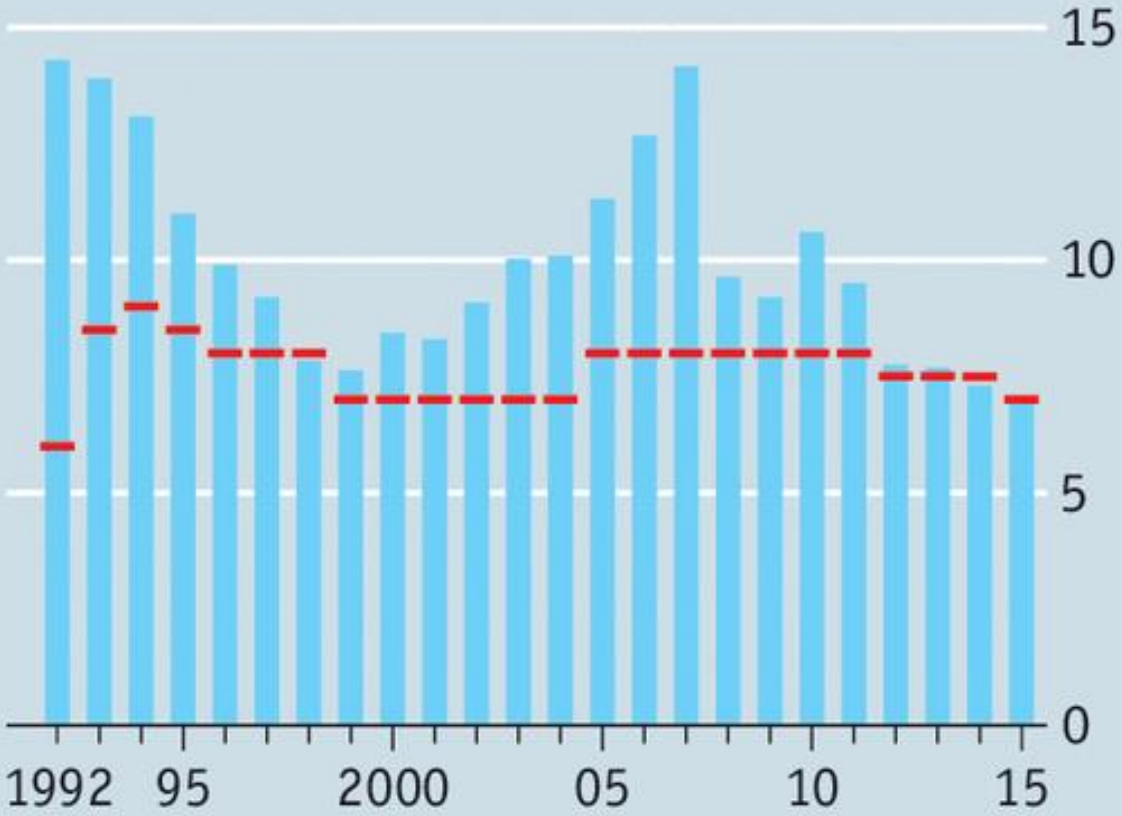
Source: Thomson Reuters

John Foley, Robyn Mak 21/01/2014

REUTERS BREAKINGVIEWS

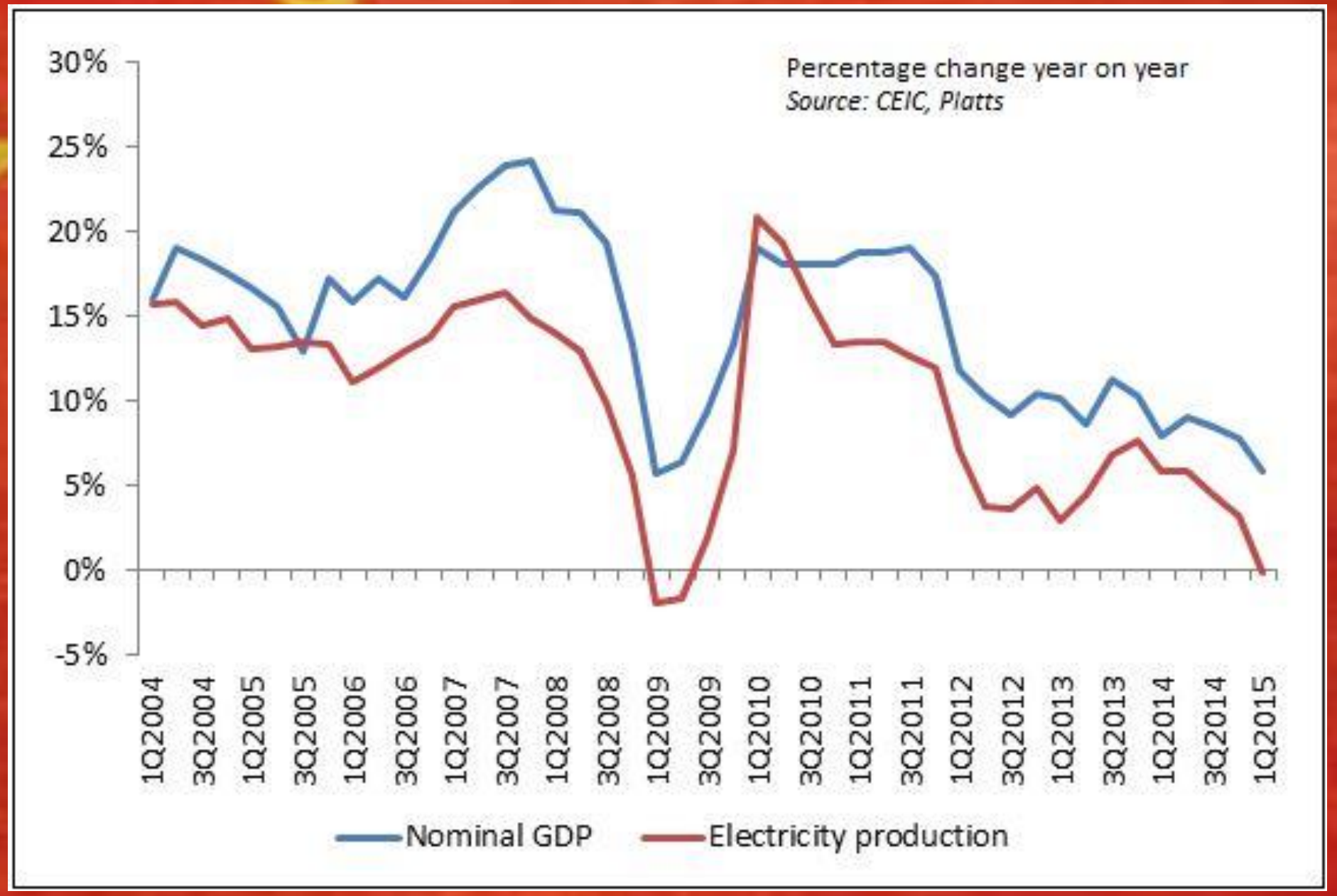
Targeting errors

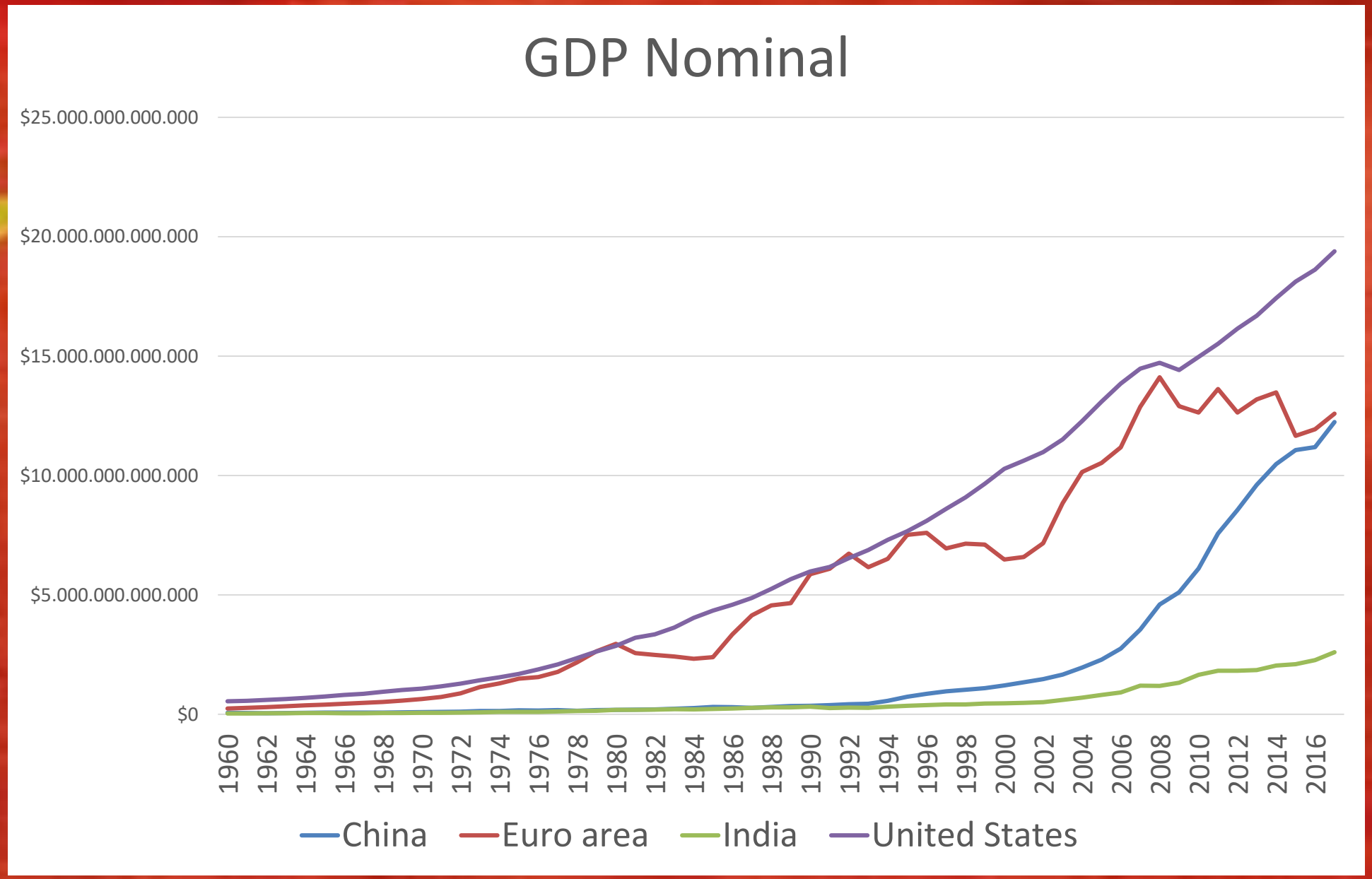
China's GDP, % increase on a year earlier



Sources: IMF; government reports

Economist.com


Percentage change year on year
Source: CEIC, Platts
30%
25%
20%
15%
10%
5%
0%
-5%
1Q2004
3Q2004
1Q2005
3Q2005
1Q2006
3Q2006
1Q2007
3Q2007
1Q2008
3Q2008
1Q2009
3Q2009
1Q2010
3Q2010
1Q2011
3Q2011
1Q2012
3Q2012
1Q2013
3Q2013
1Q2014
3Q2014
1Q2015
Nominal GDP
Electricity production


GDP Nominal
$25.000.000.000.000
$20.000.000.000.000
$15.000.000.000.000
$10.000.000.000.000
$5.000.000.000.000
$0
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1966
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1978
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1982
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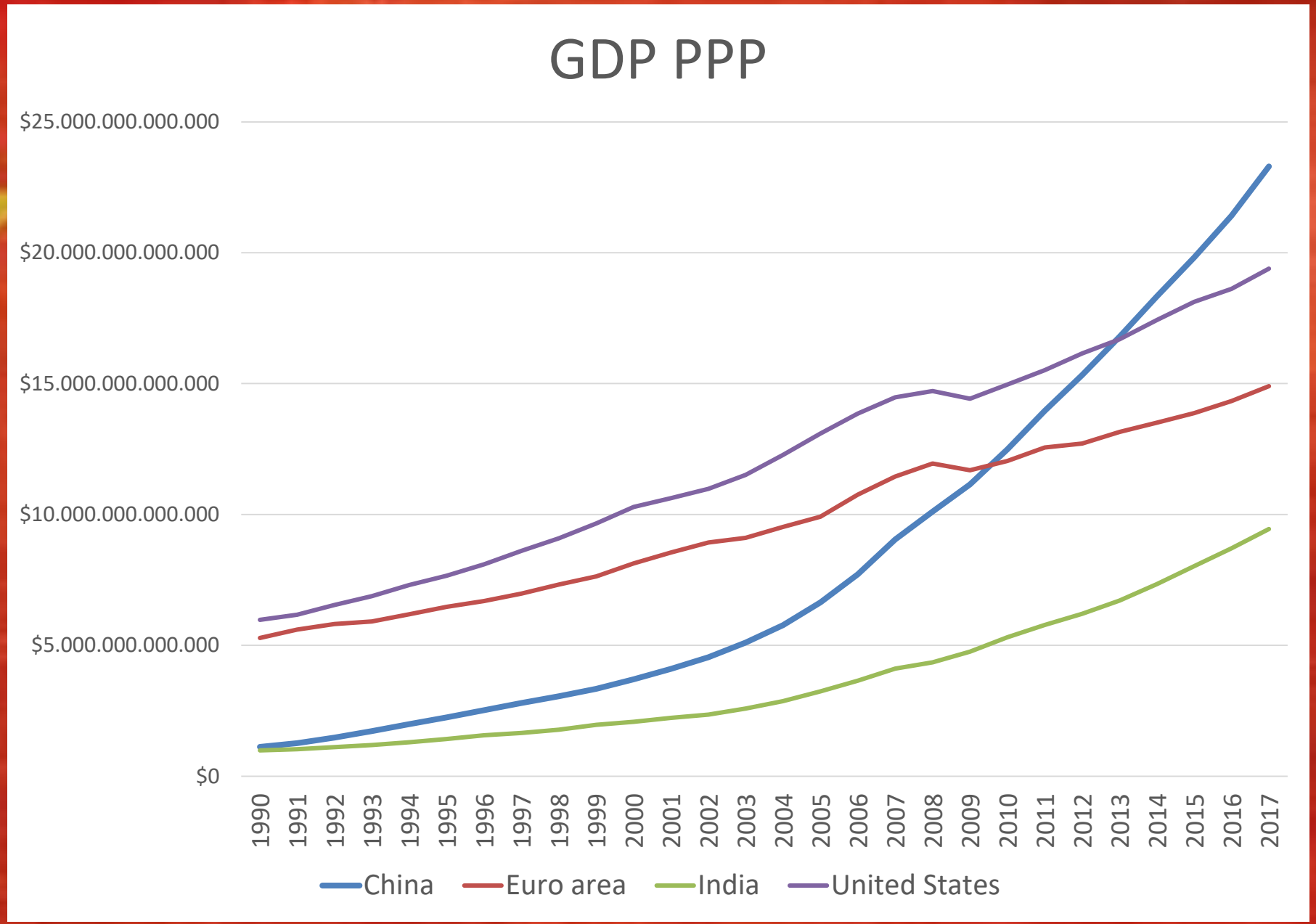
2014
2016
China
Euro area
India
United States


