

# CHINA'S ECONOMIC TRANSITION

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Lecturer – Oleg Deev  
oleg@mail.muni.cz

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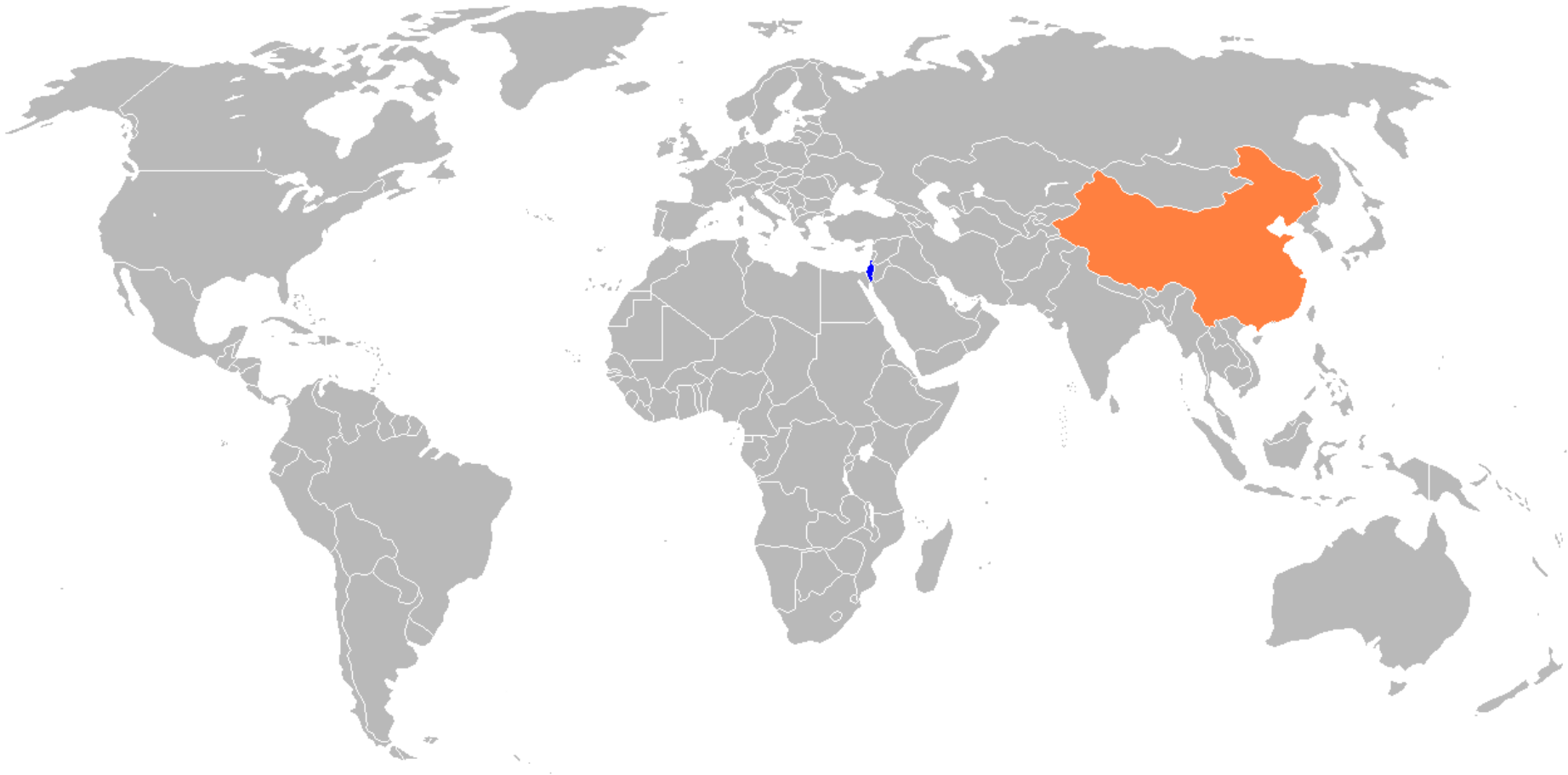
# Key factors of economic development

