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# **Institutional Reforms in a Developing Country: Transition in China**

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## **The Dual-Transformation of China: Past 20 Years and 50 Years ahead**

### **Summary**

China has been facing two sets of problems – as a low-income rural society and as a planning system. The institutional transformation from the socialist planning regime to a modern market has been constrained by its low level of economic and social development. Therefore, it is highly important to understand the “historical phase” of the development. Thus the “optimal path” of transition must be different from those countries that manage the reforms at higher level of development. It will take much longer time to reach the “objective model” as the institutions must be compatible with the economic and social maturity. Any “pre-matured” radical changes may lead to crises and backlashes.

Meanwhile, the key issue for China is how to keep the “compatibility among the institutions” to avoid any “bottle-neck” problem, such as slow political reform with rapid economic changes.

China has been one of the world's fastest growing economies in the past 20 years and has also achieved remarkable progress in the institutional transformation towards a market system. However, at the same time, people have kept asking throughout those 20 years, just as they do at the present moment, (1) where China is heading or transiting to, both in the next step and in the long-term perspective, and (2) whether China is likely to collapse due to any of the current economic, social and political problems.

This paper is an effort to answer these two questions.

## **1. The complexity of the “dual transformation” process in China**

China differs from Eastern European countries because it is a low-income, rural-society-based developing country. At the same time, China differs from other developing countries, like the Southeast Asian economies, because it is a “transition economy” sharing with Russia and Eastern European countries many similar problems, such as state-owned enterprises and government control. And China is a big country with a population of 1.2 billion, which makes any problem tougher and more difficult to handle.

This argument means that while other countries may be facing one set of problems, related either to “development” or “transition”, China faces two at the same time. It is simultaneously undertaking to transform the rural economy into a modern society and the planning economy into a market system. It is this dual nature that makes the transformation process in China more difficult, as the two sets of problems complicate and amplify each other. For instance, the legal reform in China involves not only changing one kind of laws or rules into another, but also a process of building up the whole concept of the “rule of law” and the whole set of accompanying institutions, starting from the initial condition of a rural society with a specific, “medieval” legacy of Chinese history. After the laws have been set down on paper, a large body of court interpretations needs to accumulate to get these laws firmly established in practice.

Such a dual nature of the problems faced by the economy determines the time horizon of the dual transformation: it will unavoidably take China a long time to build up an orderly, functioning market system. The past twenty years have been only the first phase and it will be no surprise if we take another 20, 30, or 50 years to fulfill our objectives. In general, institution building is a long-term process anyway. Seventy years may not be too much for a transformation from a “medieval” society to a modern market economy, compared to how much time Western countries have taken since the 17<sup>th</sup> century and bearing in mind that China did not benefit from colonialism.

Such a historical, long-time perspective is necessary to understand the current situation. Hard problems are so easy to find that they are hardly newsworthy, because the country is and will remain beset by all kinds of adversities for a long time. The real news should be changes – for better or for worse – which have come about since yesterday, and development trends for tomorrow. The question should not be whether China has problems, but whether China can develop quickly enough to close the gap to the advanced market economies. The banking sector, for instance, is poorly developed, but just 5 years ago, all the state-owned banks were not yet really banks, merely serving as government departments for financial resource reallocation. The corruption stories are disgusting, but the very fact that you can read about such stories (even if just selected ones) in official newspapers constitutes progress in many respects. A picture carried by major Western media of a garbage-collecting family with a monthly income of USD 50 is depressing and touching, but the most important thing was missing from the report: namely, that the family used to earn probably as little as USD 5 only yesterday, before they moved out from their home village in the mountains. The overall political stability that has puzzled many observers is fundamentally based on the fact that most interest groups in society have become better off in many respects over the past 20 years and still have expectations for a further improvement, no matter how difficult their current situation is. It should not be a puzzle at all if we look at it from a historical perspective.

## **2. The state sector reform and the development of the non-state sectors**

It has been pointed out by many commentators that the most serious economic problem in China is the situation of state-owned enterprises (SOEs). Inefficient SOEs have increasingly hampered economic growth. Unemployment among former state employees is the major cause of local-scale social unrest. The mounting non-performing loans owed by SOEs to state banks have caused a credit crunch that contributes to the on-going deflation. And the SOE reform does not seem to have achieved real progress in most of the large-sized SOEs. These problems have led some analysts to claim that China was (and is) on the verge of collapse and its economic growth would soon stop.