GDP PPP
$25.000.000.000.000
$20.000.000.000.000
$15.000.000.000.000
$10.000.000.000.000
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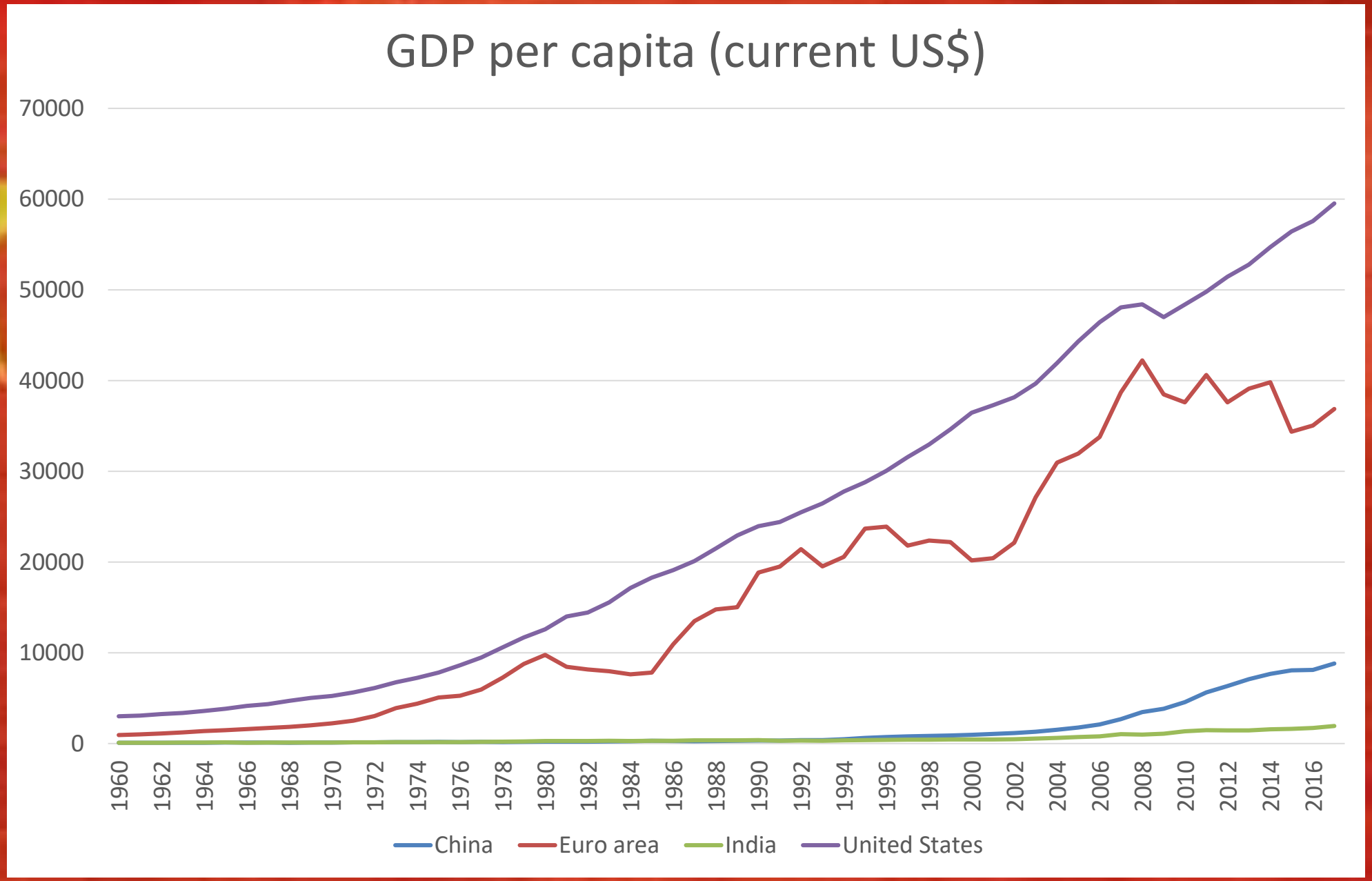
2017
China
Euro area
India
United States


GDP per capita (current US$)
70000
60000
50000
40000
30000
20000
10000
0
1960
1962
1964
1966
1968
1970
1972
1974
1976
1978
1980
1982
1984
1986
1988
1990
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1996
1998
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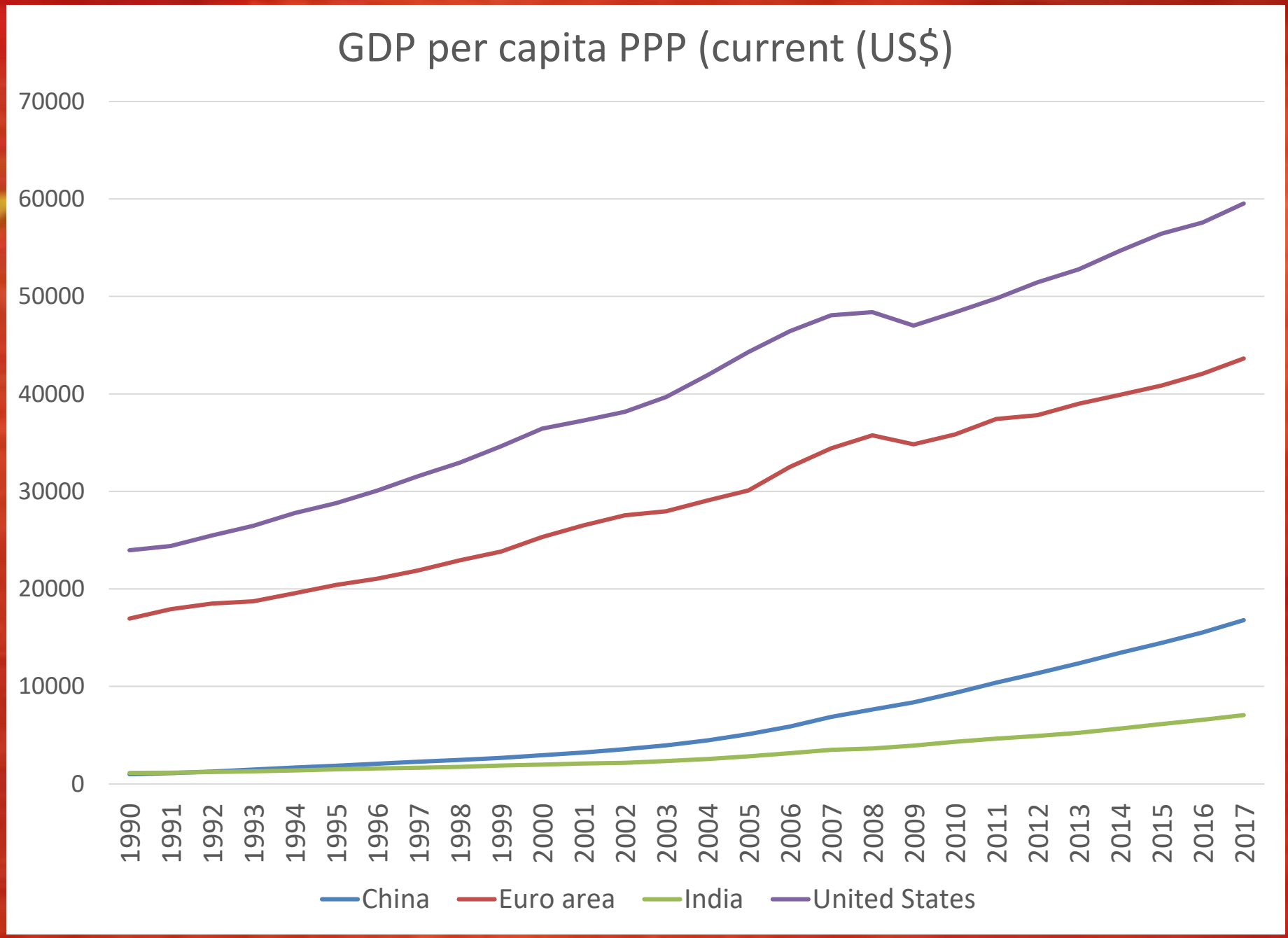
2002
2004
2006
2008
2010
2012
2014
2016
China
Euro area
India
United States