- One of the world's earliest civilization



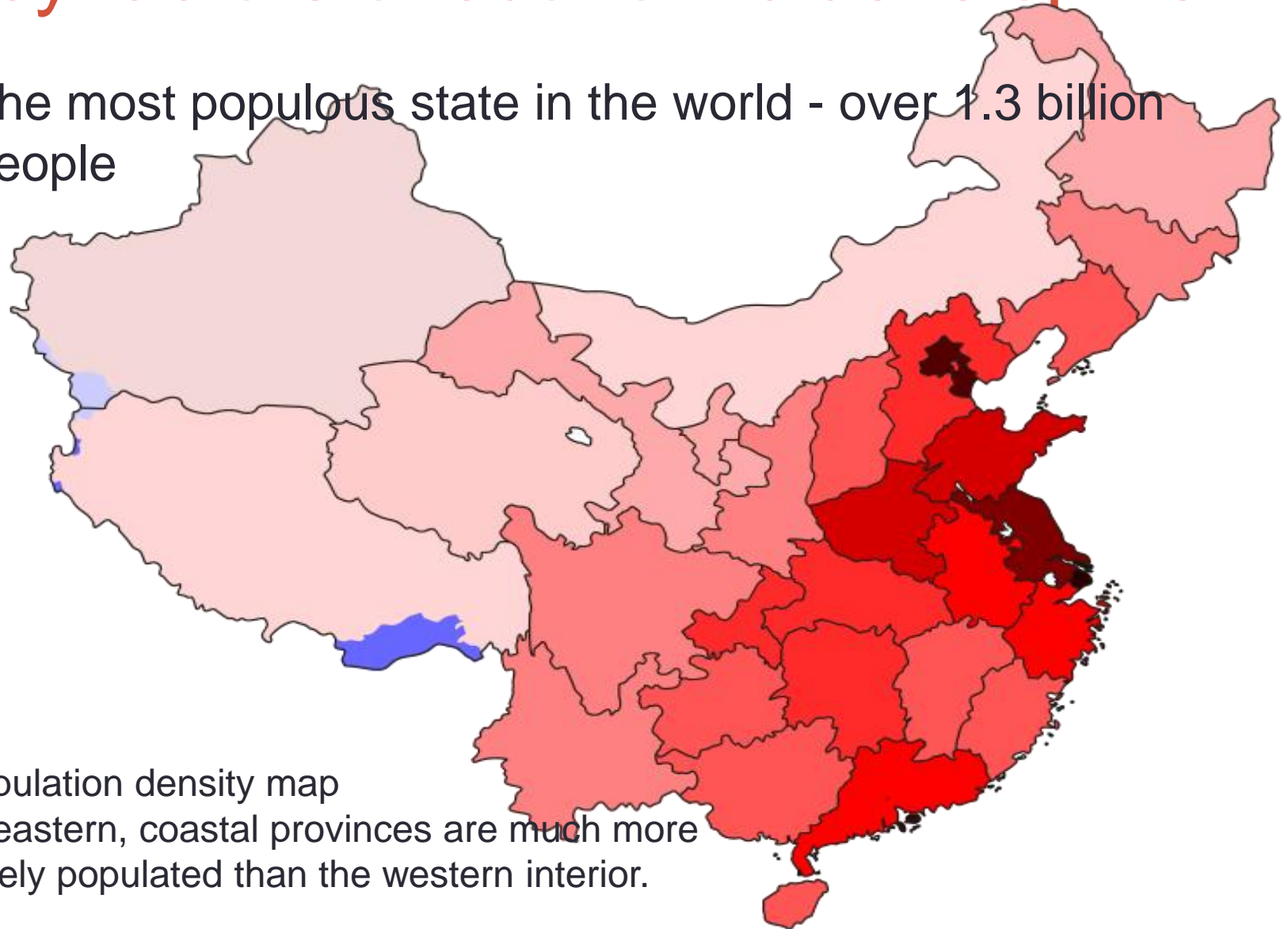
# Key factors of economic development

- The second largest country in the world by land area - 9,6 billion km<sup>2</sup>



# Key factors of economic development

- The most populous state in the world - over 1.3 billion people



A population density map  
The eastern, coastal provinces are much more densely populated than the western interior.