It seems puzzling, therefore, that China has not collapsed and growth continues and will continue in the foreseeable future.

The key to understanding this puzzle is that economic growth in China is now mostly supported by the non-state sectors (NSS), rather than the state sector. The non-state sectors, which consist of private companies, self-employed persons, share-holding corporations, joint-

ventures with foreign investment, and community-owned rural industries, a great part of which are actually private undertakings, now contribute 74 per cent of the industrial output, 62.2 per cent of the GDP, and has attained an over-100 per cent increase in employment (See Tables 1 & 2 ). This means that even though the state sector's problems have become worse and worse, the importance of SOEs has been decreasing in view of the overall economic growth and development of market economy.

**Table 1: Main indicators of the development of the NSS (%)**

Year	Share in total industrial output	Share in newly-employed labor	Contribution to fiscal revenue	Share in fixed investment	Share in retail sales
1978	22.4	28	14.1		45.4
1980	24	36.4	23.3	18.1	48.6
1984	23		23	33.9	
1990	45.4	39.5	28.7	33.9	60.4
1992	51.9	50.2	28.7	32	58.7
1994	62.7	58.9	28.6	43.6	68.1
1996	71.5	65.6		47.6	72.8
1997	68.4*	201.5**		47.5	76.7
1999	71.8*	564.0**		46.6	

*Source: 1978–96 from China Reform Foundation, 1997, p. 219; the remaining years from China Statistical Yearbook 2000.*

*\* Data have been adjusted for certain types of ownership (China Statistical Yearbook 2000, p. 409).*

*\*\* The figures reflect the change of the statistical definition of employment in various sectors: from 1997 onward, all employees working in a reformed enterprise (a former SOE) are no longer counted as state-sector employees, but included in the non-state sector. The statistics also reflect the fact that the state sector is laying off, and the non-state sector is increasingly employing. See also Table 2.*

**Table 2: Contributions to the increase of non-farming jobs by state and non-state sectors respectively**

Year	Total Increase of non-farming jobs (millions of persons)	New employment of state sector as % total increase	New non-farming employment of non-state sector as % total increase
1990	37.28	6.38	93.62
1991	8.33	38.18	61.82
1992	14.10	15.96	84.04
1993	24.03	1.29	98.71
1994	11.66	25.21	74.79
1995	21.83	2.15	97.85
1996	17.02	-1.00	101.00
1997	1.97	-101.52	201.52
1998	4.28	-464.02	564.02

*Source: China Statistical Yearbook, 2000.*

The most important feature of China's "gradual" or "incremental" approach to institutional transformation so far has been the development of the market-oriented non-state sectors, not the reform of the state sector<sup>1</sup>. The low level of industrialization and nationalization (never reached 20 per cent in terms of the proportion of state employees in the total labor force) allowed China to rely on its vast rural and "non-state" labor force to expand the new sector first without reforming the old sector for a while. In comparison, Russia did not enjoy this "luxury", because without releasing all the resources from the state sector, the new system would hardly have got started<sup>2</sup> (Sachs and Woo, 1993).

The reform of SOEs has long been delayed, compared with the "radical approach to reform" in some other countries. But one of the key elements of the "incremental approach to reform" is that the development of new sectors and changes of economic structure should create and improve the conditions for the reform of the old sector:

<sup>1</sup> Fan, Gang (1994), "Incremental changes and dual-track transition: understanding the case of China", *Economic Policy*, Great Britain, December.

<sup>2</sup> Sachs, Jeffrey and Wing Thye Woo (1994), "Structural Factors in the Economic Reforms of China, Eastern Europe and the Former Soviet Union," *Economic Policy*, April.