GDP per capita PPP (current (US$)
70000
60000
50000
40000
30000
20000
10000
0
1990
1991
1992
1993
1994
1995
1996
1997
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1999
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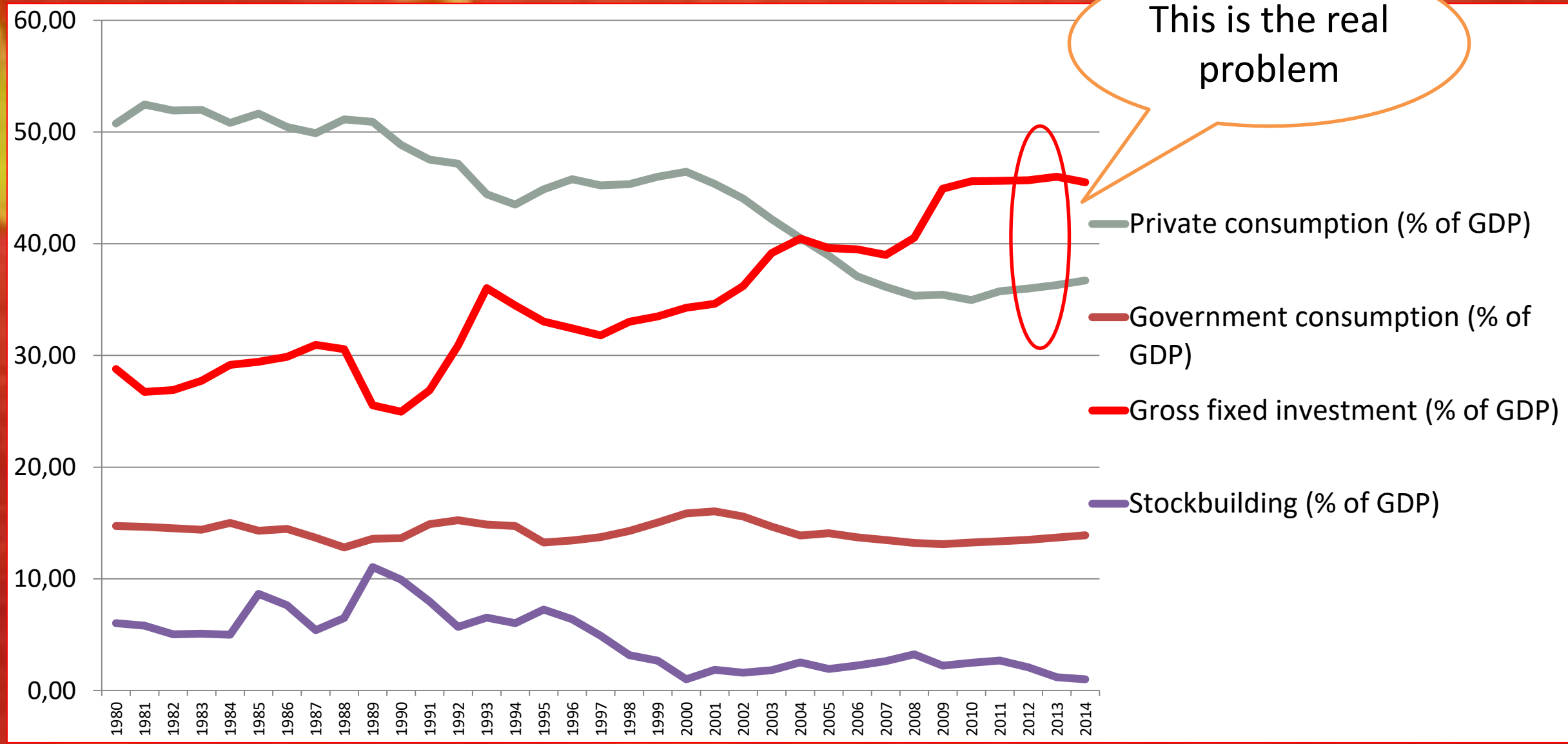
2003
2004
2005
2006
2007
2008
2009
2010
2011
2012
2013
2014
2015
2016
2017
China
Euro area
India
United States

