# 4 Market Transition: Strategy and Process

Since China launched economic reforms at the end of 1978, market transition has extended over almost 30 years. Indeed, today China has already spent as long a period building a market economy as under Maoist socialism. China's economy has been transformed by successive waves of economic reform. Over the years the content of the reform process has adapted to new challenges and circumstances, and has been continuously reformulated. There have been failures and reverses on occasion, but what is most remarkable is simply how far China has come toward a market economy and how the reform process has maintained its relevance as the challenges the economy faces have changed. By at least the mid-1990s, China had successfully moved away from the command economy and adopted a functioning market economy. Nevertheless, even today, the process of market transition in China is far from complete. Many of the institutions necessary for a market economy are rudimentary, and further market building and institutionalization are necessary. The broad issues of transition extend into every aspect of the economy today. In this chapter, the focus is on the overall process of market transition. Subsequently, Chapters 5 through 20 focus on specific sectors or aspects of the contemporary economy, covering the years since 1978, with each sector viewed within the context of China's transitional economy.

This chapter begins by examining some of the assumptions and objectives that China's reformers brought to the transition process. These assumptions led to a distinctive approach to market transition that differentiated China from other formerly socialist economies, ultimately coalescing into a strategy of gradual transformation. The breakthrough in rural China is stressed at the beginning because it was the key early success that drove reforms onward and allowed Chinese reformers to grapple with successively more fundamental issues of transformation. The chapter then lays out a basic framework for China's transition process, interpreting the overall reform process as consisting of two main phases. The first phase of gradualist, dual-track, decentralizing reforms developed directly out of the rural successes. The basic purpose of this phase was to begin the dismantling of the command economy while maintaining economic growth, an objective that was substantially achieved. Markets were introduced into nearly every area, ownership was diversified, and competition created, all within the framework of the existing institutions. During the second phase, after about 1993, the emphasis of reform shifted as it became more fundamental and thorough. The main accomplishments of this phase have been the remaking of the institutional setup to make it compatible with a market economy, the dramatic shrinkage of the state sector, and the creation of conditions enabling fair competition among all market participants. The second stage is still ongoing. While both phases of reform can be seen to have produced substantial successes, Chinese policy-makers still struggle to improve the functioning of the market economy, while coping with the social problems created by transition thus far.

## 4.1 THE CHINESE APPROACH TO TRANSITION

China's approach to economic transition was quite different from that of most of the other socialist countries. China's leaders viewed China, quite correctly, as a low-income developing country, and the imperative of economic development was constantly on their minds. It was never conceivable to Chinese policy-makers that their economy would postpone economic development until after an interlude of system transformation. It was always assumed that system transformation would have to take place concurrently with economic development, and indeed that the process of economic development would drive market transition forward and guarantee its eventual success. Individual reform policies were frequently judged on the basis of their contribution to economic growth (rather than to transition as such). In the beginning, this approach was followed because reformers literally did not know where they were going: they were reforming "without a blueprint" and merely seeking ways to ameliorate the obvious serious problems of the planned economy. But even after the goal of a market economy gradually gained ascendance in the minds of reformers, it was not anticipated that market transition would be completed until the economy reached at least middle-income status. And in fact, that is exactly what eventually happened.

The approach to transition was starkly different in Eastern Europe and Boris Yeltsin's Russia. In those countries, the predominant objective of committed reformers was to move as rapidly as feasible to a modern market economy. Reformers had a model to aim for—neighboring Western European economies—and wanted to shed the legacy of Communism as quickly as possible to begin a rapid convergence to this model. Reformers did not believe that their governments could correct distortions in their economy. There were too many distortions, too deeply interrelated. Moreover, those reformers had come to power through the democratic process and had a profound distrust of the Communist Party leaders they had replaced. How could they even be sure that party bureaucrats and planners would follow the instructions of the new governments? It was better to smash the entire edifice, eliminating as many distortions and privileges and the resulting rent-seeking opportunities as possible, and start all over from the bottom up. If in the process there was some short-term loss of output, so be it. This strategy was often called the "big bang." For these reformers, it was of critical importance to free prices as quickly as possible, to let the price system begin to work. It was seen as better to undergo the costs early, in order to lay the foundation for healthy long-term growth later. Subsequent experience, however, showed that those costs were much greater than anticipated.

In contrast, Chinese reformers saw unmet needs everywhere in their economies. Some needs were unmet because China was poor and underdeveloped, and others were unmet because the command economy was wasteful: reformers did not make a fundamental distinction between these two types. The command economy had lavished resources on expensive industrial projects while neglecting simple and easily satisfied demands of consumers. Chinese reformers, in essence, decreed that individuals and organizations should be allowed to satisfy unmet needs and earn some additional income, and if, in the process, this new activity tended to erode the command economy and had to be exempted from some of its rules, so be it. Chinese reformers lowered barriers and gradually opened up their system, giving individuals and groups the opportunity to act entrepreneurially and meet market demands. Early reforms created pockets of unregulated and lightly taxed activity within the system. Reformers allowed such pockets to open up because they were seen as contributing to developmental objectives. For example, rural communities were allowed to run township and village enterprises outside the plan because doing so would contribute to local investment and economic growth. Foreign businesses were allowed to operate freely in special economic zones because that approach would increase investment in China and might convince foreign corporations to transfer technology to China. Such policies were seen as contributing to growth while not initially threatening the overall ability of the government to manage and direct the economy.

As a result, early reforms almost never reduced or eliminated distortions; instead they loosened control over resources so that those distortions encouraged resources (people, money, initiative) to flow into these less regulated "pockets." Individuals or communities saw "niches" available that they could exploit. First movers made high profits. Only rarely did one see a "level playing field." But this process set up an economic dynamic leading to intensified competition. Gradually, the process of attracting new entrants into "pockets" in the planned economy went far enough that the overall balance between plan and market began to shift. The plan, from having been the solid material out of which a few pockets were excavated by pioneering entrepreneurs, became more like a sponge floating in a sea of predominantly market activity. From this point, achieved by the mid-1990s in most sectors, a new phase of economic reform could begin. The focus of reforms shifted toward dissolving the compulsory plan and creating uniform rules and tax rates for all sectors of the economy. The dual-track plan and market system was phased out, and most prices were unified at market prices. Astonishingly, there was never any "big bang." The process was achieved with a minimum of economic disruption and relative social stability. The contrast is striking to the protracted economic downturn and social upheaval that followed transition in Eastern Europe and Russia.

