

I Overview

For three decades after the 1949 revolution, China pursued a strategy of socialist economic development based on self-reliance and the centrally directed allocation of resources to key sectors largely through administrative means. In the late 1970s, even though most political and economic institutions remained intact, China's policymakers recognized the untenability of traditional methods of economic management and began to overhaul the economic system. While maintaining the overall framework of predominant public ownership, China adopted a policy of opening up trade and investment links with the rest of the world and began to reform its domestic economic structure. In the context of these reforms, China gradually relaxed mandatory planning, decentralized economic decision making, and allowed market forces to influence an increasing number of prices. It also permitted a larger role to the nonstate sector and began transforming institutions and structures critical for the conduct of macroeconomic policy.

In large measure, the reforms proceeded without a detailed blueprint in a style that was generally incremental and experimental, in contrast with the "big bang" approach that was adopted in other former centrally planned economies of Eastern Europe and the former Soviet Union. Much of the early reform consisted of piecemeal measures involving experiments in selected sectors and regions of the country. However, over time, the contradictions generated by this partial approach led to growing acceptance by China's policymakers of the need for comprehensive reform.

This section provides an overview of the reform process, including some of its political precipitants, and a broad description of the reform phases. Section II reviews the economic conditions at the start of the reform era and examines the special features of the economic environment during the reform period. Section III discusses domestic reforms, including the recent initiatives to transform the economy to one based fully on market forces. Section IV contains a detailed presentation of the process of "opening up" to the outside world, and Section V examines the factors that influenced the performance of selected provinces as decentralization pro-

ceeded in the context of the reforms. Section VI assesses the impact of the reforms on the structure of the economy and on the degree of its integration into the world economy. It also examines the implications of the reforms for macroeconomic management and stability. Section VII contains concluding remarks.

Politics of Reform

When China initiated its reform process in 1978, it had just emerged from a major political crisis. Following the death of Mao Zedong in 1976, the ultra left faction¹ was ousted from power by a coalition of moderate forces consisting of senior veterans of the Communist Party and younger cadres that had emerged during the period of the Cultural Revolution. In the initial years, the party was led by Mao's designated successor, Hua Guofeng, who advocated minimal deviation from Maoist doctrines with regard to political and economic systems. Instead, the party concentrated its efforts on restoring political order and reviving the economy by reverting to the policies of the early 1950s. The economy was partially recentralized and the planning apparatus was strengthened. An ambitious ten-year development plan was launched, which focused on investment in heavy industry and strong reliance on imports of capital equipment. Within two years, however, the plan was aborted because of serious balance of payments difficulties resulting from a strong surge in imports of capital goods.

By late 1978, reformist views, spearheaded by Deng Xiaoping, had become dominant in the party. At the Third Plenum of the Central Committee of the Communist Party in December 1978, the leadership made a decisive break with the legacy of the Cultural Revolution and resolved to focus the party's work on economic development. The principal contradiction in China was identified as the backwardness of the economy in responding to the needs of the people. Accordingly, the principal task of the party was defined as developing the productive

¹Popularly referred to as the "gang of four."

forces of the population.² To this end, the new leadership set out to reform those aspects of the economic system that had impeded the development of the economy.

However, although the new leadership was agreed on the need to break with the past and to reform the economic system, there was no unanimity in views on the pace and nature of reform, particularly the role of the market versus that of planning in a socialist economy. Conservatives favored retaining a central role for planning in a reformed economic system, whereas the more radical elements envisaged a greatly diminished and reformed role for planning. In the early years, such differences of views were of little political import as the reforms adopted then were experimental and partial, directed mainly at rejuvenating an economy that had become moribund as a result of years of political interference combined with the diminishing effectiveness of administrative planning. However, as the reforms began to spread across the economy, the inadequacy of a partial approach became increasingly apparent as manifested in the periodic outbreaks of macroeconomic instability. Consequently, as a more comprehensive approach to reforms became imperative, the differences in views began to bear directly on the direction and substance of policies, resulting in periodic shifts in the emphasis of policy. Despite occasional setbacks, however, the more radical views prevailed during most of the post-1978 period. In 1992, a decisive ideological change occurred when the party embraced the views of senior leader Deng Xiaoping and called for the establishment of a socialist market economy.