人口总数  
Population

亿人 100,000,000

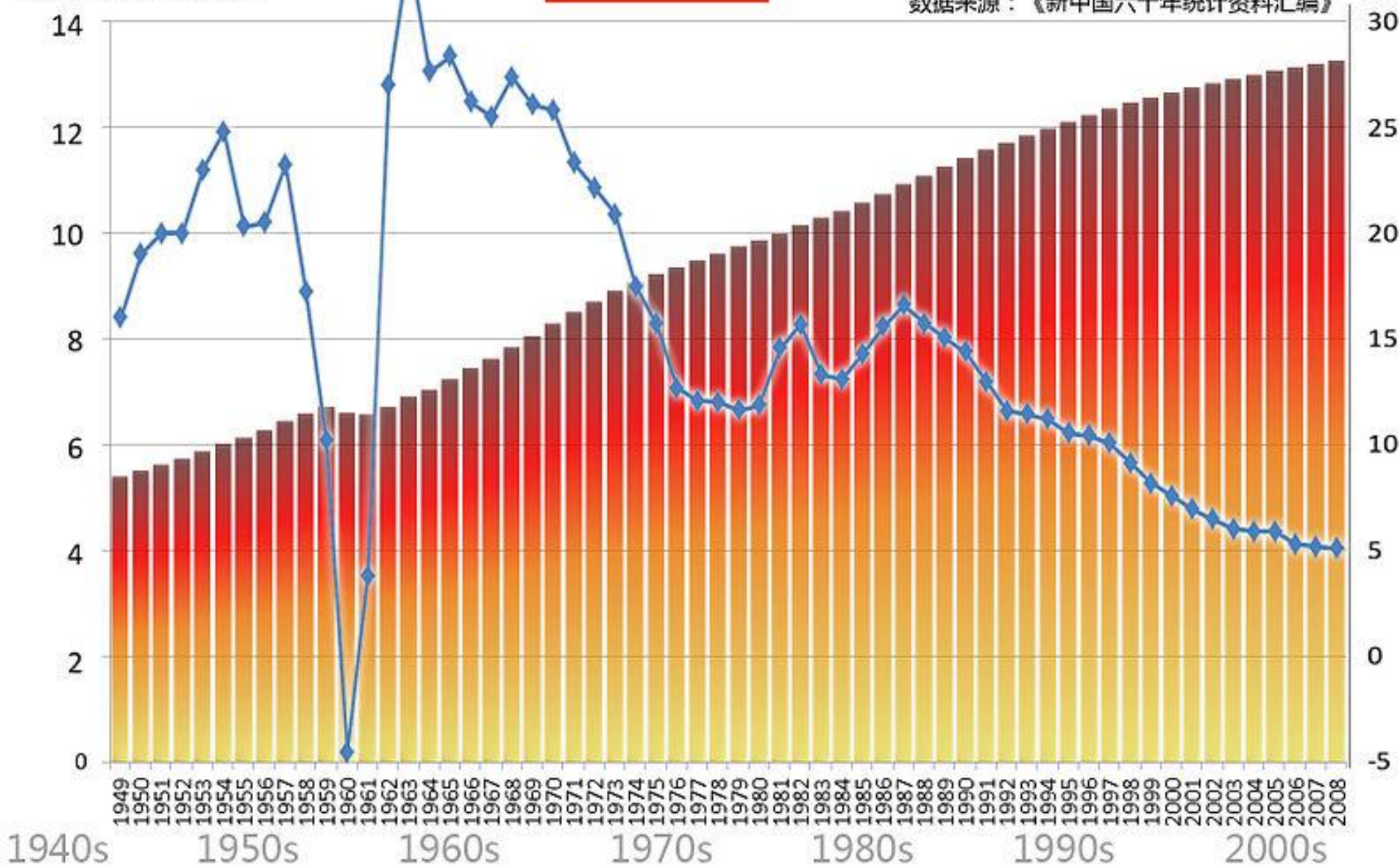


人口自然增长率

Natural Population Growth Rate

数据来源：《新中国六十年统计资料汇编》

%





# Key factors of economic development

- Authoritarian nature of governance to control people and territory





# Key factors of economic development



- Disparities between coastal and inland provinces

Shanghai  
Hong Kong  
Beijing  
Tianjin  
Chongqing



# Important Years

- 1911: End of traditional economy
- 1937: Wars
- 1949: Communist party taking control
  - Radical change in government
  - Rapid and modern economic growth (sometimes turbulent)
    - Develop a massive socialist industrial complex through direct government control
    - Inward-directed strategy rather than the coastal enclave industrialization
- 1978: Reform and opening

# The “command economy” system

- The government directly control all large factories, transportation, communication, land, and farms
- Planners assign production targets to firms and allocate resources and goods among different producers
- Investments are made by the governments. Fiscal revenues mainly come from state-owned firms' profits
- Prices do not reflect market demand and supply. Government can increase revenue by setting goods' prices (e.g. prices of labor and raw materials are set low and those of industrial goods are set high)

# Difference between the economic systems of China and Soviet Union

- The core planning system in China was much less centralized and much less tightly controlled
  - Transportation and communication were less developed in China
  - The system in China allocates a maximum of 600 varieties of industrial product. The Soviet Union had allocated 60,000 separate commodities by 1970s
  - More authority could be exercised by those in the middle, typically local government officials



# Why China turned around in 1978

- The heavy-industry-and-closed-economy strategy could not let China continue high growth rate
  - Agricultural output can not keep pace with industrial growth
- Unsatisfied people – not confident in communism as a political system (1979-1992)
  - Massive drop in living standards
  - Suppressed consumption
  - Lack of mobility
  - Urban-rural gap
  - Destruction of much traditional culture
- Death of Mao in 1976

# Deng Xiaoping (1985)



- The Chinese reform is a great experiment, something that is not described in books

# Deng Xiaoping

Identified several policy errors that contributed to the failure of the Soviet Union and its satellites:

- The Soviet economy could not sustain the costs of the Soviet Union's global military confrontation with the United States during the Cold War
- The liberalization of the political system in Soviet Union and its satellites before economic reforms could produce prosperity allowed dissatisfied electorates to vote the communists out of power



# Objectives

- To adopt market-oriented economic policies and institutions and open country to international trade and investment
- To keep Communist Party of China in power (to redefine communism)
  - Program called “Socialism with Chinese characteristics“

# Goals

- 1980s - To introduce economic policy changes gradually
  - To conduct experiments in special economic zones
  - To revise the results, and only then adopt the new economic policies throughout China
- 1990s – Export-promotion development strategy
  - To liberalize the market for international trade and investment
  - To reform the price system
  - To correctly align domestic incentives
  - To import needed management skills and technology
- To establish a macroeconomic-control mechanism to exercise monetary and fiscal policies

# Special Economic Zones (SEZs)

- Economic activities are primarily driven by market forces
- Established in 4 coastal cities and 15 coastal development areas
- Encourage Foreign Investment through tax incentives
  - Capital Inflows
  - Technology
  - Knowledge of Rest of World (Chinese Diaspora)
- Encourage Production for Export
- Contrast with Self-Reliance



# Reform in agricultural sector

- Initiated locally
- Assigning the collective farm land to each farm household
- Allowing households to keep all the products in excess of the amount required by the procurement quota
- Farmers decide what and how to plant