## 4.2 HOW DID REFORMS START? THE INITIAL BREAKTHROUGH IN THE COUNTRYSIDE

China's market transition began at the end of 1978 with a wide-ranging reassessment of nearly every aspect of the command economy. Indeed, there was at this time a broad social relaxation after the storms of the Cultural Revolution: political prisoners were freed, millions of sent-down youth returned to the cities, and discussions were relatively free and wide-ranging. In this environment, the extent of the possible was not known, and experimental reforms were launched in nearly every sector of the economy. However, it was in the countryside that reforms succeeded first, and it was the dramatic success of rural reforms that cleared the way for continuing and progressively more profound change (Chapter 10).

The rural reforms began with a simple policy decision: the government should reduce the pressure under which farmers had operated for the previous 30 years. For years, China had been locked into a losing cycle with its farmers: pressured to collect more grain from farmers, procurement targets had been kept high and procurement prices low. But farmers had resisted this unattractive bargain: grain production had grown slowly; farmer marketing had increased slowly; and farmers were unenthusiastic about investing more time and money in agriculture. At the end of 1978—indeed, at the landmark Third Plenum itself—China's leaders made a decision to ease the terms of trade with agriculture and "give farmers a chance to catch their breath." Procurement targets were stabilized and slightly reduced; procurement prices were raised; and, most importantly, prices for farm deliveries above the procurement target were raised dramatically. These decisions were not easy to make, for they involved substantial trade-offs: in order to pay for the policies, planners in 1979 had to reduce investment, double grain imports in three years, and chop back the ambitious technology import program of the "leap outward" (Chapter 3). The only thing that made these choices palatable to China's leaders was their conviction that the rural economy needed an opportunity for profound restructuring and rehabilitation.

At first, reformers had no clear idea how that restructuring of the farm economy would take place. All farmers were compulsory members of agricultural collectives, and reformers did not initially envision a change in that arrangement, but they were willing to give farmers more breathing space. Reformers at this time were emphasizing the necessity to give enterprises in other sectors expanded decision-making autonomy and better incentives, and the same offer was made to agricultural collectives. Collectives were allowed to experiment with different payment systems for farmers and better ways of organizing and marketing output. Collectives adopted a wide range of innovative approaches, but eventually they began to gravitate toward a radical solution: contracting individual pieces of land to farm households. Farm households took over management of the agricultural production cycle on a specific plot of land, subject to a contractual agreement that they turn over a certain amount of procurement (low price) and tax (zero price) grain after the harvest. This policy essentially recreated the traditional farm household economy, with the collective reduced to being little more than a landlord. Because it implied such a dramatic reduction in the role of the collectives—everything short of abolition—this policy was extremely controversial. But Chinese leaders decided not to block it, and after 1980 they gradually shifted and gave it de facto support.

What happened next was quite astonishing. The institution of contracting land to households spread rapidly throughout rural China and became nearly universal by the end of 1983. Agricultural production began to surge. Helped along by higher prices and the increased availability of modern inputs such as chemical fertilizer, production climbed rapidly through 1984 (see Chapter 11). By 1984 grain output had surged to 407 million metric tons, more than one-third higher than in 1978. There was enough grain for everybody in China. The decades in which China's industrialization had been repeatedly held back by agricultural weakness seemed suddenly to be over, and the centuries of a China fundamentally short of food were over as well.

In fact, the increase in grain output was only half the story. Freed to allocate their own labor in the way they wanted, farmers increased grain output while actually *reducing* the number of days spent in the grain fields. Instead, they sharply increased their labor input into nongrain crops and nonagricultural businesses. The number of workers in township and village enterprises (TVEs)—locally run factories—increased rapidly, and output from this sector surged as well (see Chapter 12). These TVEs were not incorporated into state plans, so their output either went to meet heretofore unmet market demands or else created new competition for the existing state-owned enterprises. In either case, TVE activity was disruptive and set off profound changes. Successful farm and TVE reforms emboldened reformers, giving them confidence to persist in the reform project. With this background, reformers were prepared to push forward in other sectors where initial efforts had not met with immediate success. Moreover, rural incomes increased rapidly, and reforms gained the support of the bulk of the rural population.

## 4.3 A TWO-PHASE FRAMEWORK OF ECONOMIC REFORM

Successful rural reforms also reinforced a certain approach to the reform process. Rural reforms had been achieved with little economic or social disruption, largely because a type of dual-track system had been adopted. When farmers contracted for their land, they agreed to turn over a certain amount of grain to the government: the rest was released to the market. Reformers saw in this experience a model of using contracts to stabilize some crucial pieces of the existing economic system while freeing up other pieces. The contracts built in vested interests—in this case, the government and its need to ensure access to grain—while also providing powerful new incentives to farmers, since they kept 100% of the harvest above the contracted deliveries. Reformers sought to extend this approach to industrial and commercial reforms, and in so doing they created a pattern of economic reform that strongly characterized the period from 1978 through about 1993. Reform overall was decentralizing, shifting power and resources from the hands of central planners to local actors, while core interests were protected, often through contracts. This process allowed entry barriers to be reduced and market forces to grow. By 1993, though, this particular pattern of reform had largely run its course. The market sphere had expanded sufficiently that the economy had "grown out of the plan." The focus of policy-makers shifted, as it became increasingly necessary to build a firmer institutional basis for the market economy that was developing. Table 4.1 shows

**Table 4.1**
Contrasting styles of economic reform

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

the main elements of reform strategy in the two periods, laid out to highlight the contrasts between them.

## 4.4 ELEMENTS OF CHINA'S TRANSITION THROUGH 1992

In discussing the 1980s (more broadly 1979–1992), the character of China's gradualist transition can be summarized in nine key features, described in the following subsections, which contributed most directly to the period's success. Also, it may not be coincidental that through most of this period the key policy-maker was Zhao Ziyang, premier from 1980 until 1987 and then first party secretary until the Tiananmen Square demonstrations in 1989. Although Zhao was always subordinate to Deng Xiaoping, it was Zhao himself who was responsible for the day-to-day policy-making that steered the Chinese transition through this first period. Zhao had to defer not only to Deng Xiaoping, but also to other senior revolutionary leaders, most important of whom was Chen Yun. Partially because of this political environment, Zhao's policy-making was cautious and gradual, and he had to be able to create at least a passive consensus behind each policy he wished to push forward. Zhao's key challenge was to extricate the economy from the grip of command-economy institutions, which he was able to do. China avoided a Soviet-style collapse by disentangling itself gradually from the institutions of the planned economy.

### 4.4.1 Dual-Track System

Perhaps the most characteristic feature of China's initial departure from the planned economy was the dual-track system. The Chinese term *shuangguizhi* refers to the coexistence of a traditional plan and a market channel for the allocation of a given good. Rather than dismantling the plan, reformers acquiesced to a continuing role for the plan in order to ensure stability and guarantee the attainment of some key government priorities (in the Chinese case, primarily investment in energy and infrastructure). The dual track implied a two-tier pricing system for most goods: a single commodity had both a (typically low) state-set planned price and a (typically higher) market price.