- The growing competition from the non-state sector brought down the monopolistic profits of SOEs and pushed them into the corner of financial difficulties. Without such difficulties, no one would like to accept the reform programs.
- The jobs created by the non-state sector prepared the ground for the “mass lay-off” in the state sector. The overall economic growth supported by the growth of the non-state sector also allows the government to mobilize some resources to compensate the unemployed state workers. As a result, over 15 million state employees have been laid off in the past 5 years, without causing major social instability.
- Because the growing private capital and entrepreneurial capacity, the “reform” takes a form closer to “taking-over” than to merely “dismantling”. As the non-state companies are not yet big enough to take over large-sized SOEs, privatization has been mainly restricted so far to small and medium-sized SOEs, except for a few cases of a joint-venture between large SOEs and foreign investors. Some reports show that in certain regions over 70 per cent of small SOEs have been privatized one way or another, including employee and management buyout and conversion into so-called “employee share-holding company” as the first step of reform.

Although many large SOEs are not yet ready to be reformed, the conditions will be surely improving with the further development of the non-state sectors.<sup>3</sup> The recent reform policies adopted by the central government have not only reconfirmed the direction of “restructuring the property rights”, but also introduced some more concrete steps towards the “diversification of ownership” by offering “executive stock options” and a further reduction of state holding in the listed companies, which were previously un-tradable.

### **3. The dynamic evolution of the “Objective Model” of the transformation**

Some questions may emerge from the above discussion of reforms about where China’s economic system is heading and what is the real meaning of the officially declared reform objective of “socialist market economy”.

To answer such questions, it may be useful to look back at how the official line was drawn at various points during the past 20 years. Box 1 shows that the official “objective formula” has kept changing and evolving (in the same direction) constantly over the past 20 years, from “planned economy supplemented with the some market elements” in 1979 to

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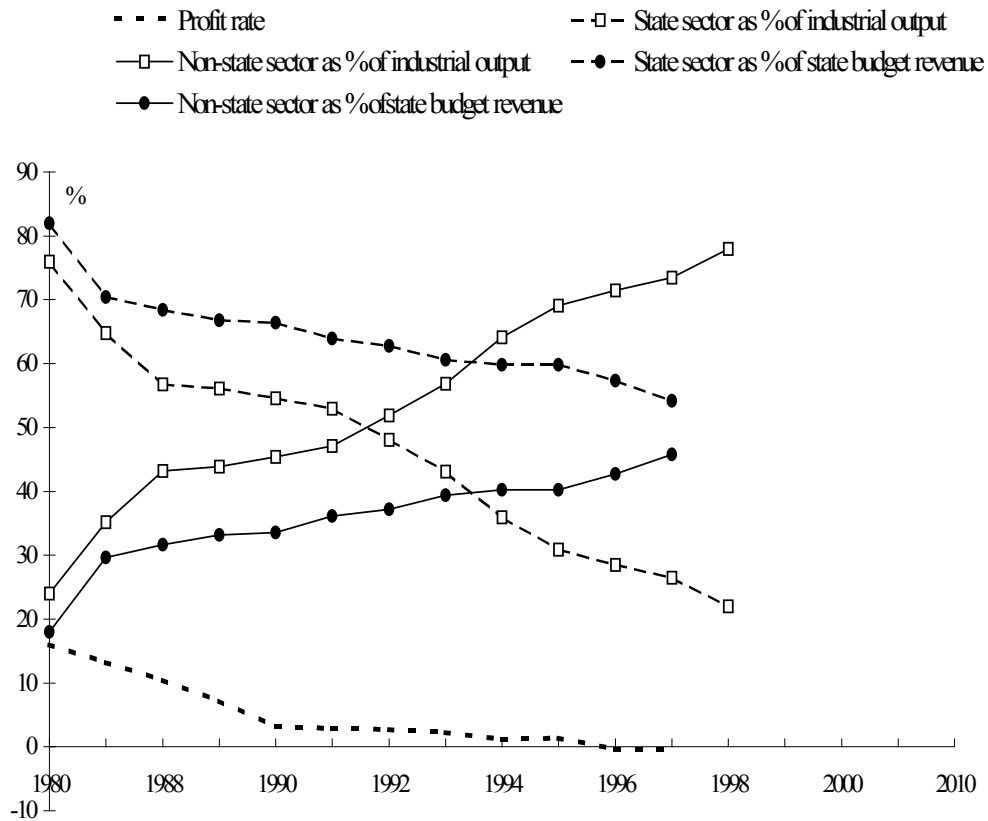
<sup>3</sup> The author once wrote in a syndicate article, published in some European newspapers, that “in some sense, a West Germany is emerging in China in the process of reforming East Germany”.