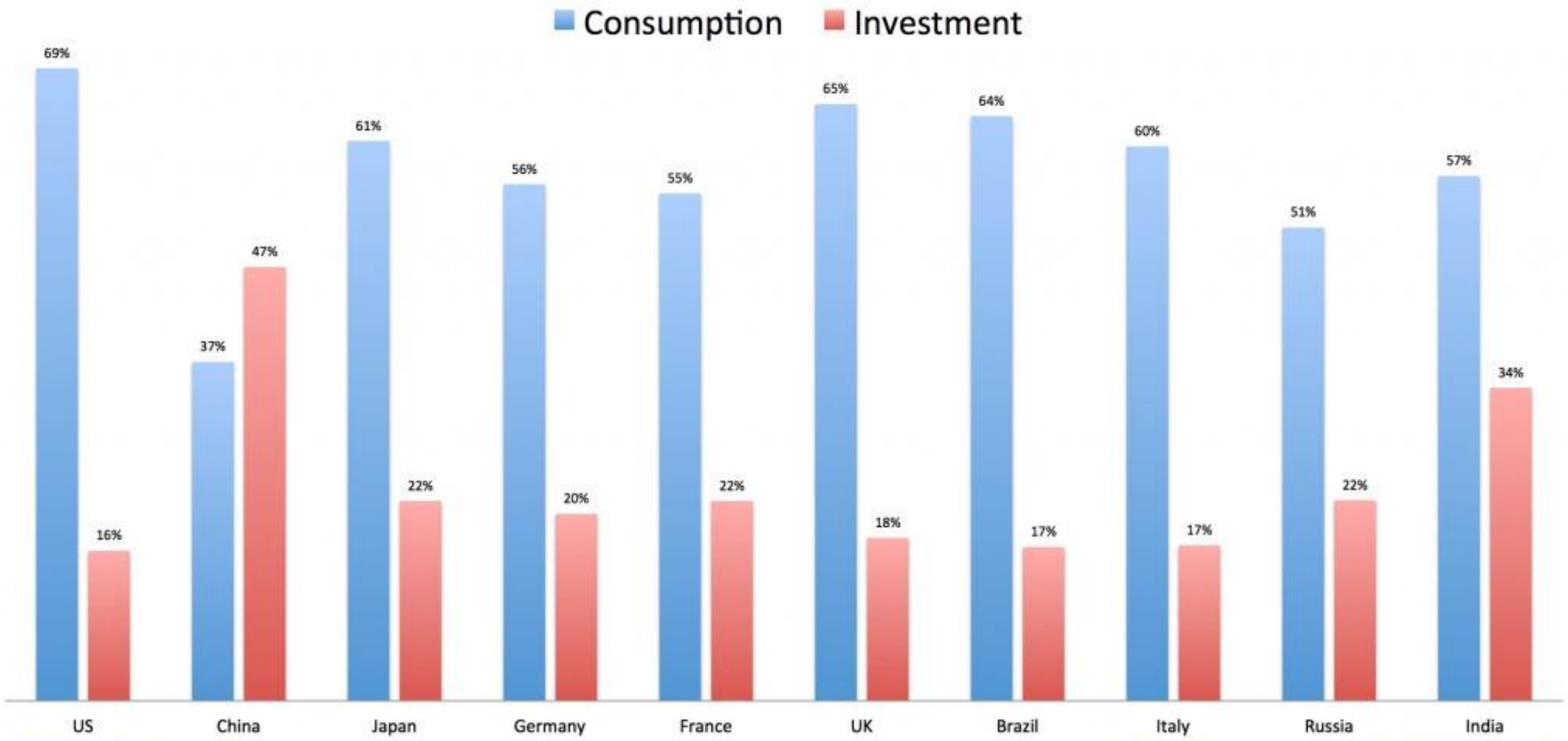
Chinese development

time		Reforms	Policies for industrial development
1978 - 1992	Market preparation	Dual track system . Some space for private firms in an increasing number of industries. Foreign firms allowed to operate in China (with constraints) abolishing of State monopoly on foreign trade. GATT (1986); lowering of tariffs (1994)	SEZs development ; FDIs attraction ; undervaluation of the currency , creation of non-tariffs barriers , import substitution; export support
1993 - 2001	Market development	Soes reform , more business oriented, 5 years plan loose importance . WTO (2001)	Less subsidy for enterprises. Support for infant industries. Large investment in infrastructure.
2002 - 2012	Socialist market economy	Market prices , trade reform (2004); establishment of SASAC (2003)	go west strategy; go global strategy; less incentives for FDIs; policies to attract and develop new technologies, Ofdi to enter new market and to “control” raw materials supply

Chinese Gdp


This is the real problem
60,00
50,00
40,00
30,00
20,00
10,00
0,00
1980
1981
1982
1983
1984
1985
1986
1987
1988
1989
1990
1991
1992
1993
1994
1995
1996
1997
1998
1999
2000
2001
2002
2003
2004
2005
2006
2007
2008
2009
2010
2011
2012
2013
2014
Private consumption (% of GDP)
Government consumption (% of GDP)
Gross fixed investment (% of GDP)
Stockbuilding (% of GDP)

