

## ***Economic Transition in China – a Model for Gradualism?***

### **Introduction**

Our discussion about the ongoing socio-economic transition in China as well as the future prospects for this massive and important country must take cognisance of some of the momentous economic policy swings and reversals that have taken place in China's post-revolutionary history. At present we are accustomed to refer to China's economic development and growth as underpinned by very practical and pragmatic thinking, quite free from ideological pre-commitments or radicalism. The often quoted phrase referring to the country's 'socialist market economy with chinese characteristics' very aptly depicts this pragmatism. Second generation leader Mr Deng Xiao Ping kicked off this pragmatism with his dictum 'seek truth from facts'.

However, post-1949 China had not always been like this. In this presentation, I will briefly review some of the main errors of judgment and strategy committed by previous generations of Chinese leadership. Observing that legitimacy in Chinese society today is pre-dominantly derived from economic performance and growth, I will address the question to what extent China's economic growth is sustainable in the long run – say for the next decade or so, coinciding with the new fourth generation of Chinese leaders.

It would be unwise to claim to be able to provide an authoritative answer. However, the 'opening up' in the early 1980s through the welcoming of Foreign Direct Investment was accompanied by a great array of domestic economic reforms. These were, in particular, the reforms in education; the introduction of the household responsibility system; the encouragement of Town and Village Enterprises; the move from a command to a price-determined system; the industrial reform as well as the regulatory reform of the banking sector and the stock markets. These all-together have provided a very comprehensive reform agenda which have realised numerous opportunities for stimulating economic growth.

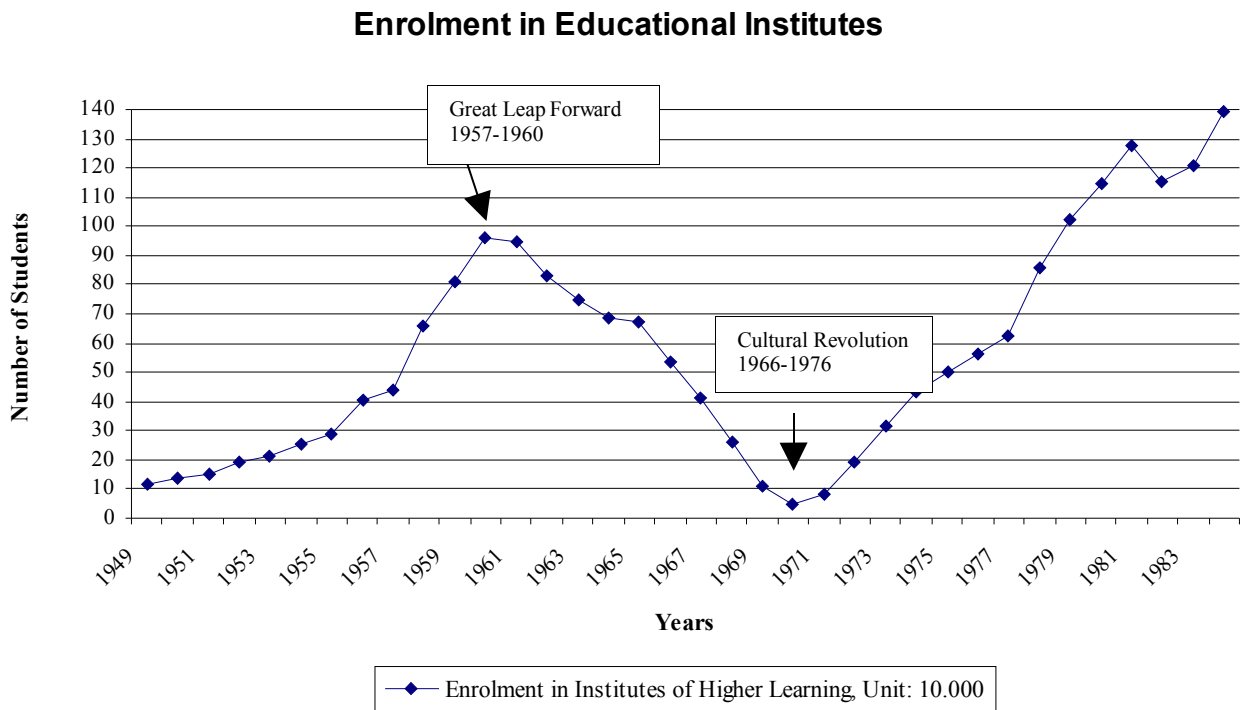
### **Errors of Judgment and Strategy by the Chinese leadership**

Yet, China's early post-revolutionary economic management was characterised by a series of enormous errors of judgment and strategy, in particular during the period 1949 to 1976. Specifically China's 'Great Leap Forward' (1957-60) and Mao's Ze Dong's 'Cultural Revolution' (1966-1976) caused enormous havoc and damage. The extent of these failures and the context in which these misjudgements were allowed to occur, is the subject a sizeable literature, way beyond the scope of this presentation. Their disastrous impact is well known, in particular the 'Great Leap Forward' which starved around 30 million people to death during the 1957-60 period, as well as the purging of some 60 percent of the party officials which took place during the Cultural Revolution.