It is important to stress that the dual track refers to the coexistence of two coordination mechanisms (plan and market) and not to the coexistence of two ownership systems. By the mid-1980s, most state-owned firms were still being assigned a compulsory plan for some output but had additional capacity available for production of above-plan, market goods. Thus the dual-track strategy was one that operated within the state sector—indeed, within each state-run factory—as well as in the industrial economy at large. This fact was essential because it meant that virtually all factories, including state-run factories, were introduced to the market and began the process of adaptation to market processes. The dual-track system allowed state firms to transact and cooperate with nonstate firms, allowing valuable flexibility. But the growing importance of collective, private, and foreign-invested firms should be considered apart from the dual-track system strictly defined, since most of these firms were predominantly market oriented from the beginning (Wong 1986).

### 4.4.2 Growing Out of the Plan

The mere existence of the dual-track system is not in itself sufficient to propel an economy in transition to a market economy. In a sense, all planned economies had some kind of dual-track system, because they all had various black and "gray" markets outside the formal planning system. But China planners in 1984 made a broad commitment to keep the overall size of the central-government materials-allocation plan fixed in absolute terms. Since the economy was growing, this commitment implied a gradual process in which the plan would become proportionately less and less important until the economy grew out of the plan. Figure 4.1 shows this process at work with respect to sales and allocation of finished steel, arguably the single commodity most characteristic of the planned economy. Up until 1984 the quantity of steel allocated by central government planners increased in step with production. Unusually in a planned economy, there was also a substantial share of total output allocated by local government planners, which also seems to have been increasing over time. A tiny share of output was sold inde-

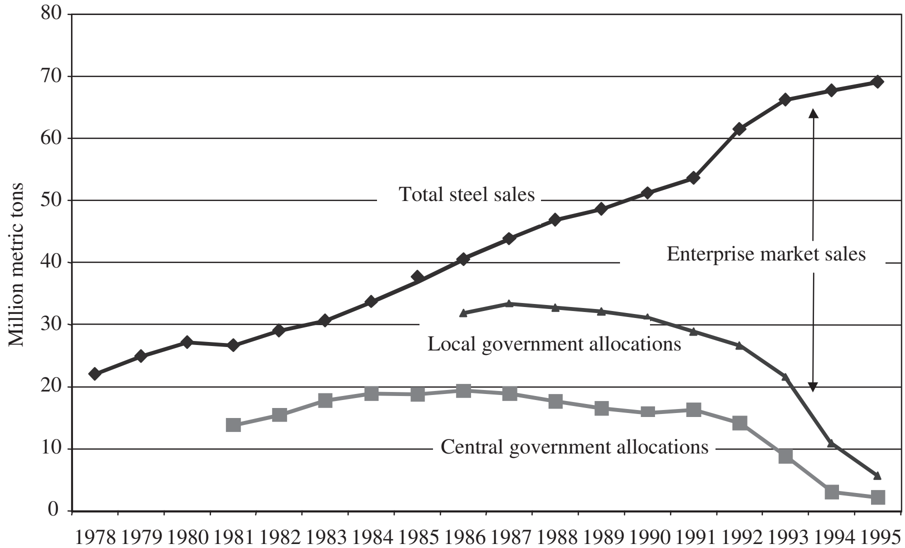


**Figure 4.1**
Steel production and planned allocation

pendently by enterprises. After 1984, though, the quantity allocated by the central government leveled off, and nearly all the increment in output was channeled onto the market, that is, left to the control of enterprises to sell at the best price they could obtain. In the early 1990s quantities allocated began to decline in absolute terms, and then dropped precipitously around 1993. After that point, the economy had grown out of the plan. A generally credible commitment to freeze the compulsory plan set in motion a dynamic process that gradually increased the share of nonplan, market transactions in the economy and made the dual-track system into an unabashed transitional device.

The commitment to grow out of the plan crucially altered incentives at the level of the individual enterprise. With their plans essentially fixed, enterprises faced "market prices on the margin" (Byrd 1991). Even those firms with compulsory plans covering, say, 90% of capacity, were in a position such that future growth and development of profitable opportunities would take place at market prices. The plan served as a kind of lump-sum tax on (or subsidy to) the enterprise. So long as the commitment not to change it was credible, it really had no impact on any of the enterprise's decision-making. Current decision-making would be based on market prices, and so would profit maximization. In that sense, the plan became irrelevant.

### 4.4.3 Particularistic Contracts

In order to make the dual-track system work, planners signed individual contracts with every state-owned enterprise. These contracts specified tax payments and contributions to the material-balance plan (somewhat on the model of the rural household contracting system). In practice, this policy meant there was no regular tax system—the de facto tax rate was specific to an individual enterprise. Each contract was drawn up on the basis of the firm's performance in a previous base year, so that each existing enterprise was grandfathered into the transitional system (see Chapter 13).

### 4.4.4 Entry

The central government's monopoly over industry was relaxed. In China the protected industrial sector was effectively opened to new entrants beginning in 1979. Large numbers of start-up firms, especially rural industries, rushed to take advantage of large potential profits in the industrial sector, and their entry sharply increased competition and changed overall market conditions in the industrial sector. Most of these firms were collectively owned, and some were private or foreign owned. The crucial factor is that the central government surrendered in practice its ability to maintain high barriers to entry around most of the lucrative manufacturing sectors. This lowering of entry barriers was greatly facilitated in China by the nation's huge size and diversity, as well as the relatively large role that local governments played in economic management even before reform. Large size and diversity meant there was scope for competition among firms in the "public sector," even if each of these firms remained tied to government at some level.

### 4.4.5 Prices Equating Supply and Demand

Flexible prices that equated supply and demand quickly came to play an important role in the Chinese economy. Beginning in the early 1980s a significant proportion of transactions began to occur at market prices, and in 1985 market prices were given legal sanction for exchange of producer goods outside the plan. Consequently, state firms were legally operating at market prices, since virtually all state firms had some portion of above-plan production. Gradual decontrol of consumer goods prices—initially cautious—steadily brought most consumer goods under market-price regimes. An important benefit of the legitimacy given to market prices was that transactions between the state and nonstate sectors were permitted, and they developed into a remarkable variety of forms. Simple trade was accompanied by various kinds of joint ventures and cooperative arrangements, as profit-seeking state-run enterprises looked for ways to reduce costs by subcontracting with rural non-state firms with lower labor and land costs.