# The agricultural production, tons

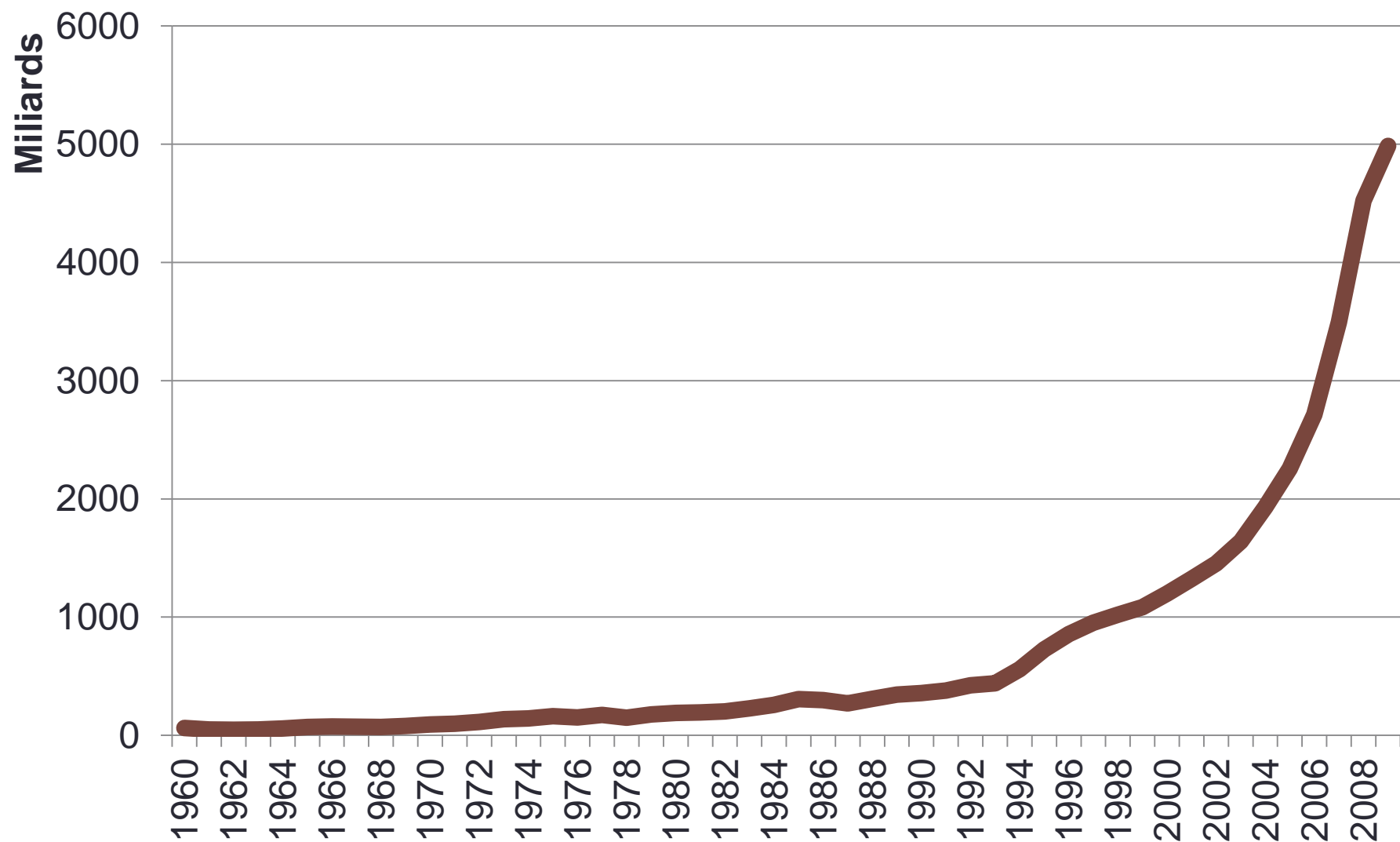
Crop	1949 output	1978 output	1999 output
Grain	113,180,000	304,770,000	508,390,000
Cotton	444,000	2,167,000	3,831,000
Oil-bearing crops	2,564,000	5,218,000	26,012,000
Sugarcane	2,642,000	21,116,000	74,700,000
Fruit	1,200,000	6,570,000	62,376,000
Meat	2,200,000	8,563,000	59,609,000

# Reform in industrial sector

- Early 1980's – state enterprises were given some autonomy in production, distribution and investment decisions
- Middle 1980's – price and input control were gradually reduced
- 1987 – the contract responsibility system
  - An enterprise was leased to its management and a fixed tax was collected from the enterprise, allowing the enterprise to keep all the remaining profits



# Gross Domestic Product



# Reform of the banking system

- 1983 – the People's Bank was officially changed to a central bank
- The conversion of the state specialized banks into commercial banks – 60% of the domestic banking business
  - the Industrial and Commercial Bank
  - the Agricultural Bank
  - the People's Construction Bank
  - the Bank of China
- 1994 - three types of banks: commercial banks, policy banks and cooperative banks, with an increasing role for private banks