A revisionist book, published after the death of Mao by leading economists of the State Planning Commission, includes a revealing account of the enrolment in higher learning institutions during the Cultural Revolution. Whereas immediately after the revolution in 1949 only some 117 thousand persons enrolled in higher learning institutes, this number climbed steadily in post-revolutionary China to reach close to one million by 1960. However, then a sharp decline set in, with enrolment falling to just over half a million by 1966, at the start of the Cultural Revolution. At the 'height' of this programme in 1970, the enrolment in higher learning institutions fell to as few as 48 thousand ! As Graph 1 shows, higher education only started to recover after Deng Xiao

Ping's educational reforms launched in the post-Mao era in 1978. Evidently, economic and social development in China could never have taken off without a highly educated human resource base and hence Deng's educational reforms were a key to success. [slide 1]

Source: Liu Suinan and Wu Qungan (1986), *China's Socialist Economy 1949-1984*, p.484,



Such momentous errors of judgment, caused by ideological radicalism and a complete lack of checks and balance on political and military power, have fortunately not been repeated by the subsequent three generations of Chinese leaders. Nevertheless, Deng's legacy of a successful initiation of economic reform and transition has been indelibly tarnished by the ruthless oppression of student opposition in Tiananmen Square in June 1989. He was ultimately responsible as the Chairman of the all-powerful Central Military Commission, which allows semi-retired leaders to pull strings from behind the scenes.

The third generation of Chinese leadership, with President Jiang Zemin and Prime Minister Zhu Rongji, is rightly credited with decisively moving the integration of China into the global economy forward, marked in particular by China's accession to the World Trade Organisation. Nevertheless, significant errors of judgment continued to be made in the political domain. One example was the appointment of an uninspiring business tycoon to Chief Executive of Hong Kong. This Executive's poor and inept handling of the amendment of article 23 of the region's Basic Law brought well over half a million protesting people on to the streets of Hong Kong only four months ago.

The new fourth generation leadership can already take some credit for several early successes – a man in space and attracting the 2008 Olympics to Beijing – but just one year after the National Congress formally appointed them, it is far too early to make any comprehensive assessment.

## Is China's Growth Sustainable in the Long Term?

In present day China, legitimacy is derived from the ability to deliver economic growth and social prosperity. Hence, any evaluation of the new leaders will hinge on the question whether or not China's economic growth and social development may prove sustainable in the long run.

Ever since the profound mistakes of the 1960s and 1970s were corrected, China has been on an enviable stable high-growth path. The country's record performance in terms of GDP growth is well known and for sake of brevity I shall take this as read. The growth performance sharply contrasts with the slow-down in the major countries of South East Asia (Indonesia, Philippines, Thailand, South Korea and others) in the context of the Asian financial crisis of 1997-1999. The Chinese growth performance is also a contra-distinction to the very chequered and unstable growth performance of Russia as well as most of the countries in Central and Eastern Europe (CEECs). Does China's success in avoiding such collapse demonstrate that its strategy of gradualism and pragmatism, at least post-1978, was superior? Or were its 'initial conditions' so much more favourable as compared with Russia or the CEECs? [slide 2]

**Table 1**  
**Key Differences in China and Russia's**  
**'Initial Conditions' for Economic Reform**

	<b>China (early 1980s)</b>	<b>Russia (early 1990s)</b>	<b>Implications for Chinese Reform</b>
<b>Surplus Labour &amp; Rural Underemployment</b>	<i>High</i>	<i>Low</i>	<i>Low-wage Export-oriented Industrialization remains feasible</i>
<b>Difference between Agricultural and non- Agricultural Income 'Urban Bias'</b>	<i>High</i>	<i>Modest</i>	<i>Comparatively easy to move people out of agriculture to TVEs and/or SOEs</i>
<b>Dominance of Industrial State-Owned Enterprises</b>	<i>Low/Modest</i>	<i>High</i>	<i>Extent of lay-offs due to restructuring more limited and manageable</i>
<b>Social Expenditure from Central Government</b>	<i>Low</i>	<i>High</i>	<i>Fiscal pressure more manageable</i>
<b>Level of Agricultural Subsidies &amp; State Ownership in Agriculture</b>	<i>Low</i>	<i>High</i>	<i>Fiscal pressure more manageable; lesser pressure from interest groups eg state farms</i>

Hence, my tentative answer is that the ‘initial conditions’ from which reforms were started were indeed so much more favourable in China than in countries such as Russia which had a much longer history of inefficient state-sponsored industrialization and agriculture. Nevertheless, the ‘right’ strategy was also essential to take advantage of these favourable conditions. Here I think in particular about the focus on education to create human resources, as well as decentralizing decision-making at the levels of municipalities and towns and villages in particular.