### 4.4.6 Incremental Managerial Reforms Instead of Privatization

State-sector managerial reforms were carried out as an alternative to a more radical policy, privatization. As state firms faced increasing competitive pressures, government officials experimented with ways to improve incentives and management capabilities within the state sector. This experimental process focused on a steady shift in emphasis away from plan fulfillment and toward profitability as the most important indicator of enterprise performance (Chapter 13). There is substantial evidence that the combination of increased competition, improved incentives, and more effective monitoring of performance did improve state-enterprise performance over the 1980s. Logically there is no reason why privatization could not be combined with a dual-track transitional strategy, but practically there are obvious reasons why there would be alternatives. Urgent privatization tends to follow from a belief that state-sector performance cannot be improved, and often leads to a short-run "abandonment of the enterprise" as the attention of reformers shifts away from short-run performance and to the difficult task of privatization. Conversely, the sense that privatization is not imminent lends urgency to the attempt to improve monitoring, control, and incentives in the state sector. Clearly, the Chinese approach worked adequately during the early stages of transition. But debate continues about whether the moderate performance improvements in the state sector that were achieved were large enough to be judged successful.

### 4.4.7 Disarticulation

Along with measures to reform the core of the planned economy, Chinese reforms also advanced by identifying economic activities that were the least tightly integrated into the planning mechanism and pushing reform in these limited areas. Early reforms followed a strategy of "disarticulation," in which successive sections of the economy were separated from the planned core. This was clearly not an intentional strategy, but rather one that emerged from the nature of the policy process and from the concern of Chinese policy-makers not to disrupt the core economy. The early establishment of special economic zones is the most obvious example of such policies—export-oriented enclaves were created that had, initially, almost no links to the remainder of the economy (see Chapter 17). This approach is also one of the reasons that reforms succeeded first in the countryside. Policy-makers realized that it was not necessary that all the countryside be integrated into the planned economy.

Beginning with the poorest areas, some regions were allowed to detach from the planned economy. So long as the state could purchase sufficient grain to keep its storehouses full, it could afford to let the organizational form in the countryside devolve back to household farming. Caution led to a strategy of disarticulation.

### 4.4.8 Initial Macroeconomic Stabilization Achieved Through the Plan

When China's reformers faced serious macroeconomic imbalances in 1979–1981, they used the institutions of the planned economy to cut back investment and relieve pressure on the economy. Rather than combining stabilization and reform into a single rapid but traumatic episode—as in a "big bang" transition—the Chinese used the instruments of the planned economy to shift resources toward the household sector and relieve macroeconomic stresses at the very beginning of reform. This dramatic shift in development strategy created favorable conditions for the gradual development of markets. Inflationary pressures were vented off as supplies grew, rather than being resolved in a quick transition from suppressed to open inflation. In a related fashion, the planning structure was used to provide an initial impetus away from the capital-intensive Big Push strategy and toward more sustainable labor-intensive sectors. This initial shift toward a more labor-intensive strategy was given urgency by the need to provide jobs for a large group of unemployed young people, including many who had returned to the cities from the countryside. Clearly, planning would be an unwieldy and ineffective instrument to carry through such a shift over the long term. But the temporary use of this instrument to lower unemployment tended to preserve stability and solidify support for the reform orientation.

### 4.4.9 Continued High Saving and Investment

Continued high saving and investment were made possible by a gradual takeover of national saving from government by households (Chapter 18), made possible by macroeconomic stability. The Chinese government intentionally reduced its share of GDP during the early stages of reform in order to allow rural and urban households more resources and better incentives. Fortunately the steady increases in household income and the increasing opportunities in the economic environment led to a rapid increase in household saving. The fact that households were willing to rapidly increase their voluntary saving was a side benefit to the relatively stable economic environment reformers purchased through gradualist reforms. Rapidly increasing household saving indicates that households believed their assets would be reasonably secure. In turn, household behavior contributed to macroeconomic stability because it offset the reduction in government saving that took place at the same time. Reduced government saving was due to a steady erosion in government revenues, which itself was ultimately traceable to the dissolution of the government industrial monopoly. Total national saving remained high, thereby sustaining high levels of investment and growth. An indirect consequence was a vastly enhanced role for the banking system, serving as an intermediary channeling household saving to the enterprise sector. While this process was relatively smooth, it was difficult for the government to acquiesce in and to manage the decline in its resources, and macroeconomic policymaking became more complex and more difficult.

### 4.4.10 Conclusion of First-Phase Reforms

On balance, and in retrospect, the policies described here can be seen to have a clear coherence and to have been overwhelmingly successful. Reduction of the state's monopoly led to rapid entry of new firms. Entry of new firms combined with adoption of market prices on the margin led to enhanced competition and began to get state-sector managers accustomed to responding to the marketplace. Gradual price decontrol was essential. Competition eroded initially high profit margins for state firms and induced the government, as owner of the firms, to become more concerned with profitability. The government experimented with better incentive and monitoring devices, and this experimentation improved state-sector performance. Nonetheless, the state sector grew more slowly than the nonstate firms that were entering new markets. The economy gradually grew out of the plan, as both the plan itself and the state sector as a whole became less dominant elements in the economy. Yet this growth occurred with economic continuity that was attributable to the maintenance of a small planned sector as a kind of stabilizer, as well as to robust saving and investment that powered continued economic growth.

However, the ultimate success of the first-phase reform process was not always self-evident while it was ongoing. On the contrary, reform was always contested, and the achievements of reform were constantly subjected to harsh scrutiny from conservatives who were skeptical of reform. One result of this policy competition was a pattern of "two steps forward, one step back." Reforms seemed to advanced strongly in certain years (1979, 1984, 1987–1988) and retreat in other years (1981–1982, 1986, 1989). Relating to these policy cycles, macroeconomic cycles also persisted throughout the reform process. Bold reform measures tended to be implemented after stabilization had achieved some success. Reform measures then contributed to renewed macroeconomic imbalances, eventually leading to a new period of macroeconomic austerity. As a result, the outcome of macroeconomic policies was frequently fundamental in determining the success or failure of specific reform initiatives (see Chapter 18). Oddly, this pattern of "political business cycles" mirrors the experience in the socialist economy; after 1978, however, the expansionary phases were phases of accelerated reform, rather than phases of political mobilization.

At times, these macroeconomic cycles yielded a side benefit. Planners were unable to keep up with rapidly changing cycles and were buffeted by rapid changes in economic conditions. The almost intractable task of planning an economy can only be carried out in conditions of artificially imposed stability; without that stability, the inadequacy of attempts to plan the economy became increasingly evident. But individual cycles also imposed very substantial costs on the economy, as well as undermining political support for reformist politicians. Indeed, by far the most serious challenge to the reform process came in the wake of just such a cycle, when deteriorating cyclical economic conditions in 1989 fed an upsurge of urban discontent.