“socialist market economy” with the withdrawing of SOEs from most “competitive industries” and the introduction of “mixed ownership”.

From this point of view, it does not seem very meaningful to spend too much time to clarify “what is” the current official objective. A more useful exercise is to analyze when, why and in what direction the objective changes. Such an analysis reveals that nothing is left to chance and the logic of political economy prevails. For instance, a major policy shift took place in 1993, when the words “socialist market economy”, replacing the “planned economy”, were first adopted by the “Reform Decisions” of the Central Committee of the Chinese Communist Party (CCP). This move followed the previous year’s announcement that the share of the non-state sector in the industrial output had exceeded for the first time 50 per cent (see Figure 1). In 1996, the state industrial sector as a whole suffered its first ever “net loss”. Then, in the following year, the CCP adopted the policies of “diversifying ownership” and “developing private sector together with the state sector”. Then, in 1998, the Constitution was amended by adding the provision that “Private ownership enjoys equal protection and promotion as state ownership”. In short, the definition and contents of “socialist market economy” change over time according to the changing circumstances. With the further growth of the private sector and private business community, which serves as the main basis of the economic prosperity and social stability, the Communist Party has recently started to invite private “millionaire” businessmen to join the Party (see Box 1). There is no doubt that the official “objectives” will keep changing in the same direction.



**Fig 1 Political Economy Dynamics of China's Transition**



It may be correct to say that the lack of clear-cut reform objectives is a major weakness of the Chinese transformation. But talking only about “what is achievable and acceptable” without specifying a “final destination” may have its pragmatic virtues and save a lots of political costs.

**Box 1: The gradual evolution of the official “Formula” of reform objectives since 1978**

<b>Time</b>	<b>Formulation of reform objectives</b>
1978 – Oct. 1984	Planned economy supplemented with some market elements
Oct. 1984 – Oct. 1987	Planned commodity economy
Oct. 1987 – June 1989	“The state regulates the market and the market regulates enterprises”
June 1989 – 1991	“Organic integration of planned economy and market regulations”
1992	A share-holding system and a (newly started) security market can function under socialism
Oct. 1992	Socialist market economy
1994	“Corporatization of SOEs and reform of property rights”
1997	Developing the state sector together with all other kinds of ownership; “holding on to large SOEs while letting small ones go to the market”.
1998	Constitution amendment: private ownership enjoys equal promotion and protection
Oct. 1999	SOEs withdraw from competitive industries; diversification of ownership of corporate and “mixed ownership”; executive stock options for SOEs.
July 2001	“Three representative functions of the Party”; permission for owners of private and individual enterprises to be Party members; further development of various ownership forms.

*Source: various official documents of the CCP Central Committee.*

**4. Can the reform and growth continue for another 20 years? Pitfalls and ways-out**

Why “20 years”? First of all, the destruction of an institution is easy and can be accomplished overnight, but institution-building takes time. For a country like China, it may take much longer to build up modern market-based institutions, including all that is required

by the rule of law. Second, it may take 20–40 years for China to finish its industrialization process, during which more than 400 million rural laborers will have to find new jobs in non-farming sectors in the current global environment of technological revolution and over-supply.

There are many obstacles and potential explosive issues which may cause crises or a “collapse” and stop the process of transformation and economic growth. Some major economic problems include, among others:

- huge non-performing loans and financial risks;
- large numbers of the unemployed and social unrest;
- income disparity in general, and
- regional disparity in particular;
- rural poverty;
- challenges of globalization;
- corruption and government reform.

The discussion of these issues will show that despite the great difficulties in dealing with the problems, there are still some ways out.

#### **4.1. The financial risk**

China is now notorious for its high percentage of non-performing loans (NPL) in its state banking system. The official estimate of the NPL/total credit ratio in the major state banks was about 26 per cent in 2000, and 24 per cent in 2001, equivalent to about 25 per cent of the GDP. If we add the NPL transferred to the Asset Management Companies (AMC), which were specially designed to deal with the NPL, the total NPL/GDP proportion might be estimated at as much as 40 per cent. This may be one of the highest ratios in the world.

