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China’s economy: A remarkable transformation

China’s emergence as a leading world economy is not a complete surprise. Economists like Angus Maddison had predicted its resurgence some time ago (see references). The most remarkable aspect of this transformation has been the role of the private sector in achieving such a high rate of growth. Nonetheless, as can be expected following such a substantial re-orientation of what was once a state dominated economy, there are challenges ahead.

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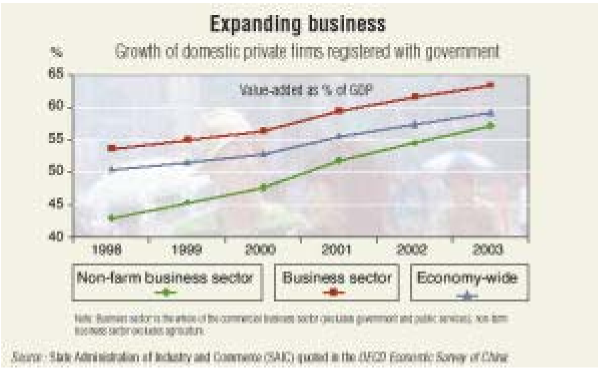

The pace of economic change in China has been extremely rapid since the start of economic reforms just over 25 years ago. According to official statistics, economic growth has averaged 9.5% over the past two decades and seems likely to continue at that pace for some time. National income has been doubling every eight years. Such an increase in output represents one of the most sustained and rapid economic transformations seen in the world economy in the past 50 years.

The size of the economy, when adjusted for differences in purchasing power, is already larger than all but one or two OECD economies, depending on the purchasing power parity used for comparison. While average incomes are still below those in other middle income countries, there are large parts of the country that resemble developed East Asian countries just one generation ago and are proceeding along a similar rapid catch-up path. Many industries have become completely integrated into the world supply chain and, based on current trends, China could become the largest exporter in the world by the beginning of the next decade, with as much as 10% of global trade compared with 6% at present.

This extraordinary economic performance has been driven by changes in government economic policy that have progressively given greater rein to market forces. The transformation started in the agricultural sector more than two decades ago and was extended gradually to industry and large parts of the service sector, so that price regulation was essentially dismantled by 2000 outside the energy sector. During this period, the government introduced a pioneering company law that for the first time permitted private individuals to own limited liability corporations. The government also rigorously enforced a number of competition laws in order to unify the internal market, while sharpening the business environment by allowing foreign direct investment in the country, reducing tariffs, abolishing the state export trading monopoly and ending multiple exchange rates.

The momentum towards a freer economy has continued this decade with membership of the World Trade Organization leading to the reform of a large number of China’s laws and regulations and the prospect of further tariff reductions. In 2005, regulations that prevented privately-owned companies from entering a number of sectors of the economy, such as infrastructure, public utilities and financial services were abolished. Overall, these changes have permitted the emergence of a powerful private sector in the economy.

But that is not all. The government has also introduced wide ranging reforms into the state-owned sector that dominated the economy in the early 1990s. State-owned enterprises have been transformed into corporations and many have been listed on stock exchanges since these were re-opened 15 years ago. Since 1998, a policy of "letting small enterprises go" through privatisation and closure on the one hand, and restructuring large companies on the other, has proved successful. The number of state-controlled industrial enterprises fell by over one half in the following five years and their payroll dropped by over 14 million, thanks in part to the introduction of more flexible employment contracts. This process was helped by the creation of unemployment and welfare programmes.

These and other reforms have improved the framework for mobilising the resources generated by one of the highest rates of savings in any economy–the gross saving rate approaches half of GDP–generating a particularly rapid increase in the capital stock, although such growth estimates can only be approximate. Investment has also led to an increasingly urban society–a movement that has gone in step with a flow of people from the land into the service and manufacturing sectors of the economy. Since workers in agriculture have low productivity, this movement has given a sharp boost to growth.

Moreover, the government has pursued a policy of raising the educational qualifications of young people. It launched a programme to give all children nine years' education, moving recently to ensure that all rural areas achieve this goal by 2006. Higher education has also been transformed. The wages for educated staff have been pushed up by the growing influence of a market economy.