But will the ‘right strategic choices’ mean that China’s growth is sustainable in the medium to long term – say, throughout the next decade? The recent Global Economic Projections 2004 by the World Bank does indeed seem to suggest this, as it projects high growth for East Asia into 2015 with a growth path of 6.2 per cent per annum for the East Asia sub-region, implying a continuation of Chinese growth of at least 7 to 8 per cent (World Bank, 2003, Appendix 3, p. 280).<sup>1</sup>

But will the new leadership be able to deal with the manifold challenges and risks of political dissent and the need for greater openness and transparency; with the risks posed by food and energy insecurity; environmental degradation; growing inequality between and within regions, in particular growing urban poverty; the inadequacy of social security systems except for a very few; the massive inter-sectoral and inter-regional migration and, amongst others, the ever increasing stock of non-performing loan portfolios? Will it be possible to manage all these enormous challenges in an orderly fashion?

All of these challenges will need their own specific answers. I believe that the two most important determinants for continued growth will be the (i) slowing down the growing inequality between urban and rural areas as well as urban poverty and between regions in general (ii) the success in managing internal migration. Of course, migration between sectors and regions and managing growing inequalities are closely linked.

### **Growing inequality - The case of China**

Let me briefly elaborate the theory about the distributional effects of opening up the economy. In the case of trade liberalization, relative prices of the products will change – relative prices of imported goods will reduce. This will enable gains for consumers whose welfare is improved as they can now obtain these goods cheaper. However, there are also losses for import-competing industries.

Will the owners of the different factors of production (labour, land and capital in particular) gain in equal measure? Or will the distribution of gains be different – with one of the factors gaining more? The Stolper-Samuelson theorem shows that in full-employment equilibrium an increase in the relative price of capital-intensive products will increase the return to the factor capital. And conversely, an increase in the relative price of labour-intensive products will increase the return to labour.

Hence, the standard neo-classical trade theory would suggest that the first case is likely to increase inequality, whereas the second case is likely to reduce inequality.

However, if we move away from the restrictive assumption of full employment, the picture will change fundamentally. In case of unemployed labour resources, the likely gains or losses for labour are determined by the ‘volume’ effect only – increased (or reduced) demand for labour. But the wage levels will remain unchanged (i.e. at minimum wage for the sectors where this is

effectively enforced and near-subsistence wage in labour surplus sectors of the economy). In this case the likely impact of increasing openness of the economy is an *increase in inequality*.

It is much beyond the scope of this presentation to go into the empirical assessment of all the factors at play. To make such an assessment, we would have to look at many different types of labour, distinguishing between skilled and unskilled people, between doctors and lawyers and industry workers and unskilled workers, as well as between rural and urban, agricultural and non-agricultural sectors .

My view about the situation in a developing economy such as that of China is that its international trading capability is constrained by the lack of high skilled labour – managers, IT-professionals, engineers, designers, supervisors, accountants, economists. These forms of human capital will be at a premium in the opening up of production and trade. Hence, for the well-qualified professional there isn't much reason to be afraid of globalisation – indeed, they should be expected to be clamouring for more of it.

But at the level of the aggregate national economy things will not look all that rosy. Industrial workers and small peasant workers will stay as they are – or may be worse off if their services are no longer demanded. At the aggregate level, the level of inequality is likely to increase. Owners of scarce factors of production (capital, land, high-skilled labour and social capital) are bound to gain disproportionately.

At the end of the day, the bill will be presented to the fortunate few, as growing inequality has numerous social costs. Here I am in particular thinking of growing crime, the need for spending on personal protection and security and the increased threat of violence.

## **I. Internal Migration – The case of China**

Let us examine now the Chinese migration context in somewhat more detail. To derive at the migration impact of the ongoing reform and restructuring – bound to be accelerating with WTO entry – one has to look at the medium-to-long term policy objectives as well as the key instruments used to effect these. Impacts on growth and on labour demand will be assessed and some qualitative conclusions for the migration implications will be derived.

The push and pull factors for internal migration operate in the context of the economic restructuring and the opening up of the economy. I shall discuss these factors for four sectors of the economy, distinguishing between the rural economy (with some 900 million persons involved or dependent on it) and the urban economy (300 million persons).

The rural economy must be distinguished into those sub-sectors where agriculture is the main or only source of livelihood and the rural non-agricultural sector which rely on the provision of services for agriculture as well as the famous town and village enterprises (TVEs) – one of the most dynamic parts of the Chinese economy. For the urban economy one should distinguish between the industrial and the services sectors, in view of their radically different profiles in terms of material and human capital and also their prospects for the future.