## 4.5 THE TIANANMEN INTERLUDE

During 1988–1989 one of the severe cycles of macroeconomic imbalance described in the previous section led to a serious political crisis. Urban discontent in 1989 was fueled by a number of factors: rising inflation that eroded real incomes, anger at corruption and arbitrary privilege, and rising expectations about political and economic change. All these feelings were powerful motivating factors to students who poured into Tiananmen Square in central Beijing to mourn the unexpected death of Hu Yaobang, who had been an important reformist leader. Hu, in fact, had been particularly respected because of his willingness to fully rehabilitate more than a million Chinese who had been scapegoated and persecuted by either the Anti-Rightist Campaign or the Cultural Revolution, or both. A volatile mixture of expectations and grievances fueled extravagant hopes and massive disillusionment, and led to months of demonstrations in China's main square. Reformist leader Zhao Ziyang refused to order the military to clear the square by force. Ultimately, Zhao was ousted, and conservative leaders ordered the military into the square. Hundreds were killed, many of the most influential reformists in the government were sidelined or exiled, and the course of China's reform was forever altered.

However, the process of market transition resumed after about two years of backsliding. Economic reforms were able to survive because of the broader dynamics of the process. Certainly, economic causes were an important part of the social crisis leading up to the Tiananmen debacle. Soaring inflation during 1988–1989 ate away at real urban incomes that had been protected for most of the 1980s. A sense that the government was failing to honor a kind of implicit social compact with urban residents fueled discontent. At the same time, the measures that had been taken to curb inflation were already starting to bite into economic growth and cause expectations of the future to be revised downward. In this difficult short-term environment, the sense that political promises had been betrayed and political reforms were running off the tracks fueled a powerful sense of disillusionment and protest.

Yet from a long-term perspective, it is more striking that it was very rare for a major social group to suffer significant economic losses during the 1980s. In particular, the position of workers in state-owned enterprises (SOEs) was protected during the course of reform. The resulting pattern has been labeled "reform without losers" (Lau, Qian, and Roland 2000). Rural residents gained from the dissolution of collectives, improved agricultural prices, and the rapid growth of nonagricultural production in the countryside. Urban residents gained either because they were able to exploit new niches in the economy or because their economic position was protected by continuing government support for state enterprises. The broad enjoyment of the benefits of reform—and the absence of a group clearly disadvantaged by reform—meant that reform was still widely popular, despite the debacle at Tiananmen Square.

After the Tiananmen Square political crisis, a period of conservative ascendancy followed, between 1989 and 1991. The conservative attempts to roll back reforms were completely without success, however, and are often forgotten. Urban inflation, which had seemed so corrosive in 1988, was in fact quickly controlled, and market forces corrected other imbalances in the economy with a speed that surprised conservatives and left planners far behind. As it became clear that the conservatives had no viable program, their support among the Communist Party elite began to crumble.

It was in this situation, as the pendulum was swinging back toward renewed reform, that Deng Xiaoping himself emerged to give that pendulum a forceful push. In early 1992, Deng took a "Southern Tour" that had him visit the SEZs he himself had authorized more than a decade earlier. Deng gave a ringing endorsement to the concept and reality of the SEZs, a traditional bellwether of Chinese Communist elite opinion. Deng reemphasized the need for accelerated economic reform and specifically reaffirmed a nonideological, pragmatic approach to experimentation. "Development is the only hard truth," Deng declared, "It doesn't matter if policies are labeled socialist or capitalist, so long as they foster development." Deng's pronouncements were about principles, not practical policies, but they were sufficient to restore the government's commitment to economic reform and tip the balance of political power in Beijing. In October 1992 the 14th Congress of the Communist Party convened and endorsed a "socialist market economy," making clear that markets must extend to all main sectors of the economy. This was one of Deng Xiaoping's last decisive personal interventions in Chinese policy-making. Of course, while Deng's advocacy was sufficient to reignite economic reform, Deng was unwilling and perhaps unable to resume progress in political reform. As a result, Deng's legacy ultimately included an unbalanced combination of vigorous economic reforms and relative political stagnation.

## 4.6 THE SECOND PHASE OF REFORM, 1993–PRESENT

The post–Deng Xiaoping leadership was associated with a new phase of economic reform, but one that developed organically out of the earlier phase. In economic policy the figure of Zhu Rongji quickly emerged as the most important voice. Zhu established himself as the dominant voice in policy-making in mid-1993, while he was still vice premier, and was then formally elevated to premier in early 1998. Zhu's policy-making was rather different from that of his most important predecessor, Zhao Ziyang. Zhu had a strong, decisive personality and often made quick, personal decisions. Zhu presided over much of the second period of economic reform, until he stepped down as premier in 2003.

The contrasts between this period and the preceding one were shown schematically in Table 4.1. Key features of the second phase of reform can also be conceptualized in terms of prerequisites, regulatory changes, and outcomes. Three policy measures were essential prerequisites to the overall package: ending the dual-track system, recentralization of fiscal resources, and macroeconomic austerity. Having established a firm macroeconomic policy base, reformists shifted to a focus on regulatory and administrative restructuring in the key market sectors: the banking system, the tax system, the system of corporate governance, and the external sector, through membership in the WTO. The outcomes of this policy regime were a shift from inflation to price stability, a dramatic downsizing of the state-enterprise sector, the acceptance of a moderate amount of privatization, and the emergence of a "reform with losers." Zhu Rongji's policies were consistently associated with stronger, more authoritative government institutions and more decisive policy-making.

### 4.6.1 Prerequisites

#### 4.6.1.1 Market Reunification

By the early 1990s the dual-track system had served its function. Figure 4.1 shows that after 1991 allocation of materials (in this case, steel), after having been kept constant for several years, dropped off rapidly. By the end of 1993, material-balance planning was abolished altogether. The orthodox planning system disappeared with barely a whimper, scarcely noticed. Particularistic contracts with individual enterprises were also allowed to lapse. One side of those contracts had become obsolete (delivery of within-plan output), while the financial side was in conflict with impending fiscal and tax reforms, which were high on the reform agenda.

#### 4.6.1.2 Recentralization

It seems paradoxical that centralization could be a main tenet of reform in the second reform era, when decentralization had been a key part of the first era of reform. In fact, though, it was essential that further economic reforms develop a more appropriate division of responsibilities between central and local. During the first period of reform, the motivating force behind decentralization had been the need to introduce markets and incentives into the system. During the second period, management responsibilities were more clearly divided between center and local, but in a way that tended on balance to be recentralizing in terms of the ultimate control of resources. The central government needed to strengthen its regulatory and macroeconomic management functions. In order to do so, it also needed to establish an adequate and reliable source of finance revenues, which it was able to do. Figure 4.2 shows the outcome, a fundamental turning point in 1995. During the course of more than 15 years of reform, China's fiscal position had eroded significantly, dropping from 33.8% of GDP in 1978 to only 10.8% at the low point in 1995. The decline of budgetary revenues was driven primarily by the inexorable erosion of the old system in which state enterprises raised revenues from their monopoly position. More generally, fiscal decline was also the logical result of a transition strategy that stressed decentralization of authority and benefits, along with releasing resources from government control to the marketplace. Despite the successes achieved in transition, by the early 1990s it was widely perceived that China had a serious fiscal crisis. Key fiscal reforms—discussed in Chapter 18—provided a new, broader tax base for the economy and led to a steady revival of government budgetary collections. From 1995 onward, a modern tax system was gradually built up.