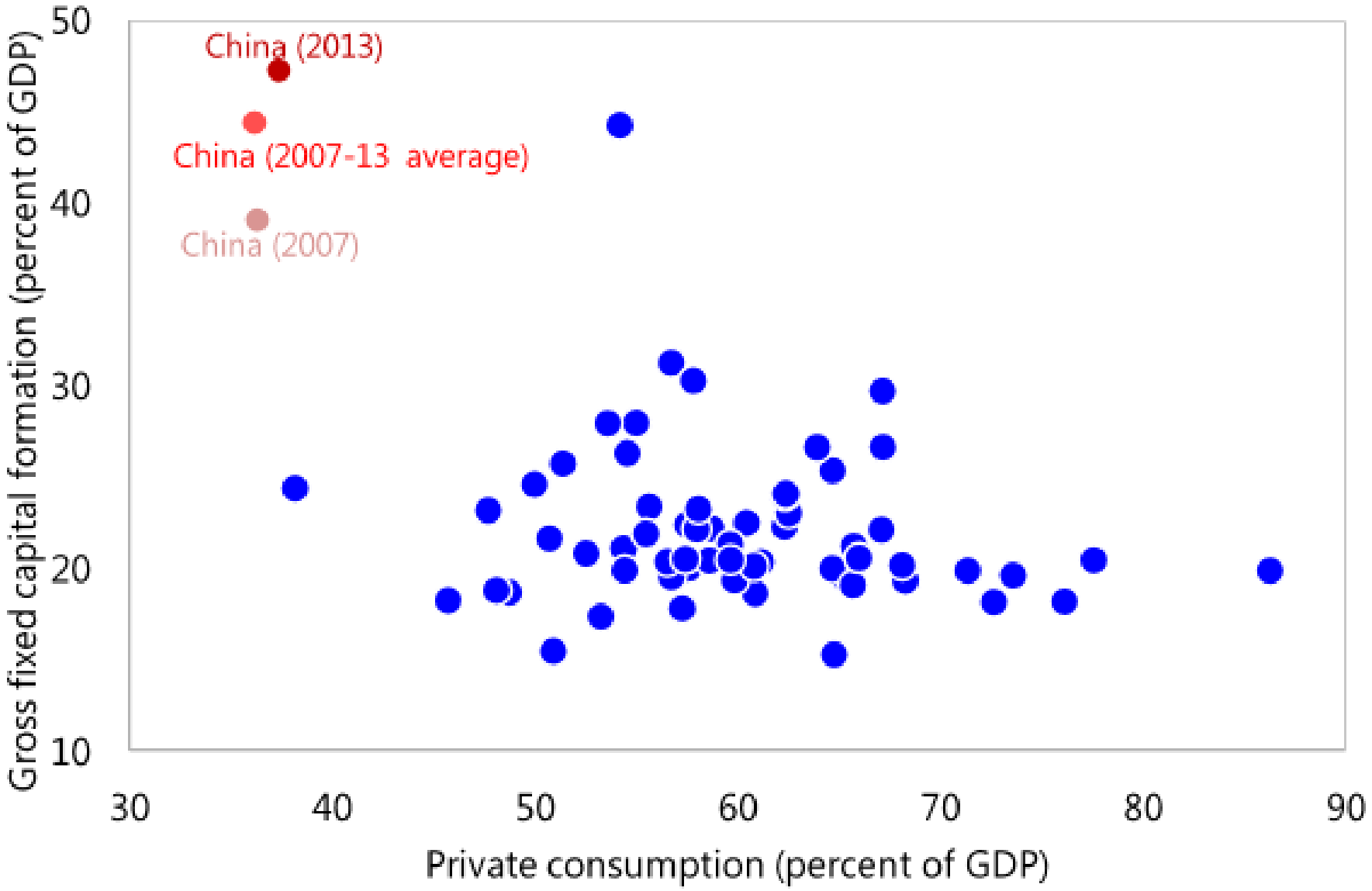
Consumption vs Investment as a % of GDP

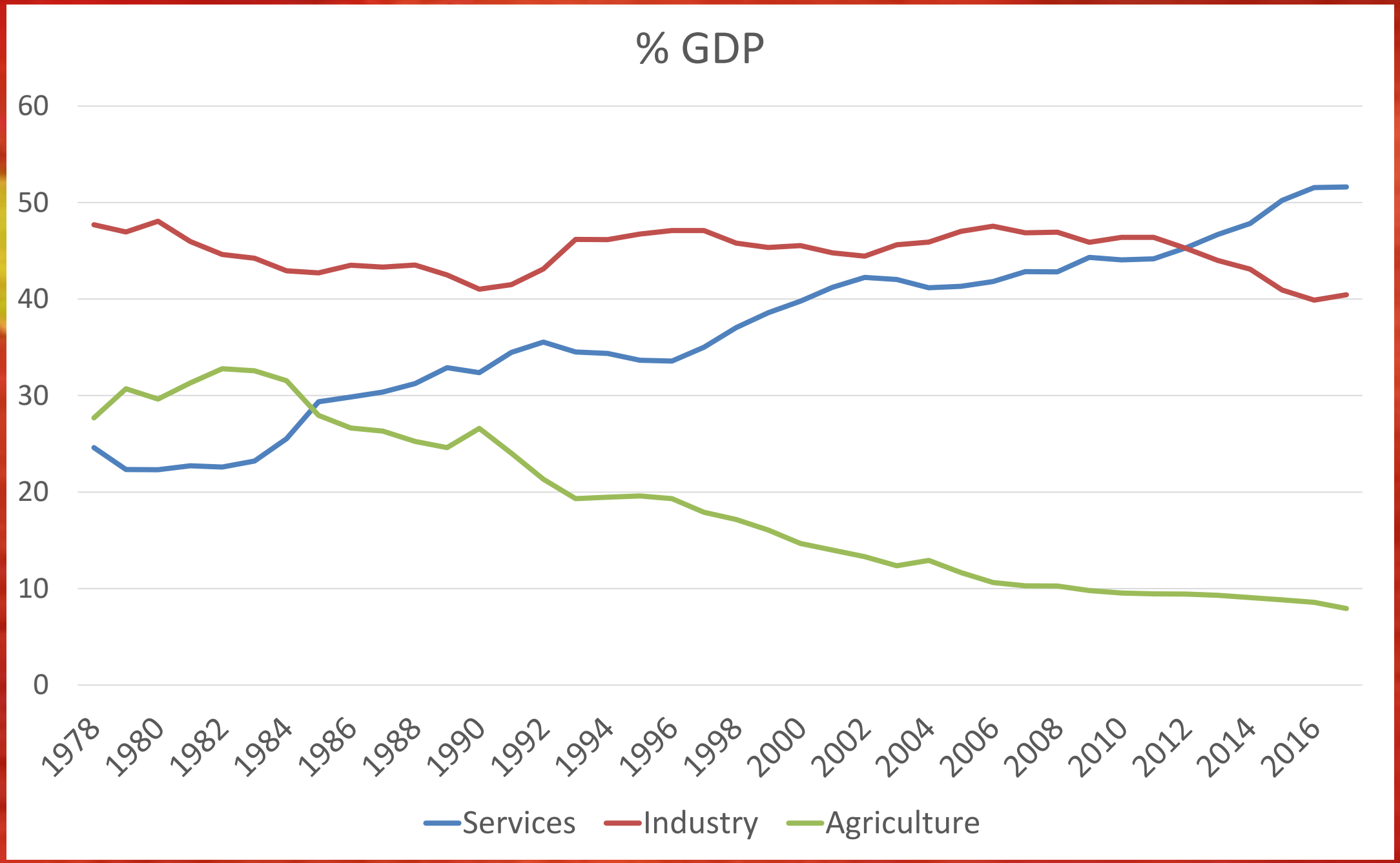


Data Source: CIA World Factbook

Private Consumption and Investment

(Industrial Countries and Emerging Markets; average, 2006-13)




% GDP
60
50
40
30
20
10
0
1978
1980
1982
1984
1986
1988