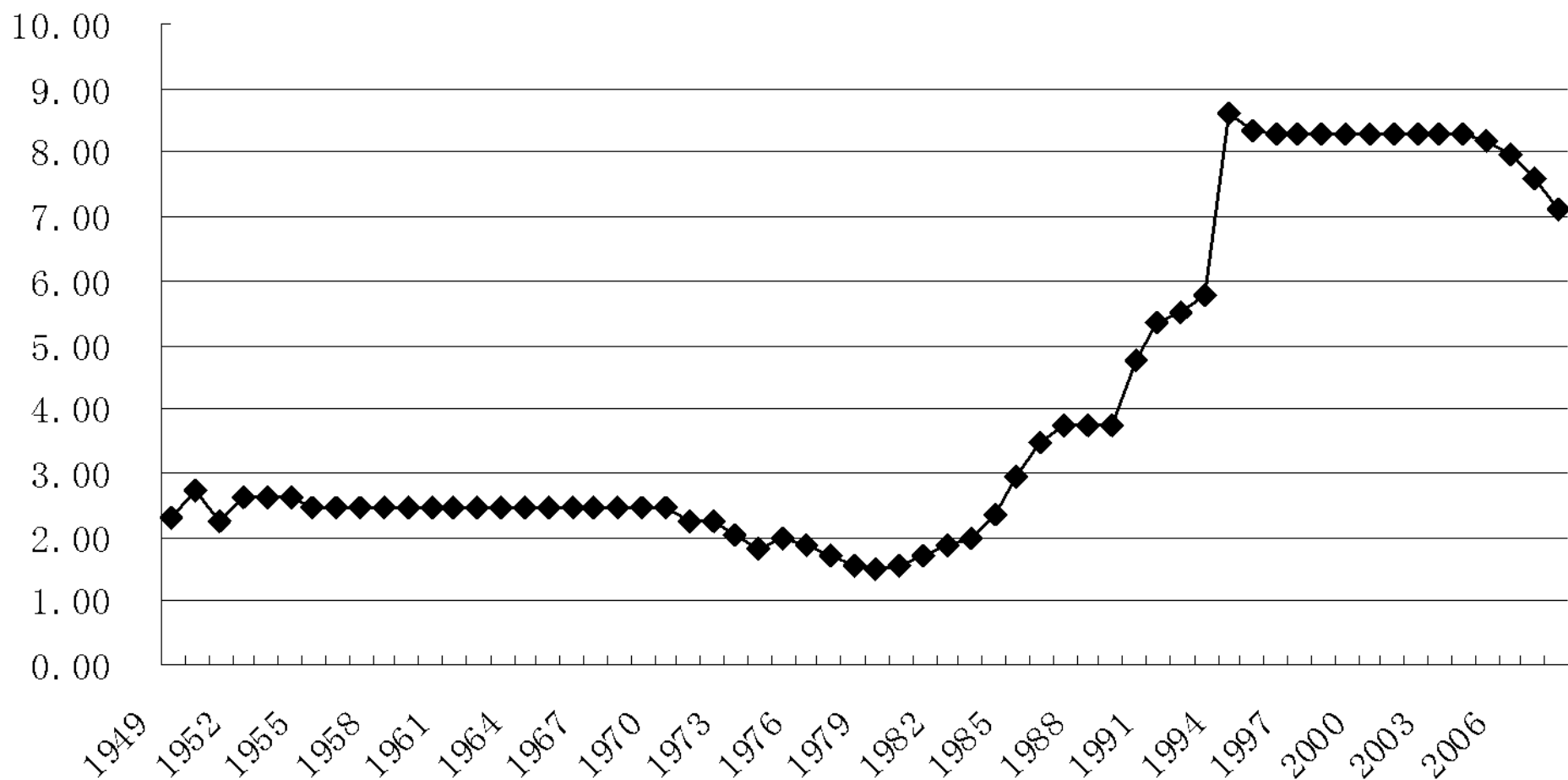
# Reform of the banking system

- Commercial banks do not function effectively?
  - Political interference (banks are under government ownership)
  - Lack of trained personnel
  - The control for interest rates for loans and deposits
  - Insufficient incentives
- Banking crisis in China is nearly impossible
  - An asset management company is set up for each of the large commercial banks to take over non-performing loans
  - Chinese people keep most of their savings as bank deposits (They assume that deposits are guaranteed by the government and are safe)