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**TABLE 2: LINKAGES BETWEEN OPEN ECONOMY REFORMS AND MIGRATION  
-- People's Republic of China Post -WTO Membership**

<b>Sector of Employment</b>	<b>Key Medium/Long Term Policy Objectives</b>	<b>Key Policy Instruments</b>	<b>Key Impacts on Growth and Labour Demand</b>	<b>Migration Implications</b>
<b><i>RURAL Agricultural</i></b>	<ul style="list-style-type: none"> <li>Reduce agricultural production prices to less than world price parity levels</li> </ul>	<ul style="list-style-type: none"> <li>Reducing tariffs on imports</li> <li>Scrapping the Grain Management System</li> </ul>	<ul style="list-style-type: none"> <li>Accelerate growth, but sharply reduce labour demand (approx 75-80 million persons between 2000-2010) -- 8 mln annual reduction</li> </ul>	<ul style="list-style-type: none"> <li>Strong push factor for rural to urban migration</li> </ul>
<b><i>RURAL Non-Agricultural</i></b>	<ul style="list-style-type: none"> <li>Increase efficiency of SME industry and service delivery (TVE's)</li> </ul>	<ul style="list-style-type: none"> <li>Enhance management and profitability of TVE's</li> </ul>	<ul style="list-style-type: none"> <li>Continued fall in number of TVE's as well as limit on labour absorption , (much below historical record of absorption of 7 million annually)</li> </ul>	<ul style="list-style-type: none"> <li>Reduced opportunities for peasants to stay in rural areas</li> <li>Estimates of 'Floating' rural-urban workers at 100 mln bound to rise</li> </ul>
<b><i>URBAN Industrial</i></b>	<ul style="list-style-type: none"> <li>Reduce labour hoarding in the SOEs to increase profitability and efficiency</li> </ul>	<ul style="list-style-type: none"> <li>Privatisation, lay-offs and closure of SOE's</li> <li>Financial discipline and AMCs to address non-performing loans</li> </ul>	<ul style="list-style-type: none"> <li>Estimated loss of employment of 25 million persons</li> <li>Very few new jobs in industry</li> </ul>	<ul style="list-style-type: none"> <li>Reverse urban to rural migration, with focus on TVEs</li> <li>Push factor for international migration</li> </ul>
<b><i>URBAN Services</i></b>	<ul style="list-style-type: none"> <li>Increase Competition in Service sectors (retail, banking, insurance, administration)</li> <li>Build up social security system</li> </ul>	<ul style="list-style-type: none"> <li>Open up distribution sector to foreign competition and invite foreign investment</li> </ul>	<ul style="list-style-type: none"> <li>Increase of employment opportunities (but limited)</li> </ul>	<ul style="list-style-type: none"> <li>Push factor to international migration.</li> </ul>

Thus the overall implication is one of a massive migration within China – with some 100 million people to leave the rural agricultural sector over the next ten years. As discussed, the absorption of this enormous flow into the other three sectors of the economy is bound to be problematic.

Outward bound flows and international migration is a likely ‘side –effect’ of the enormous structural change that is taking place. Some of these Chinese citizens will be destined for the OECD countries, including Japan, the United States and the EU. In my view, this is the inevitable positive correlation between the globalisation (here signified in the WTO membership) and international migration.

The Doha Development Agenda, once brought back on track in the 6<sup>th</sup> Ministerial meeting in Hong Kong, CHina some time late next year, should include a full discussion of the ‘temporary movement of natural persons’ – a component of trade in services under the GATS agreements – and include agreements on the type and extent of such migration between ‘sending’ developing countries such as China and ‘receiving’ OECD countries, including the EU. In my view this issue should have been given greater importance at the EU-China summit.

### **Concluding Remarks**

The odds for Chinese continued growth are basically good because of the basic structural factor of a comparatively low-wage surplus labour economy still holds true. The constraints and risks relate primarily to natural resource scarcity -- energy and environment-- as well as of a political nature -- with demands for greater openness, more effective governance and reduced inequality. Even though the political rhetoric of the late 1980s counselled against 'bourgeois' liberalization, it can hardly be denied that much of what actually happened in the 1990s may be aptly described by precisely that term.

The policy approach has been very gradual indeed -- China is taking a long time to unbundle its state-owned enterprise sector and it is also not very effective in addressing its the issue of the non-performing loans, which is closely linked. However, the success was not so much a matter of the right pace, but rather more a consequence of the favourable starting position.

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<sup>i</sup> The Projections are based on several 'optimistic' assumption regarding energy prices, in particular a long term decline in the real price from 27.4 \$ per barrel to 20.6\$ by 2015. As China will be a major importer of oil and other energy sources, this may be considered too optimistic.