Evolution of Conceptual Framework

Although China has successfully pursued a strategy of reform and opening up of its economy for 15 years, the reforms have not derived from any comprehensive blueprint. In general, the reform measures were first introduced on an experimental basis in some localities—often as a result of local initiatives—and were adopted on a national scale only when they had proved successful at the local level. This pragmatic approach to reforms helped to avoid major economic disruptions and to transform the economy from a predominantly central planning system to one in which market mechanisms play an important role.³

²Under Mao, the principal contradiction had been defined as the continuing struggle between classes, and hence the main task of the party was to continue the revolutionary struggle.

³The pragmatic approach embodies the principle of “seeking truth from facts” and has been described as “crossing the river by feeling the stones under the feet.”

An important ideological issue that has permeated the reform process is the nature of a market system and whether such a system is consistent with socialism; the role of planning is a corollary issue. In the initial phase of the reform process, the issue was resolved by viewing the market as a useful supplement to a predominantly planned economy.⁴ In the mid-1980s, the role of the market was elevated when the goal of economic reforms was stated as the establishment of a “socialist planned commodity economy.” In this formulation, China was considered to be at a primitive stage of socialism in which the commodity economy was an essential part. Hence, the objective of reform was to establish an economic system that combined planning with the use of market forces.⁵

It is in this context that the importance of the resolution of the Fourteenth Party Congress to establish a “socialist market economy” should be seen. The party summed up the experience of the previous 15 years and embraced Deng Xiaoping’s argument that the market mechanism is merely an instrument of economic development and not a defining characteristic of a social system; the socialist character of the economy is preserved by the predominant ownership of the public sector (including the state and the collectives⁶) over the means of production. The market system is therefore fully compatible with either capitalist or socialist systems. Under the new paradigm, the aim of reform is to establish an economic structure in which market forces, under the macroeconomic influence of the state, will determine relative prices and the allocation of resources. The new paradigm is an important ideological breakthrough because it eliminates the ambivalence of the leadership over the direction of reform and allows for bolder policies to be undertaken to achieve the stated goal of establishing a market economy.

Phases of Reform

The economic reforms in China may conveniently be viewed as unfolding in several phases: the first

⁴This perception of the relation between planning and the market is often described as the “bird in the cage” theory, which was propounded by party veteran Chen Yun. In this metaphor, the market is the bird and the plan is the cage. The cage can be enlarged to give greater freedom to the bird, but without the cage, the bird will fly away—which is analogous to disorder in the market.

⁵In this view, the relation between the state and the market is captured by the expression “the State controls the market, the market guides the enterprises.” For an elaboration of the theoretical framework, see Zhao Ziyang (1987).

⁶Collectives are basically communities at the level of the village or township or a neighborhood in an urban area.

phase spanned the period 1978–84; the second phase, 1984–88; the third covered 1988–91; and the fourth began in 1992. In the early stages, reform efforts focused on rejuvenating the economy and overcoming the adverse effects of key Maoist doctrines that had been the guiding principles of economic policies during the greater part of the 25 years preceding reforms. In the view of the leadership, the main factors retarding the development of the economy were (1) a deep distrust of the market system; (2) egalitarianism and reliance on collective efforts with their invidious effects on individual work incentives; and (3) a policy of extreme self-reliance bordering on autarky at all levels from the national to the provincial and commune. Although Mao had held a deep aversion to bureaucracy, his suspicion of the market system left the dilemma of how to coordinate myriad activities to maintain macroeconomic balance. He had sought to resolve this by decentralizing the administrative system of planning and advocating self-reliance at the local level. Private initiative was tolerated but highly regulated.

First Phase (1978–84)

Initially, the policies pursued were similar to those adopted in the early 1960s to rehabilitate the economy in the aftermath of the Great Leap Forward.⁷ These policies placed greater emphasis on material incentives and allowed a larger role for the market. In particular, procurement prices of agricultural products were increased, the diversification and specialization of crops were encouraged, restrictions on rural markets (trade fairs) were relaxed, and the organization of farming was decentralized from the collective to the household level. In industry, the bonus system was reinstituted, the retention of depreciation allowance was permitted, and experimentation began on profit retention by state-owned enterprises. In foreign economic relations, preferential policies were conferred on special economic zones with the aim of attracting foreign investment and technology, promoting exports, and having them act as laboratories for bolder market-oriented reforms.