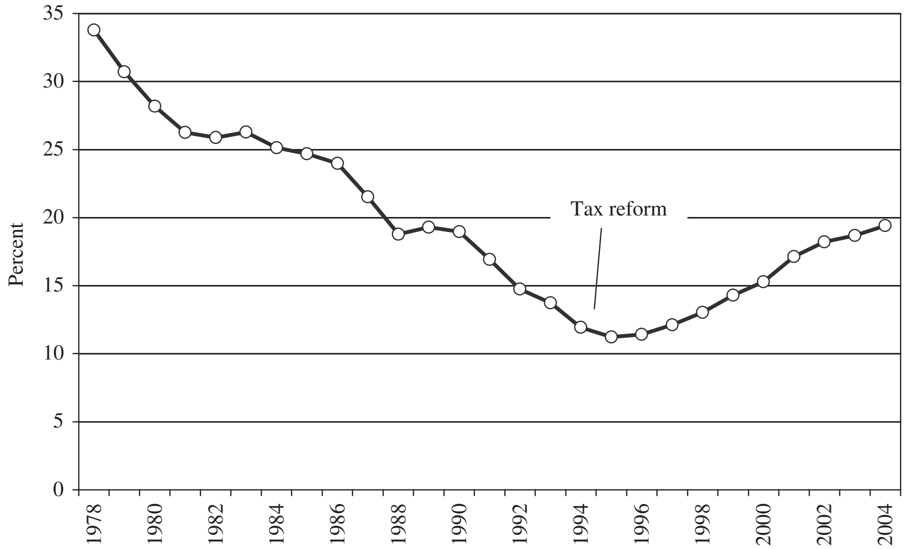


**Figure 4.2**
Budgetary revenue share of GDP

#### 4.6.1.3 Macroeconomic Austerity

Macroeconomic austerity was both a short-term and a long-term necessity. In the wake of Deng Xiaoping's Southern Tour a gold rush mentality of speculation and financial excess quickly led to a surge of bank credit and accelerating inflation. Zhu Rongji made his mark by initiating a tough period of macroeconomic austerity in mid-1993. A financial crackdown was clearly necessary, but it turned out that this crackdown signaled the beginning of a new macroeconomic policy regime, which delivered much less cheap credit to state-owned enterprises and a slower growth of money and prices. By 1997 at the latest, it was clear that Chinese policy had shifted to a long-term policy of macroeconomic conservatism and had managed to deliver a significant degree of macroeconomic stability (see Chapter 18). This shift was an essential prerequisite to making public enterprises responsible for their own profits and losses, providing them with a "hard" budget constraint. Tough macroeconomic policies created conditions under which further enterprise restructuring was driven primarily by market forces.

### 4.6.2 Regulatory Approach and Administrative Restructuring

Zhu Rongji also presided over a new, more regulatory approach to economic reform. The new reforms were regulatory in the sense that they introduced new rules (and new prices) that at least in principle applied equally to all economic actors. There was more focus on creating and regulating competition as a force for economic change and less on direct government action in managing productive enterprises. By the 1990s, with the economy having "grown out of the plan," the most important tasks were to improve the legal and regulatory environment, create a "level playing field," and reduce some of the most obvious distortions in the economy. Regulatory and administrative reforms in the four most important sectors of the economy are described in the following sections. The commitment to this new direction was strongly signaled early on, when three crucial measures—a new fiscal system, a new foreign trade system, and the new Company Law—were made effective on January 1, 1994.

#### 4.6.2.1 Fiscal and Tax System

Fiscal reforms in 1994 were designed to arrest the slide in budgetary revenues, but also to transition to a broader tax base by implementing a 17% value-added tax and other business taxes. These taxes had relatively low rates, compared to the old system, but they were uniform and applied to all economic actors. The strong performance of tax revenues after 1995 showed that broadening the tax base was successful. Fiscal reforms were also designed to put central-local government fiscal relations on a sounder and more stable basis. They did so by increasing the share of total taxes initially collected by the center and establishing a set of rules for sharing revenues between central and provincial governments (see Chapter 18).

#### 4.6.2.2 Banking and Financial System

The banking system underwent fundamental restructuring during the second half of the 1990s. The People's Bank of China (PBC) had been nominally established as a central bank in 1983, but at that time it remained beholden to government officials at both central and provincial levels. The bank was finally given a workable organizational structure in late 1998, when a restructuring plan abolished the provincial-level branches and set up nine regional branches along the lines of the U.S. Federal Reserve Board. Combined with a renewed mandate to conduct monetary policy, and with a monetary policy board established as a governance and advisory body, the central bank began to play an active role in determining and implementing monetary policy. This administrative restructuring took place in tandem with the adoption of macroeconomic austerity: state-run commercial banks soon found themselves facing a much harder budget constraint, as their access to easy government money was curtailed. In turn, they began to pass tougher standards on to their clients in state-owned enterprises.

Shortly after the constitution of a central bank system, banking authorities began to tackle the enormous problem of lax financial supervision and nonperforming loans in all the state banks. In 1999 four asset management corporations were established to take over some of the nonperforming loans of the four big state commercial banks and begin to liquidate them for as much residual value as possible. Clearly, these are essential steps on the long and difficult road to a stable banking system. Eventually, in April 2003, the PBC supervisory functions were spun off to the newly created China Bank Regulatory Commission (see Chapter 19).

#### 4.6.2.3 Corporate Governance

A large-scale effort to restructure the state-owned corporate sector was begun with the passage of the Company Law at the end of 1993. The Company Law contained provisions for all state-owned enterprises to gradually reorganize as limited-liability corporations with clarified corporate governance institutions. These provisions have been only gradually implemented but have slowly transformed the organizational structure of the Chinese public sector (see Chapter 13). The systematic restructuring of corporate governance was combined with selective listing of state-owned companies on China's newly opened stock markets, which grew significantly during the late 1990s (Chapter 19). Together these measures changed the structure of China's large state-owned companies and created a demand for government regulation that had not previously been evident. With implementation of a securities law in July 1999, the China Securities Regulatory Commission's (CSRC) branches became operational nationwide, thus forming a centralized and unified network of securities supervisors. At the same time, a host of new central government agencies were established to deal with other types of regulatory oversight, including, for example, the State Intellectual Property Office and the State Administration of Technical and Quality Supervision. China began to make progress toward a regulatory state.