In some sense, a domestic financial crisis has continued in China since 1996. Indeed, the high level of non-performing loans owed by SOEs to the state banks has caused a sort of credit crunch since 1996. The monetary authorities and the banks have had to tighten the financial discipline and to take risk control as their first priority. As a result, the volume of new credits to SOEs has been reduced and some kind of monetary contraction has ensued that contributes to the on-going deflation since October 1997. It is the high level of non-performing loans and the insolvency of the banks, in comparison with some other Asian

countries, that lead people to believe that a financial collapse in China is highly probable in the near future.<sup>4</sup>

But some elements necessary to make a correct judgment of China's financial situation and a valid prediction of a crisis are missing here.

One of the major reasons for China's high-level NPL is that the government shifted all its fiscal responsibilities for SOEs to the state banks in the mid-1980s. Since that time, the government has provided neither equity investment, nor subsidies for SOEs, all the needs of which have been met by the state banks instead, in the form of loans. From this point of view, the non-performing loans owed by SOEs to the state banks are actually quasi-government deficits. But at the same time, it is a serious mistake not to take into account the situation of the government budget in the assessment of overall financial risks. The reality is that while the NPL level is extraordinarily high compared to other countries, including some Southeast Asian economies, China's government debt has remained extraordinarily low by world standards. At the end of 2000, it was only equivalent to less than 14.5 per cent of the GDP. Such a comprehensive picture<sup>5</sup> (see Table 3) explains why China still enjoys some financial stability despite the high-level NPL and why the Chinese government is still able to mobilize resources to stabilize the economy, including the use of debt-financing as an expansionary fiscal policy instrument to deal with the deflation. It also explains why China remains capable of keeping the growth and reform going.

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<sup>4</sup> See Nicholas Lardy, 1998, "China's Unfinished Economic Reform", Brookings Institute.

<sup>5</sup> We may define the sum of government debt, NPL, and total foreign debt as the "government comprehensive liability" for China, being an indicator of the financial risk of the economy. An international comparison based on a similar calculation for Southeast Asian countries shows that China's overall liability is not too bad (about 50 per cent), as compared with 73–114 per cent in the other countries. See FAN Gang, 1999.

**Table 3. Financial risk indicators in Chinese economy**

<b>2000</b>	<b>%</b>
NPL over GDP – official statement	<b>25</b>
Liability of AMCs over GDP	<b>16</b>
Government domestic debt over GDP	<b>14.5</b>
Total foreign debt over GDP	<b>15</b>
Current balance of the social security system	<b>0</b>
<b>Overall national contingent liability</b>	<b>70.5</b>
GDP Growth rate	8
Budget deficit as % of GDP	2.8
Interest rate on government bonds (1 year)	2.4
Growth rate of budget revenue (3-year average)	19
Current account balance USD billion	20.5
Capital account balance USD billion	1.9
Total short-term foreign debt over GDP	1
Foreign exchange reserve, USD billion (until Sept. 2001)	200.1
Inflation rate	0

Meanwhile, China's external balance remains quite manageable, too. Both the current account and capital account are in surplus, and the foreign exchange reserve has risen to USD 220bn by now. Foreign debt has been well serviced so far, and the short-term debt over GDP ratio is also extraordinarily low, amounting to just 1 per cent. In addition, China's capital account is not opened yet, and the portfolio investment is minimal. Therefore, it seems safe to say that there will be no financial crisis in China in the foreseeable future, similar to those which occurred in some Asian countries in 1997–8.

The solution to the NPL problem and the way to ensure eventual financial stability will depend, of course, on the reform of SOEs and the banking sector, which will take as long to accomplish as will the whole economic transformation. The good news is that some kind of

consensus has been reached among policy makers and bankers at all levels, who all agree that strenuous efforts are needed to stop the growth of NPL.

#### 4.2. Unemployment

To avoid confusion and misjudgment of the problem, it should be noticed that there are three kinds of unemployment and under-employment in China.

First, the **unemployment of urban labor**, reflected by the official “urban unemployment rate” (about 3.5 per cent of urban labor force in recent years). It is mainly accounted for by newcomers to the urban labor force, by people in transition between jobs, and by people who have been laid off in the private sectors. The formally registered urban unemployed are covered by an unemployment insurance managed by the social welfare department of the government.