Second Phase (1984–88)

The success of the initial rural reforms emboldened the authorities to adopt a wide-ranging set of measures to reform the urban industrial sectors in 1984. These measures included the establishment of a two-track pricing system; the introduction of enterprise taxation; the reform of the wage system to establish a closer link between remuneration and

productivity; and the breakup of the monobank system leading to the establishment of a central bank. The investment system was reformed to encourage enterprises to borrow from the banking system to finance projects rather than relying on the state as in the past. The revenue-sharing system between the central and local governments was revised to allow for greater retention of revenue by the latter. To attract more capital and technical know-how, 14 major cities in the coastal areas were opened up to foreign trade and investment. In 1986, many of these measures were revised and expanded. These included establishing swap centers for trading of retained foreign exchange earnings, decentralizing trade through the establishment of local foreign trade corporations, and adopting a contract responsibility system for enterprises similar to that in agriculture.

Third Phase (1988–91)

The period from mid-1988 to 1991 represented a period of retrenchment. The reforms adopted were successful in spurring demand and production, which led to rising inflation, and by early 1988 the annual inflation rate reached double-digit levels. The plans for a new round of price reforms were deferred, and there was some reversal of earlier reforms as price controls were recentralized under a “rectification program” during which the authorities took strong measures to cool the overheated economy. The retrenchment measures succeeded in stabilizing prices, but they also resulted in a sharp slowdown in the economy, particularly in the industrial sector. As a result, losses of state-owned enterprises mounted, interenterprise debt escalated, and inventories accumulated, threatening to destabilize the macroeconomic situation. To avert a looming economic crisis, in late 1990, the authorities resorted to stimulative monetary and investment policies to reactivate the economy. Reflecting the change in policy stance, the economy began to recover in 1991. During this latter period, the authorities took advantage of generally stable prices to make substantial realignments in relative prices and to liberalize certain prices.

Fourth Phase (1992–Present)

In early 1992, the authorities declared an end to the rectification program and announced their intention to accelerate the process of reform and opening up. The process culminated in October 1992 when the Communist Party formally embraced paramount leader Deng Xiaoping’s view that the market system was not incompatible with the ideals of socialism and called for the establishment of a socialist market

⁷See Riskin (1987).

economy. The new paradigm represents an important ideological breakthrough and has paved the way for the authorities to begin to formulate comprehensive plans to establish a fully market-based economy. In March 1992, the country's constitution was amended to delete references to a planned economy and to enshrine the new goal of establishing a market system. Other important initiatives included an acceleration of the work program to develop a legal and regulatory framework to support a market economy, the decision to undertake a major restructuring of the role and functions of government, and plans to speed up enterprise, financial, and social reforms.

Salient Features of the Chinese Approach to Reform

The reform process in China has often been characterized as gradual and incremental, in contrast with the reforms undertaken in countries in Eastern Europe and the former Soviet Union. This probably arises from the different political circumstances of these countries at the time the economic reforms were initiated. As mentioned above, although there was a political crisis just two years prior to the inception of reforms in China, the Communist Party had remained intact, and a powerful coalition had emerged within the party that was united in wishing to undertake economic reforms with the ultimate aim of developing China into a modern socialist state. In other words, the goal of the Chinese leadership was not to transform the entire political economic system but to develop the Chinese economy as rapidly as possible within the basic framework of socialism and the existing political system.

What are some of the salient characteristics of the reforms undertaken during the past 15 years? In general, the reforms were undertaken first on an experimental basis in some localities before they were applied to the whole country. In the view of China's policymakers, this gradual approach to reform had several advantages. First, major disruptions to the economy were avoided, and in case the policies turned out to be deficient, they could be modified to suit national and local conditions. Second, by implementing first those policies that were likely to be successful, the leadership was able to build up political support for further reform. This was particularly important in avoiding social unrest and political conflicts that could derail the whole reform process. Third, for certain reforms to be effective, it was necessary to build new institutions, to set up new legal and regulatory frameworks, and to train personnel to become familiar with the new practices, all of which are time-consuming tasks. Fourth, the administrative apparatus of the planning

system would continue to be available—albeit with diminishing effectiveness—until a new system could become effective.