#### 4.6.2.4 External Sector: Membership in the World Trade Organization

Extensive foreign-trade reforms were passed at the end of 1993 that unified China's foreign exchange regime, devalued the currency, and established current-account convertibility. These were important steps forward that Chinese authorities expected to clear the way for membership in the WTO. As it turned out, an arduous process of negotiation and compromise was required before China finally acceded to the WTO in December 2001. Accession involved Chinese acceptance of an extraordinarily broad range of regulatory undertakings, designed to allow China to harmonize with international standards. At the same time, and even more fundamentally, WTO accession implied an important further step in the degree of openness of the Chinese economy and in the extent to which foreign goods and companies could compete in China.

## 4.6.3 Outcomes

### 4.6.3.1 From Inflation to Price Stability

After 1996, Chinese inflation was tamed. Although cycles were not completely eliminated—another expansionary phase emerged after 2002—the overall macroeconomic context swung sharply toward price stability. The context of price stability and increased competition greatly intensified the product market pressure on Chinese firms, especially public enterprises.

### 4.6.3.2 State Enterprise Restructuring and Downsizing

From the mid-1990s, Chinese authorities began to cut the formerly close ties that bound government and state-owned enterprise. Public firms faced increased product market competition and pressure, on the one hand, and reduced access to funding from government banks, on the other. Gradually state-owned enterprises moved toward a significant restructuring and downsizing, encouraged by the government. State-enterprise restructuring has meant converting vaguely defined public ownership into more explicit, legally defined ownership categories, sometimes involving privatization. Following the 15th Communist Party Congress in September 1997, local government officials were given an almost free hand to proceed with state-sector reforms that included bankruptcy, sales and auctions, and mergers and acquisitions. Throughout the 15 years of economic reform, between 1978 and about 1993, although the state sector had shrunk in relative importance, it had continued to grow in absolute terms, both in output and in employment. As Figure 4.3 shows, since the mid-1990s state-enterprise employment has declined dramatically. While some of these workers are in firms that remain government controlled (but no longer traditional state-owned), the overall size of public enterprise employment dropped by more than 40%.

Given the decentralized nature of the Chinese economy, the progress of state-owned-enterprise restructuring depended on the incentives facing local governments, which “owned” the majority of SOEs. In fact, SOEs had already ceased to be “cash cows” on which local government officials could draw: Industrial SOE profits were 15% of GDP in 1978, but fell below 2% of GDP in 1996–1997. Local governments began to rethink the value of possessing

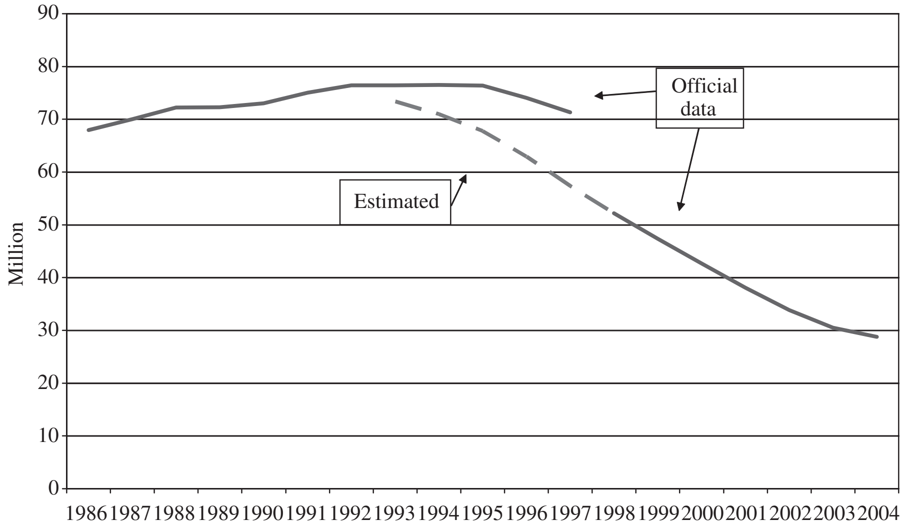


**Figure 4.3**
SOE workers

their own SOEs and increasingly concluded that they derived few advantages from local state ownership that could not be achieved just as well from a generally prosperous local economy.

#### 4.6.3.3 Privatization

The Chinese government has never unambiguously embraced privatization and continues to avoid the term in favor of vague circumlocutions such as "restructuring." However, privatization, often in the form of management buyouts, became common in the TVE, collective, and SOE sectors after the mid-1990s. More generally, private businesses have been given gradually increasing recognition and legitimacy. Indeed, the rise of private business is perhaps an inevitable consequence of a policy shift toward a level playing field. By the end of 2004 the urban private sector, without counting foreign-invested firms, employed about twice as many workers as the traditional state sector: 55 million, compared with less than 30 million in SOEs.

#### 4.6.3.4 Reform with Losers

The momentous changes in transition strategy have broken sharply with one of the key characteristics of reform in the early period. Reform after 1993 clearly imposed significant losses on substantial social groups. Most directly affected were state-enterprise workers, who had been a relatively privileged group in the past. Millions have been laid off, and further millions have abandoned failing firms (see Chapter 8). Subject to employment uncertainty for the first time since the establishment of the PRC, some state workers suffered precipitous losses in income and social standing. In general, groups and individuals are less sheltered from competition than in the past. Thus, while transition has continued to move ahead, the benefits of transition are now far more unequally spread among the Chinese population than was the case in the 1980s.

## 4.7 CONTEMPORARY CHALLENGES

The shift in transition strategy around 1992–1993 means that China's approach to transition is now somewhat less distinctive than it was previously. Economic policy-making in China now more closely resembles that in other transitional economies, such as Poland and the Czech Republic, and there is no longer a polar opposition between "big bang" and "gradualist" transitions. Reformers in both groups of transition economies now focus on maintaining stable and consistent fiscal and financial policies, and both are engaged in building a regulatory environment that can reduce corruption, support an advanced market economy, and protect fair and equal competition. The qualitative responses to the challenges of transition are now more similar.