Second, the **rural under-employment**. There is a total of about 600 million rural laborers, of whom 200 million have become engaged in non-farming activities (about 100 million have already settled in cities), and 70 per cent of the rest are actually underemployed, cultivating very small plots of household land. However, the rural people are never considered as totally unemployed, because every rural inhabitant is entitled to a piece of farming land, small though it may be. Therefore this group should be categorized as “under-employed”. The high level of underemployment drives rural people out (of rural areas or of agriculture), in search for better-paid jobs in other places and other industries. If they find such jobs, they are better-off; if not, they may return to their land as the last resort, to get a livelihood (or find “security”). But the employment of rural people has never been the responsibility of the government. They have never been covered by any government-run social-security program, either, even under the previous socialist welfare system. From this point of view, rural under-employment is in principle not a short-term political issue, and the rural people in fact do not expect the government to solve their job problems.

In the long run – in, say, 40 years – bearing in mind the population growth, a total of 400 million rural laborers may have to be reallocated to non-farming industries. Otherwise, the increasing urban-rural income disparity may cause great social instability.

Third, the **laid-off former state employees**. This is a real political problem by nature. The laid-off state workers had been guaranteed employment for life by the government under the previous, implicit or explicit, socialist “social contract”. The reform put them out of jobs. But so far the laid-off state employees are protected under some special arrangements as they retain a special status of “off-post workers” (*Xia-gang Zhi-gong*). With this special status,

they are entitled to receive a certain minimum payment (higher than the unemployment insurance payment), re-training programs and several job offers during the 2–3 year period after being laid off. In 1997–2001, more than 23 million state workers became laid off. But so far the problem seems manageable in terms of social stability, as the laid-off people are protected relatively well by the government. Under the best scenario, their number might drop to 20 million in the near future. But no one assumes this should happen overnight.

While the figures pertaining to the first two kinds of unemployment (under-employment) may change with the macro-business cycles, the third one is mainly an institutional issue, independent of the cycles – some people must be laid off simply because the reforms proceed. More importantly, the first two kinds of unemployment do not seem very troublesome politically, whereas the mass lay-off may pose a danger to social stability.

But it should be noticed that, with the changed overall economic conditions, the lay-offs have become politically more acceptable in the past years:

- The SOEs concerned are already troubled by financial difficulties and many of them are unable to pay the workers anyway. Most worker protests in the past years have been caused by the delay (6 months, 10 months, etc.) in wage payment. Without much hope for improvement, people realize more and more clearly that the SOEs are no longer reliable as a guarantee of employment and income growth. In short, staying with SOEs becomes less and less attractive a choice.
- Meanwhile, after 20 years of development, the non-state sector now provides many more jobs. The possibilities of finding a new job in the non-state sector (or just simply becoming self-employed) and getting better paid are both increasing, assuming that overall growth continues. In other word, to leave the SOE sector increasingly becomes a viable alternative.
- The lay-off package for the workers normally enables them to keep some benefits they enjoyed in the SOEs. The government has increased the expenditures on the so-called “Urban Reemployment Centers” in the past two years and consequently has improved the financial situation of the unemployed.<sup>6</sup>

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<sup>6</sup> In 1998, a new program was introduced by the central government, i.e., the “Urban Re-employment Center”(URC). The key new element of the URC is that the lay-off and re-employment should be financed by 3 parties, i.e., the central government, the local government, and the company, instead of only the company as before. This apparently has improved the situation of the laid-off people. According a Ministry of Labor report,

In conclusion, it seems that China can still manage mass lay-offs involving 3–5 million employees each year in the near future, without running the risk of major social unrest.

The real problem for China, however, is how to create jobs for the 400 million rural laborers in the coming decade. Obviously, this is tantamount to the question of whether China can continue its growth for the next 40 years.

#### **4.3. Income disparities**

The increasing income disparity between groups, regions and rural vs. urban populations has become a major economic and social problem since the beginning of the reform. Consequently, increasing concerns and complaints are voiced about all these disparities, although they have not as yet given rise to major conflicts or social unrest. But the following facts should be kept in mind:

1. The starting point of China's economic and social transformation was an over-equalized society under the former socialist regime. The introduction of the market system means in itself an enlargement of income differentials, without which the old system would still prevail in China. From this point of view, the disparity is introduced deliberately and is seen as a good thing. For example, there must be lay-offs and there must be a relative decrease of the state employees' income, in order to reform SOEs and develop the private sector at the same time.