# The open-door policy

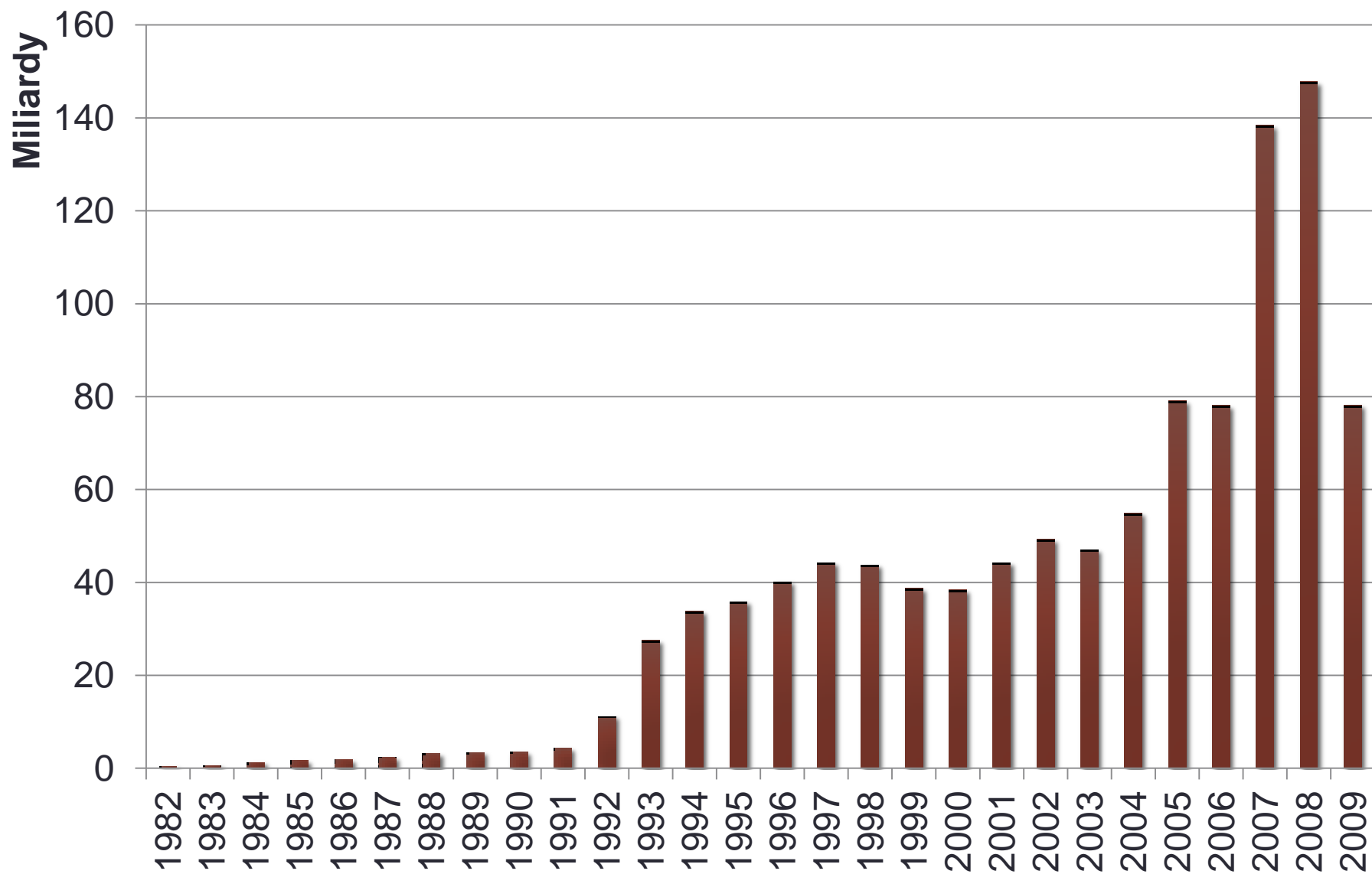
- The volume of foreign trade has increased from just below 10 percent of GDP in 1978 to over 35 percent in 1996
- Trade deficits in the 1970s and the 1980's were changed to trade surpluses in the 1990s
- Control of foreign exchanges was gradually relaxed
  - successive devaluation of the Chinese currency from 1.7 yuan / US dollar ratio in 1980 to 8.6 in 1994, the exchange rate was made equal to the market rate and the Chinese currency became convertible as far as trade transactions were concerned
- The encouragement of foreign investment