Still, the high level of investment should not obscure the need for much better allocation of capital. To be sure, government debt has been stabilised at only one-third of that seen in the OECD area. But banks have not been lending on a commercial basis and so bad loans are equivalent to 30% of GDP and this will, eventually, have to be financed by the government. A start has been made on re-organising the major banks. A considerable effort is still needed to ensure that the whole of the banking system acts in a commercial manner. Moreover, capital markets need to be reformed: the state-owned shares of listed companies should be made tradable and both stock and bond markets need to be opened to private companies.

Better commercial laws are also needed, notably concerning both the start-up and closure of companies. A new company law is required to lower barriers to the formation of new enterprises, while a bankruptcy law is needed to formalise the rights of secured creditors and make it easier for private companies to obtain credit.

Such moves would consolidate the role of the private sector whose upsurge has been one of the most remarkable developments in China's boom. Though precise measurement is difficult, a definition which considers as private all companies that are controlled neither by state nor collective shareholders suggests that the private sector was responsible for as much as 57% of the value-added produced by the non-farm business sector in 2003.

The growing importance of the private sector reaffirms a shift towards a market economy, but it also puts a premium on the maintenance of a stable macroeconomic environment, notably in the area of prices. However, the existence of a relatively fixed rate of exchange against the US dollar has exposed the economy to inflationary or deflationary impulses. Indeed, the past decade has seen considerable volatility in the inflation rate, almost eight times that in the United States and four times that in Western

Europe. In the current cycle, currency inflows have led to a need to purchase dollar assets to stabilise the exchange rate and it has been difficult to avoid boosting the domestic money supply as a result of these transactions.

Overall, a policy of allowing greater flexibility in the exchange rate would allow the authorities to more easily adapt monetary policy to domestic concerns, so guarding against the risk of any further increase in inflation and allowing market forces to determine bank interest rates to a greater extent. The July 2005 revaluation of the currency, together with the associated change in the exchange rate arrangements, represents a step in this direction.

Imbalances

Understandably, rapid expansion and increased importance of the market have led to income inequalities opening up between people and regions. Nonetheless, absolute poverty has been reduced – indeed, by some accounts, over half of the reduction in absolute poverty in the world between 1980 and 2000 occurred in China. Moreover, even in the poorer western and central areas of China, the growth of incomes has been just one percentage point lower than for the country as a whole. This performance outweighs that of many developing countries, though it pales in relation to growth in the coastal areas of the country.

Increased public spending has helped lessen some of the inequalities in economic development. Programmes are now in place to reduce taxation and illegal fees in rural areas, so boosting incomes. But these policies need to be complemented by a reform of fiscal transfers to reduce the gaps between expenditure requirements and local revenues in the poorer parts of the country. Such initiatives could be usefully complemented by efforts to create a national, or at least provincial, labour market. At the moment, it is difficult for workers and their families to move permanently to a different area and if they succeed their right to rent their farm may be forfeited without compensation. Even for a temporary move, many permits are required and often local publicly-provided services are either not available to migrants or only available on unfavourable terms.

Still, rural-urban migration will bring increased urbanisation that will need to be managed carefully. At present, Chinese cities are more equally sized than those in other economies and government reports have highlighted the benefit of creating agglomeration along the coast and major rivers. Market forces are beginning to influence the residential sector as close to 70% of homes are now owner-occupied. However, the short length of commercial and residential leases (40 and 70 years, respectively) may constitute a barrier to high-quality development as buildings on the land revert to the state at the end of a lease.

Pollution is clearly another challenge. With five of the ten most polluted cities in the world being in China, air pollution is estimated to impose a welfare cost lying between 3% and 8% of GDP. Investments under the last two five-year plans have improved pollution controls markedly weakening the link between economic growth and increased pollution. The key to further improvements will be carefully monitoring emissions from major sites and then ensuring that local environmental bureaux effectively sanction infringements of standards. As in several other areas, this underlines the need for China to step up its institutional reforms and ensure that laws, of which there are many good ones on the books, are actually enforced.

China's economic transformation has been impressive, offering many lessons as well as challenges. These are discussed in detail in the OECD's first ever *Economic Survey of China*. The last decade might be characterised as an era of accelerating reforms; to sustain rapid growth over the next decade, reform momentum will need to be maintained and consolidated.

Explain briefly:
1. Key reforms in business regulation in China supporting development of private sector.
2. Challenges to the macroeconomic stability of rapidly growing Chinese economy.
3. Fiscal redistributions responding to urban-rural population flows.
4. Measures to tackle environmental pollution.