2. In the past 20 years, a large majority of the population, including most inhabitants of poor rural areas, have been better off in real and absolute terms, although the relative position of some groups may have deteriorated. This situation is fundamentally different from the case when a large proportion of the population is worse off in absolute terms. The groups who end up being worse-off are mainly older state employees over 40–45 years of age. They have been laid off and find it especially difficult to get new jobs. However, as a generation who remembers the shortages and hunger of the 1960s and 1970s, they seem more tolerant to the current difficulties (compared to the younger generations, who benefit the most from the reform and growth), because of the feeling of overall improvement. Even so, they still strongly oppose the reforms and succeed in slowing down their pace.

3. With a population of 1.2 billion inhabitants, most of whom still live in the countryside, hoping for better income jobs in non-farming industries, China's wage level for

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the percentage of workers who got paid in time increased to 97 per cent in 1998 from the previous year's 12 per cent.



the blue-collar workers could remain very low for a long time. At the opposite end of the spectrum, with the growth of the financial market and high-tech industries, a small group of white-collar people may soon catch up with the international income standards. Therefore, the problem of income disparity may be a long-lasting one. China has to face it, as long as it intends to achieve economic development. It is hard to expect from the government to do much about it, if it is committed to the market-oriented reform and economic growth.

The key policy issue here is not how to make a government “income policy” narrow the gap, but how to ensure that the majority of the population are better off in absolute terms, while sustaining the overall economic growth. In this regard, the further promotion of labor intensive industries, together with the development of “high-tech” branches, could be the right policy to increase the income of the vast majority across the board.

#### **4.4. Regional disparity and mass migrations**

As a result of rapid opening up and growth of the coastal regions, regional disparity becomes one of the most sensitive political issues in China.

The problem should not be exaggerated, however. The decentralization of the government and the increase of regional economic differences do not necessarily lead to attempts at a “split-up”, as speculated by some observers.<sup>7</sup> China is now much more integrated than ever, as the market forces bring benefits to all. The poor regions are more dependent on the rich regions’ labor market, capital flows, and technology transfers; and the rich ones (like Guangdong) rely more than ever on the markets and resources of the other areas. Every region has its own reasons to complain about the “disparities” one way or another. But it is clear that having an integrated national market is in everyone’s interest.

Meanwhile, there are other factors that contribute to narrowing the gap in per capita income between regions.<sup>8</sup>

- As the living standards and labor costs (as well as land costs) have continued to grow in coastal regions for the last couple of years, investment, both foreign and domestic, has started to move inward to central China, along the Yangtze River. Growth rate in

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<sup>7</sup> We do not discuss ethnic factors in this paper.

<sup>8</sup> It should be noticed that part of the problem of regional disparities is institutional. For example, the slow growth of the Northeast regions has been mainly due to the concentration of SOEs in those regions. From this point of view, the problem will not be solved until the reforms advance.

those regions (such as Anhui and Hubei) has already exceeded that of the coastal regions in the previous 3 years.

- The government has started to increase fiscal transfers to and investment in the interior regions, although still on a very limited scale. Recently, the central government has announced a plan of further “exploration” of the West that would be a major part of the Tenth Five-year plan for 2001–2005.
- Migrations play an important role. People have started to move out of poorer regions to richer regions, looking for better-paid jobs. A working population of over 200 million has migrated to such places as the coastal cities. In the long-run, migration may be the only way for some regions to increase their per capita income, given the resources and the geographical conditions. It can be expected that China will experience even larger mass domestic migrations and the population map will be significantly changed as the economic transformation proceeds.

In conclusion, it seems that regional disparity is not a serious obstacle to continued economic growth and neither is it a major potential source of social instability.

#### **4.5. Rural development and urbanization**

China has experienced an over-supply of grain in recent years, so the voices asking “who will feed China” have been fading. However, the low productivity of agriculture and low rural population income will remain challenging problems both at present and in the near future.

The key issue here is that there are too many people working on the small cultivable area and, therefore, the ultimate solution to the problem is nothing else but industrialization and urbanization, which move people out of the land. Studies show that the marginal product of labor in agriculture is almost negligible and only the reduction of the number of people who rely on the land as their source of income can make the use of modern technology feasible in China’s agriculture. And only an increase of farmland area per head can bring a meaningful increase of per capita income in the agricultural sector.