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1994
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2002
2004
2006
2008
2010
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2014
2016
Services
Industry
Agriculture

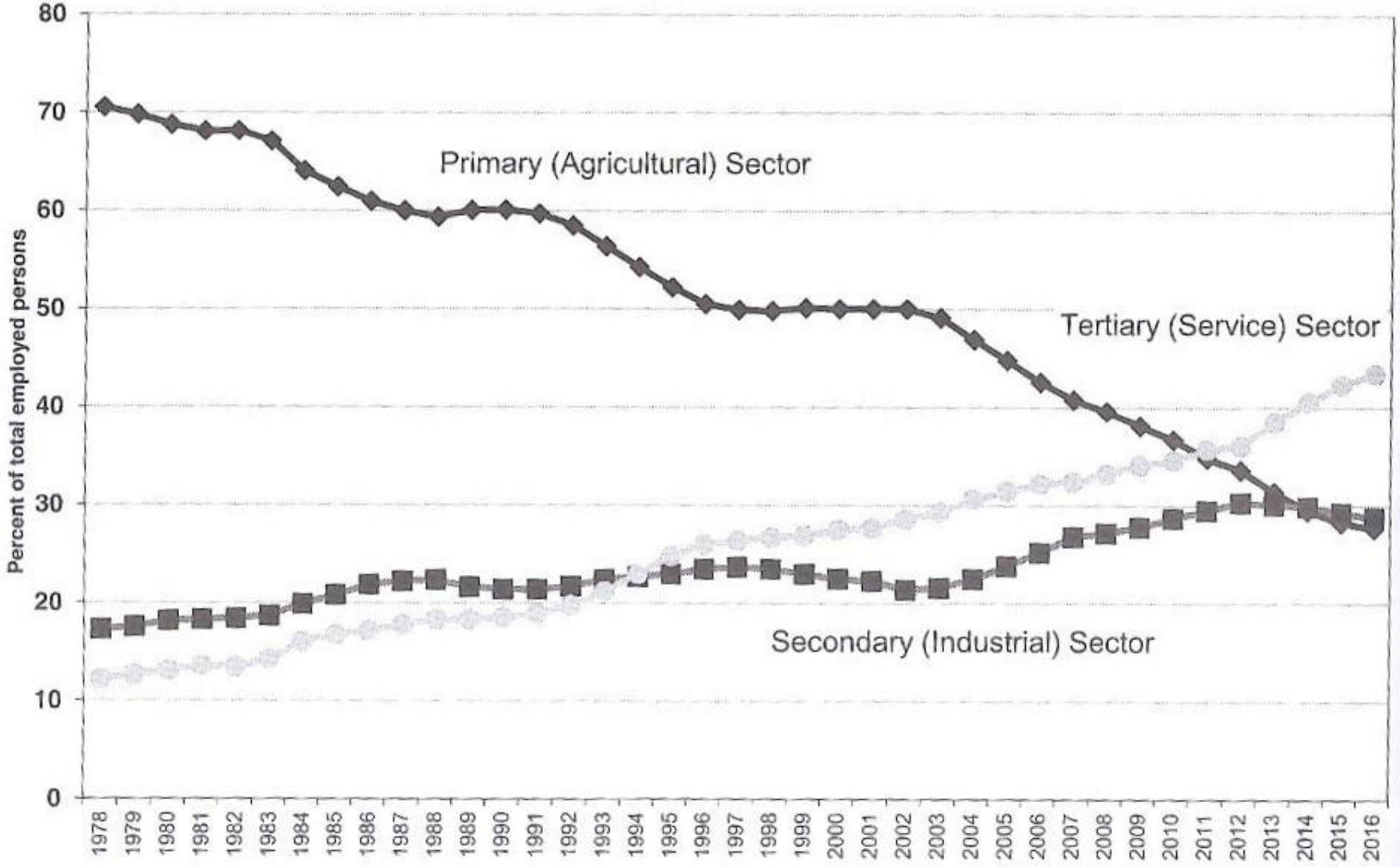
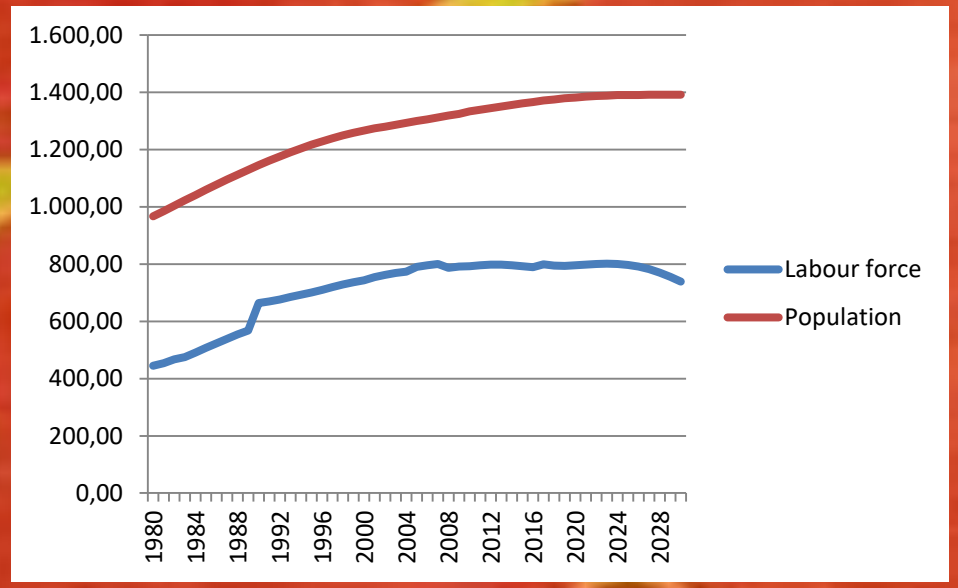
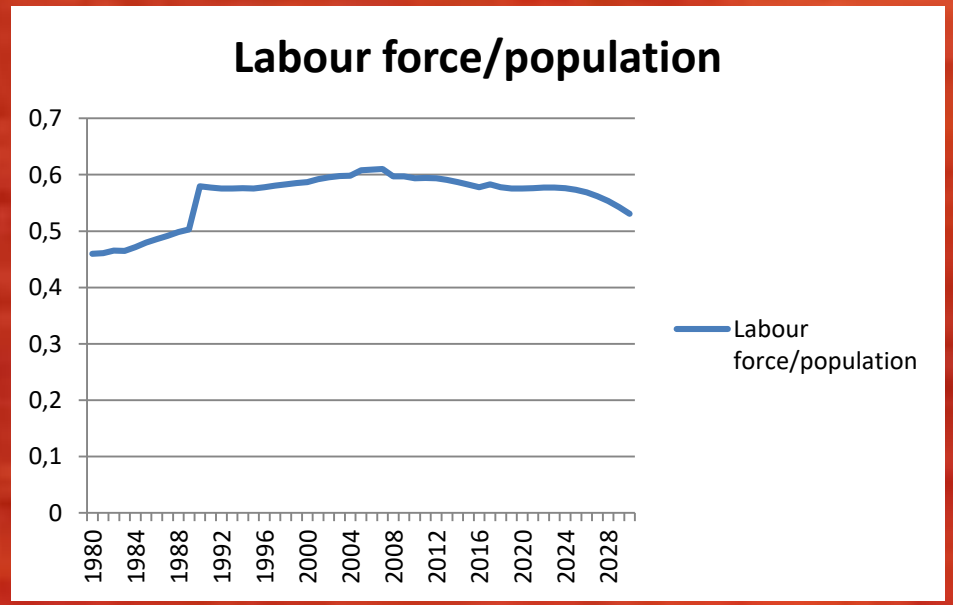