# Exchange rate (yuan / US dollar)





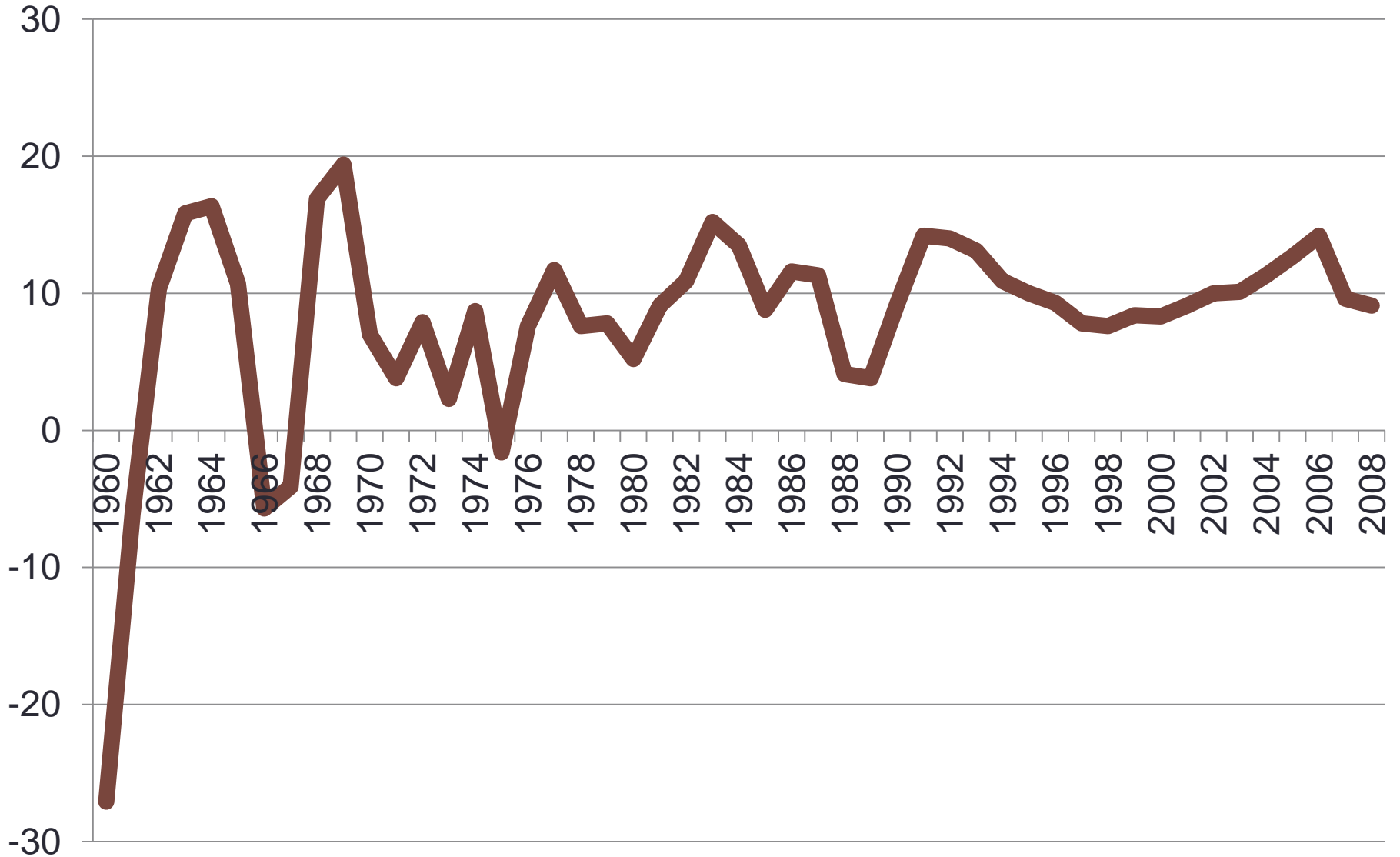
# Direct foreign investment



# Development of non-state sectors

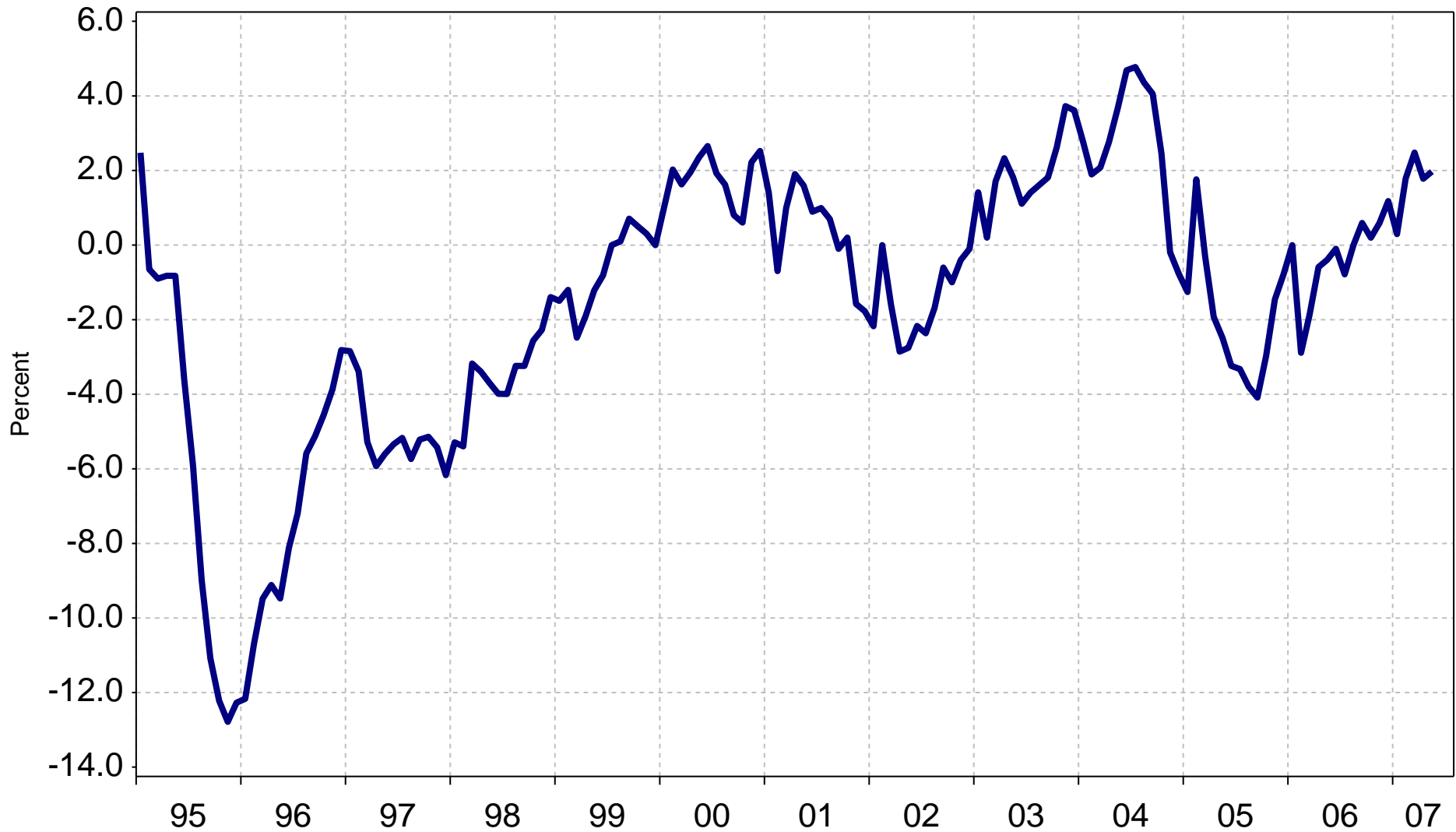
- Permission for entrepreneurs to start up business
- Collectively owned township and village enterprises
  - were built by the political and economic resources of the township and village governments to increase revenue
  - are subject to market competition
  - employ the managerial skill of competitively selected and highly paid managers
  - utilize the high-quality labor force available in the countryside
  - publicly owned
  - are operating without a modern legal framework