Nevertheless, the Chinese experience has many valuable lessons to teach. These lessons come from a broad view of China's transition, however, and not from specific policies that should be transplanted to other economies. After all, the Chinese policy-making process has been extremely complex, and produced dramatically different outcomes in different periods of "gradualist" transition. Discussions of China's transition have often failed to make this clear. Sachs and Woo (1994), for example, argue that the successes of China's early reforms were actually due to the advantages of underdevelopment, which gave China a relatively large, flexible, rural economy that served as a seed-bed of reform. However, underdevelopment surely has costs as well as benefits, and is unlikely to be make reforms unambiguously easier. The early reforms were successful precisely because they were effectively adapted to the specific challenges and opportunities provided by China's situation at that time. Second-stage reforms were then dramatically recast and adapted to a whole new set of challenges and opportunities. As McMillan (2004) points out, the lesson is not that a specific set of circumstances provides intrinsic advantages, but rather that careful policy-making, firmly grounded in local conditions, has a much better chance of success than prepackaged policy prescriptions. Moreover, policies that give weight to development of social and economic capabilities will be more successful than policies that overemphasize institutional changes. As Deng Xiaoping said in the midst of China's transition process, "development is the only hard truth."

Despite the remarkably successful record of transition thus far, there is no guarantee of continued success in the future. In 2003, a new administration took over in China. Hu Jintao became the top Communist Party official and government leader. Wen Jiabao succeeded Zhu Rongji as premier, and continuing the transition-era division of responsibility, immediately became the predominant economic policy decision-maker. Under Wen, the style of policy-making has changed rather dramatically, becoming more consultative and deliberate than under Zhu Rongji. The fundamental policy direction has not significantly changed, although the policy agenda has broadened. It has become clear that policy-makers today face the dual challenge of advancing the transition process while also cushioning the impact of changes that have increased inequality and reduced economic security. On the one hand, the transition process is far from complete; on the other hand, problems created during the second phase of transition urgently require remedial action.

The second phase of transition was far more profound and thorough than the first phase, but in many areas the institutions created are still far from adequate. The financial system (Chapter 19) remains dominated by state-owned banks and subject to influence by government and well-connected insider groups. Weak legal accountability finds its reflection in the financial system in a trail of nonperforming loans and bad assets, followed by government bailouts. The tax system has been reconstructed but fiscal relations between central and local governments are still weakly specified, and local fiscal capacity gravely underdeveloped (Chapter 18). Chinese corporations have been given a coherent legal charter, but most are far from developing world-class standards of corporate governance and the ability to compete in the global marketplace (Chapter 13). Chinese regulatory agencies have been created, but they are still not fully independent from the government management bodies from which they were originally "hived off." This list could be extended but the key challenges and focus of reform remain strengthening the financial, fiscal, and regulatory apparatus and building the institutions of a sophisticated market economy.

The specific challenges are changing and becoming, in a sense, more "political." China is struggling to develop a broader and sounder system of ownership, with a stronger, and more transparent system of property rights. The need to develop a legal and regulatory system is increasingly urgent, and the demand for legal rights and regulatory fairness is increasingly widespread in the population. But thus far, progress in developing a regulatory apparatus has been limited by the fact that transparency, accountability, and oversight run into limits when they touch on the ultimate structure of political power. China's reformers have made numerous efforts to strengthen checks and oversight within the system, but they all ultimately rely on a kind of self-policing by the CCP. The economy is still politicized, and powerful interest groups frequently involve the cooperation of political and economic elites. Under these circumstances, corruption is inevitably a serious problem, both in its own right and because of the way it obstructs resolution of other problems. A true "level playing field" remains to be created.

A different set of challenges face China's reformers as they struggle to cushion the impact of economic changes on vulnerable sectors of the population. Inequality has increased sharply (Chapter 9), and economic life has become much more uncertain. In the rural sector, incomes have increased but have lagged stubbornly behind urban incomes. Chinese policy-makers used the first phase of transition very effectively to build support for further reforms. As mentioned previously, reform in the 1980s was a kind of "reform without losers," making some better off without significantly harming any major group. But this set of benign social outcomes was sacrificed after the mid-1990s. Unable to indefinitely protect SOEs from competition, reformers shrank the state sector quickly. Not surprisingly, once policy-makers made up their minds to "smash the iron rice bowl" and downsize the state-sector, marketization leapt ahead, even though pension and health-insurance programs were far from complete. As a result, significant segments of society, in both urban and rural areas, feel left out of the prosperity they see developing around them. Reformers need to carry out remedial work, repairing some of the holes that have developed in the urban social safety network, and bringing some basic social security protections to rural workers. More broadly, reformers need to ensure that reforms bring as many economic benefits as possible to a large majority of the population, protecting the more vulnerable sections of the population while also, incidentally, reinforcing the pro-reform sentiments that developed during the 1980s.

Indeed, the post-2003 Hu Jintao–Wen Jiabao administration immediately shifted the rhetorical emphasis of the government toward greater solicitude, toward rural areas, and toward regions and individuals left behind in the development process. Expressions of good intentions have been followed by significant policy changes that, for example, have reduced the tax rate in rural areas, and eliminated some of the unreasonable extra burdens that rural-to-urban migrants experience in cities. Still, these shifts in orientation need to be reinforced by effective policies that bring the benefits of growth more inclusively to a broader swath of the population. This will not be easy. Current policies lock in the growth of an increasingly competitive and open economy. The commitments to the WTO, of which China became a member in December 2001, limit China's ability to protect large sections of the economy from international competition. This will inevitably accelerate the pace at which the market discriminates between successful and unsuccessful market competitors. While this process is driving the creation of a more productive and competitive economy, it also increases the urgency for China to provide effective policies to ease the transition of millions out of obsolete, low-productivity jobs, and speed their finding of productive roles in the emerging economy. Only if the benefits of reform are broadly spread will China be able to make the next step to a highly functioning market economy.

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### Suggestions for Further Reading

Wu (2005) has the best comprehensive coverage of China's transition. For a quick introduction to the contending perspectives on China's gradualist approach versus the Russian and Polish "big bang," see McMillan (2004) and Havrylshyn (2004). Some key works that discuss transition in Eastern Europe and in China include World Bank (1996), Sachs and Woo (1994) and McMillan and Naughton (1992).

Lau, Qian, and Roland (2000) introduced the analytic concept of "reform without losers," which serves as the basis for the two periods of reform used in this text. Qian (2003) is also an absorbing account. Naughton (1995) covers the period through 1993 in more detail. Qian and Wu (2003) adopt a similar two-period interpretation.

### Sources for Data and Figures

Figure 4.1: Naughton (1995): 224.

Figure 4.2: *SYC* (2005, 271, and preceding years). Official data have been adjusted to make the categories consistent over time and comparable with international conventions. Official data treat subsidies to loss-making state enterprises as a negative revenue item; these subsidies have been added to both revenues and expenditures.

Figure 4.3: *SYC* (various years) and statistics published by the Ministry and Labor and Social Security (various years). See Chapter 8 for discussion.

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