Another important feature of the reforms was the use of intermediate mechanisms to smooth the transition between two different economic systems to avoid major disruptions that could result from an abrupt shift from one system to another. Specific examples included establishing a dual-track pricing system to improve the allocation of resources at the margin; establishing a swap market in foreign exchange retention rights to improve the use of foreign exchange; setting up open economic zones to introduce foreign capital and technology to China; using the contract responsibility system to encourage behavior by economic agents that is closer to that of the market; authorizing some local governments to enact and experiment with market-oriented legislation; and decentralizing decisions to motivate officials at the local level. The use of intermediate mechanisms can be seen as a way of encouraging economic agents to adapt their behavior prior to the eventual phasing out of the planning system. Moreover, because the reforms were interconnected, for any one measure to be fully effective, it would be essential to implement all reforms simultaneously—an impracticable task given the limited experience and knowledge available in China. For instance, to establish a fully market-determined exchange rate, it is necessary to rationalize the price structure, to harden the budget constraint of enterprises, to commercialize the state-owned banks, and so forth.

A distinguishing feature of the Chinese reforms is the attempt by the leadership to preserve the socialist character of the economy. As such, the authorities have not pursued a strategy of mass privatization as in some of the transitional economies of Eastern Europe and the former Soviet Union. However, any constraint this might have imposed on reform has been diminished by limiting the concept of socialism to the dominance of public ownership and control of strategic sectors in the economy, supplemented by nonstate and private ownership. The modified definition has allowed the authorities considerable leeway in implementing policies that promote the development of the market system, such as the use of material incentives. The household responsibility system in agriculture is one example. Although land continues to be publicly owned, its use and management is contracted out to individual households. The emphasis on "ownership" has allowed the authorities to implement changes to the "operating mechanism" of state-owned enterprises (SOEs) to sever the close links between these and the state, particularly with respect to their finances and management, with the aim of transforming them into autonomous units re-

sponsible for their own profits and losses.⁸ Another important aspect of the new framework is the highly successful policy to promote the development of the nonstate sector. This sector is defined to include collective enterprises, individual and private businesses, foreign-funded enterprises, and joint-ownership enterprises. The rapid growth of the nonstate sector has strengthened the economy and has facilitated efforts to transform the traditional state sector.

A major concomitant of the market-oriented reforms to date is the progressive decentralization of economic decision making. Indeed, to a significant extent, this decentralization has stimulated some aspects of the reform process—notably in agriculture and the external sector—although it has also complicated other aspects, in particular the implementation of demand management through indirect means in a more market-oriented setting. Although decentralization was a recurrent theme during the pre-reform period, the more recent process is distinguished from the past by its depth and extensiveness, as well as the fact that it has been combined with the use of market mechanisms. Over the years, the administrative apparatus of planning had been devolved to the local authorities, but decentralization since 1978 has gone far beyond that by severing the ties between the economic agents and the state, by allowing economic agents to base their decisions on market sig-

nals, and by conferring considerable autonomy in resource allocation on the local governments. This has become a self-sustaining process as local authorities have used their growing autonomy to strengthen their hand in negotiations over resource-sharing with the center and in taking initiatives in such areas as investment.

An important consequence of the partial approach to reform so far has been the tendency for the economy to experience “stop-go” cycles of macroeconomic instability as the authorities have relinquished direct control over the economy, while indirect instruments have remained ineffective because of the incompleteness of reforms. As decentralization has proceeded, the traditional administrative system of macroeconomic control has become less effective as local authorities and state-owned enterprises have gained greater autonomy to pursue their narrow objectives of promoting growth and development within a relatively weak framework of financial discipline. As a result, macroeconomic instability has tended to become more severe with each cycle. So far the authorities have managed to regain control of the economy on each occasion by combining economic policy actions with direct administrative intervention. However, such an approach has become increasingly risky as is evident from the last episode in 1988–91. The task of maintaining macroeconomic stability is likely to remain one of the key challenges ahead even as the authorities take steps to establish a more effective system of macroeconomic management in the latest phase of reforms.

⁸Section III elaborates on enterprise reforms to date.