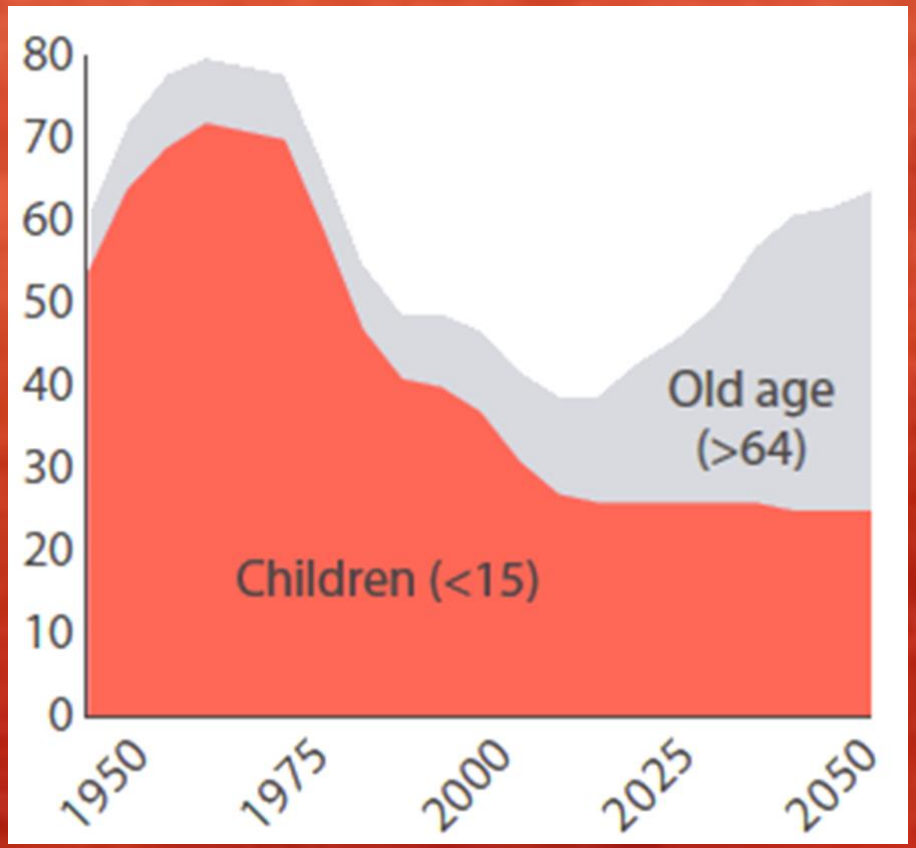
Figure 7.2
Structural change in employment.
Sources: *SYC* (2016, table 4-3); *SAC* (2017, 12).

Labour force and population





China getting older




GDP= C+I+G+(exp-imp)

How to keep Investment high

- Financial repression
- Cost deferral: environmental costs, land, energy
- Target responsibility system: local leader to meet growth targets had to do investments

Harrod-Domar Model

- Fix capital as only source of Growth
- This holds if there is a surplus of labour force
- k=K/Y (k is the number of unity of K to have an unity of Y)
- Assume k is fix = 4 in the short run
- Y=(1/k)*K
- dY=1/k*dK
- The growth rate of GDP is dY/Y=1/k*dK/Y
- Since dK/Y=investment /Y relabel it "*i*", for the investment rate
- Call dY/Y "g", GDP growth rate
- We have g=*i*/k

Harrod-Domar Model

- Assume k is fix = 4 in China (fairly possible)
- g=*i*/k
- It means that if Investment are 40% of GDP g=10% (10%=40%/4)
- But generally k is not fixed – it can converted in a variable that consider productivity
- k=*i*/g it tells us the number of units of capital to provide an additional unity od output (and is variable)
- The lower the number the better
- Call it “incremental capital/output ratio” (ICOR)

Table 7.2
Incremental capital/output ratio (ICOR).

	Fixed investment (percentage of GDP)	GDP growth	ICOR (annual average)
1979–2000	30.8	9.7%	3.2
2001–2010	39.2	10.5%	3.7
2011–2016	44.0	7.7%	5.7

Source: *SAC* (2017, 21–37).

ICOR for lower middle income countries = 4

US ICOR from 2002 2012 =6 Investment 10,8% of GDP and growth 1,8%

Y=f(K,L,H....)

- Output depends mainly on Capital (K), Labor (L), and Human Capital (H)

1. Growth decomposition (how much growth can be attributed to each input)
2. Total factor productivity (TFP): the residual tell US how much productivity cannot be explained by K,L,H and so tell us how much more output was produced by a more productive use of inputs

$Y=AK^{\alpha}L^{\beta}H^{\gamma}$

- $\alpha+\beta+\gamma=1$ (Cobb-Douglas with constant return of scale and diminishing return of each factor)
- Difficult to calculate coefficients but one you have it you can calculate the growth of input and the residual
- $\ln Y=\ln A + \alpha \ln K + \beta \ln L + \gamma \ln H$
- Now we can express any value of Y, K,L,H in term of their growth rate
- $G_Y=G_A+\alpha G_K+ \beta G_L+ \gamma G_H$
- $G_A = G_Y - (\alpha G_K+ \beta G_L+ \gamma G_H)$ this is the residual term and measure the change of productivity of all factors put together