The rural industries in the past 20 years have played an important role in improving the income level of rural people and supporting the overall economic growth. As a result, the industrialization of the Chinese economy progressed significantly: non-farming employment<sup>9</sup>

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<sup>9</sup> This includes the workers in rural industrial enterprises and rural self-employed non-farming individuals.

as the percentage of total labor force was up to 54 per cent by the end of 1997. More than 100 million rural laborers have found new jobs in non-farming sectors. This process has been slowing down in recent years, demonstrating its limitations, as it has not been accompanied by urbanization. At the end of 1998, only 32 per cent of the total population lived in cities and towns. Such a disproportion between industrialization and urbanization is one of the major bottlenecks for further growth.

The government is adopting policies to speed up urbanization. More large cities or groups of cities are to be built in the coastal areas. However, in the foreseeable future, China's agriculture will remain highly labor-intensive and the increase of rural income will be very limited.

#### **4.6. Challenges of globalization**

There has been a growing consensus among the Chinese people that globalization is a process you have to participate in or you would be marginalized. People have realized that the opening-up has been actually one of the main pushes for domestic reforms and it is the only way to "catch up". The opening-up process will continue and accelerate with or without China's WTO accession.

On the other hand, people have learned from the Asian financial crisis that the opening-up and globalization are full of risks and bring about great challenges. To a country handicapped by serious domestic institutional problems, an over-speedy opening up could be devastating. Therefore, domestic reforms and market liberalization should be pursued together in a compatible way and a "premature market liberalization" should be avoided. It can be predicted that further opening of the Chinese market will continue to be, generally, a gradual process in order to minimize the costs. Nothing dramatic or radical should be expected. In particular, the financial market opening and the capital account convertibility of foreign exchange will not happen soon.

With the WTO accession, China may be able to enjoy a high level of foreign direct investment (over USD 40bn per year now, but hopefully over USD 60bn by 2003) in the near future. The trade surplus will be declining due to the deflation pressures on the international market and the further opening of the Chinese market. It may not be a bad thing because the previous high-level balance-of-payments surplus and foreign exchange reserves are actually not economically efficient for a developing country like China. But in the foreseeable future, China's international accounts will remain balanced and no debt crisis should be expected.

#### **4.7. Corruption and the government reform**

There has been some progress in the government reform in recent years: the restructuring of the administration has been under way since 1998; the anti-corruption campaign has been hiked up; the village election is now the nation-wide practice; and the People's Congress now plays a greater role as a balance to the powers of the administration. But there is no doubt that China's economic transformation requires further acceleration of government reforms.

A great part of the corruption problem is tied to the existence of large state-owned economic sectors, and not only the government bureaucracy and political structure. Therefore, the privatization of SOEs and reforms of other state-owned institutions will be among the key factors to reduce corruption.

The on-going development of the private sector and the fast growth of the middle class are laying down the foundation for the political transition towards a constructive, rather than destructive, democracy.

Very importantly, there seems to be a consensus among most Chinese people that China should under no circumstances go back to the chaos or civil wars which stopped its development in the past century. For most people, nothing is more important than the continuation of economic prosperity and the catching up on the international market. The fear of civil wars and social chaos will bring some last-minute compromises among conflicting groups. This, plus the perception of being better off than in the past, are the essential foundations of political stability.

And the examples of relatively peaceful and gradual transition to a constructive democracy in some Newly Industrialized Asian Economies (such as Korea and Taiwan) make people confident that China may be able to do the same too.

#### **5. Conclusion**

The Chinese economy obviously faces many problems and difficulties, each of which could lead to some kind of crisis or "collapse". When China enters a new stage of development and transition following the WTO accession, many scenarios could apply with equal probability. But according to the analyses above, it seems unlikely that China is headed for a financial crisis, political turmoil or vast social unrest in the near future. The government still has some room for policy maneuver, both financially and politically. Growth will continue at a level lower than before, but still as high as 7–8 per cent. The reform will go on

in all aspects, although still in a gradual manner. No dramatic changes are expected in the next 5 years, but the gradual accumulation of small evolutionary steps can be very meaningful. However, the question remains, of course, the same: is the progress at the present stage sufficient to lay down the foundation for further development, or is it too small to avoid a crisis at the next stage?

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