$$G_A = G_Y - (\alpha G_K + \beta G_L + \gamma G_H)$$

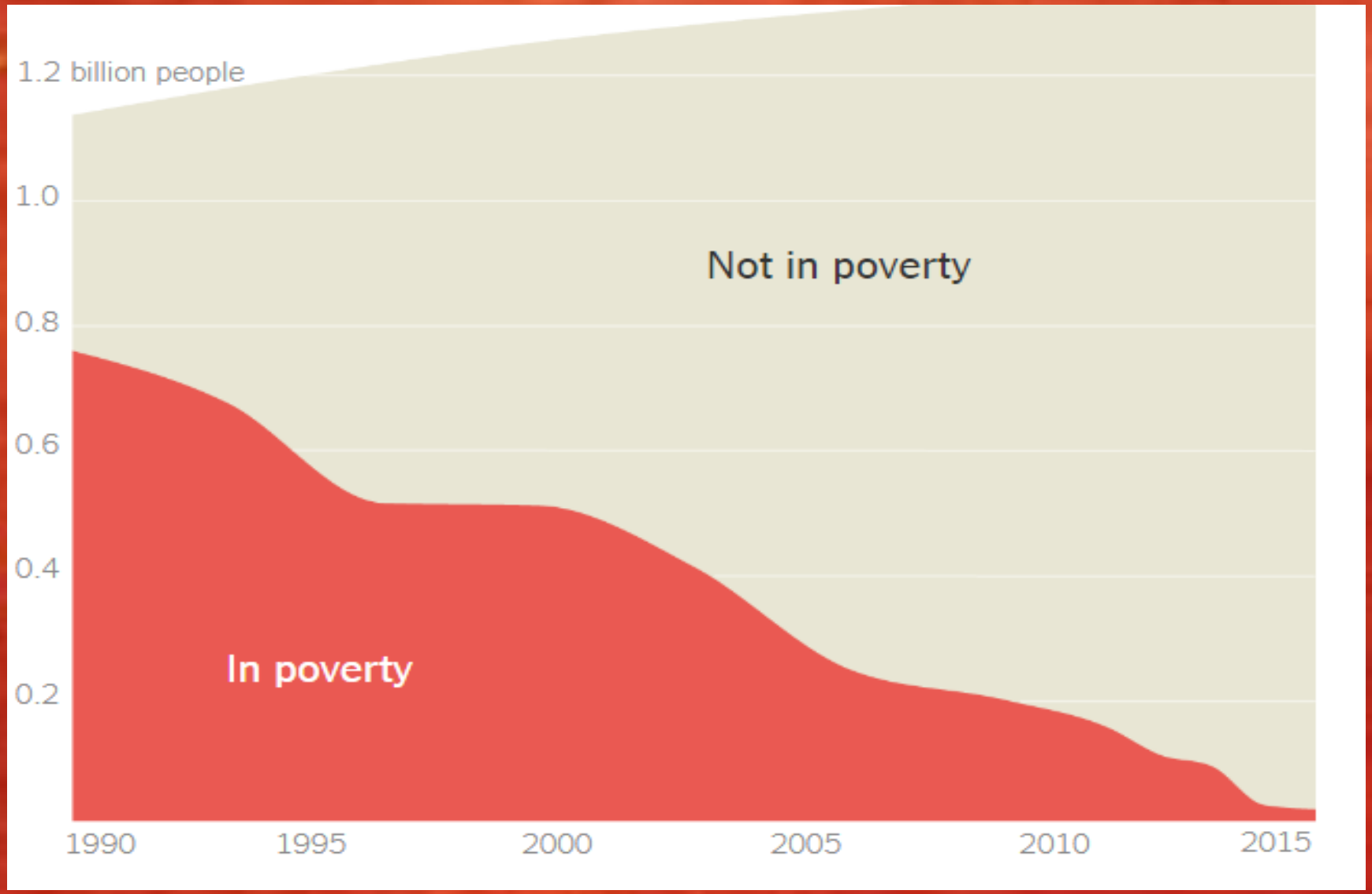
- Technological progress
- Institutional or organizational progress
- Reallocation of factors

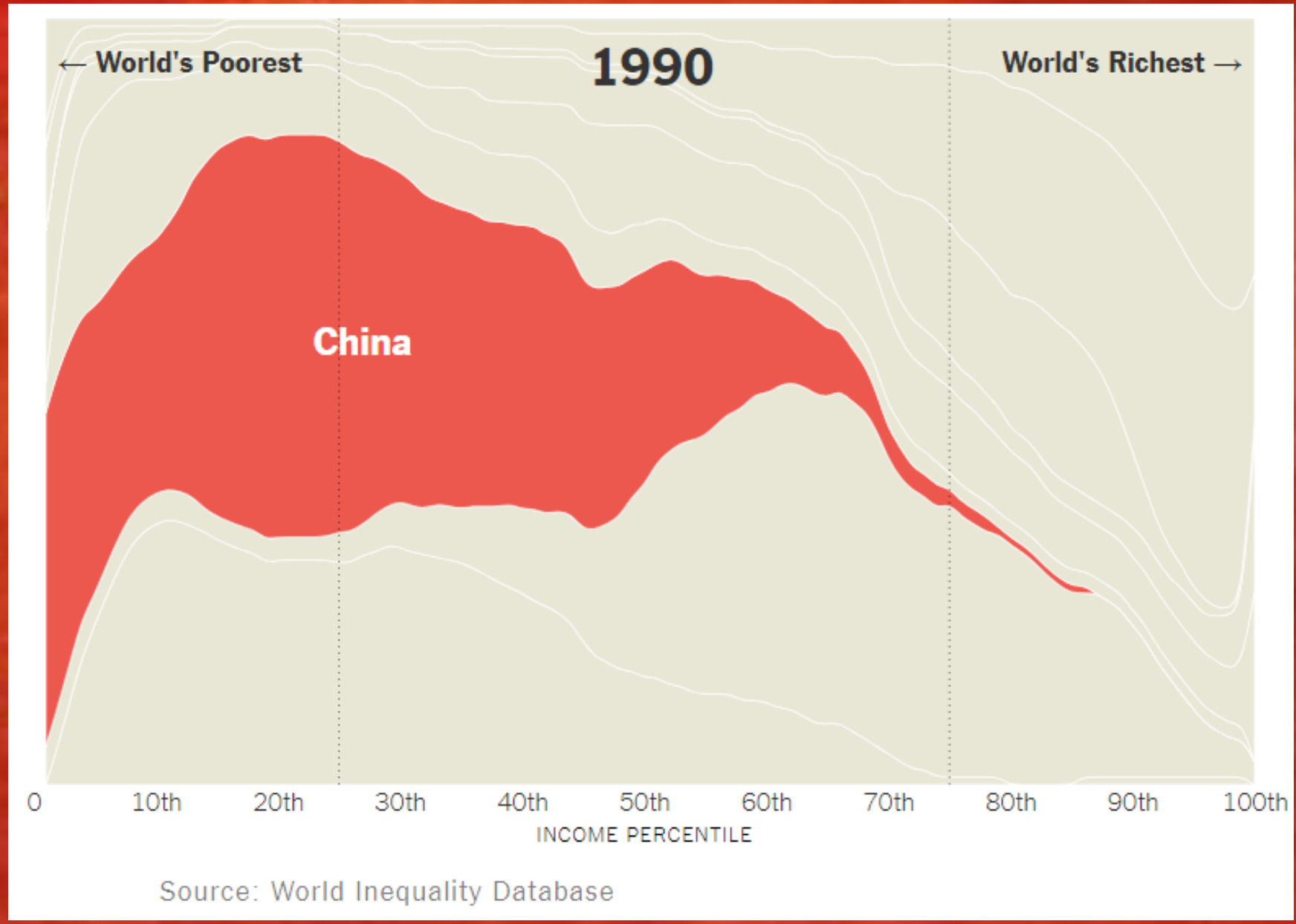
Table 7.3
China GDP growth and TFP (1952–2005).

Period	GDP growth	Fixed capital	Labor	Human capital	TFP
1952–1978	**4.4%**	**5.8%**	**1.9%**	**2.5%**	**0.5%**
During which:					
1952–1957	6.5%	1.9%	1.2%	1.7%	4.7%
1957–1978	3.9%	6.7%	2.0%	2.7%	−0.5%
1978–2005	**9.5%**	**9.6%**	**1.9%**	**2.7%**	**3.8%**
During which:					
1978–1995	10.2%	8.9%	2.3%	3.2%	4.0%
1995–2005	9.1%	11.5%	1.0%	1.7%	3.2%

Source: Perkins and Rawski (2008).

A success story





Source: World Inequality Database

Source: World Inequality Database