# GDP growth rate, %



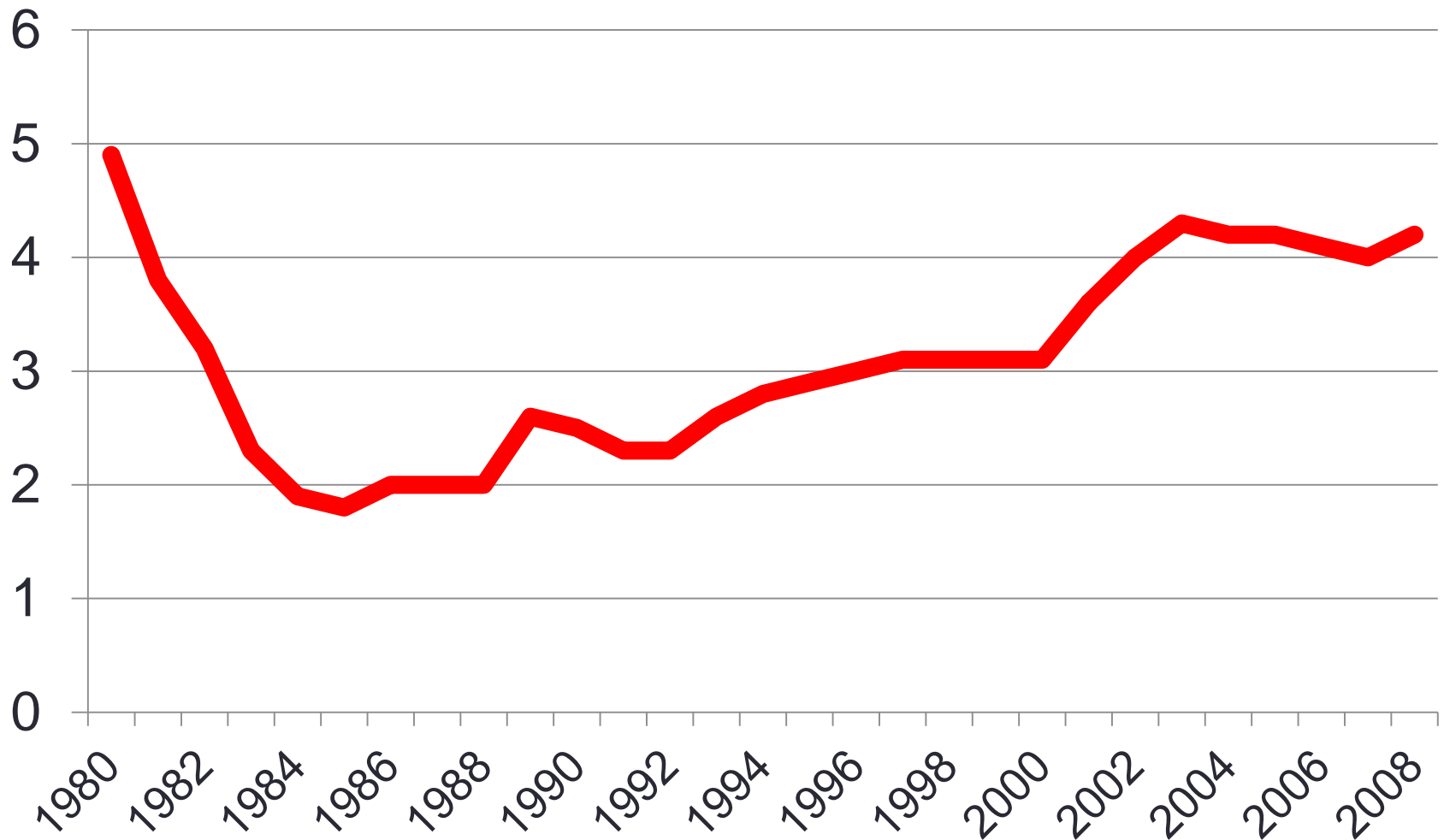
# China - Consumer Price Inflation

Annual percentage change in consumer prices



Source: Reuters EcoWin

# Unemployment rate, %





# RESULTS

- The world's second largest economy
- The largest trading nation
- The largest recipient of FDI in the developing world
- Income per capita increased 6 fold
- Never before in history have so many millions of people been lifted out of poverty in such a short time

# Is China the only country that has been growing so fast?

- No. Many other economies have been growing rapidly in the past decades – so poor to begin with
  - Other east Asian economies
- But China is the one that grows the fastest and for the longest period, in terms of GDP per capita
  - China: over 30 years of growth with high growth rates
- Possibly growth rate will slow as western income levels would be approached

# Why the reforms were successful?

- China enjoyed the advantages of backwardness
- Planning was less entrenched in China than it has been in other transitional economies
- China had always had a strong administrative capacity
- Properties of the labor force
  - Large labor pool
  - Skilled and disciplined
  - Lower cost – average \$1 per hour and work 58 hours/week
  - No organized unions
- Exports inexpensive low and medium tech goods
- Imports technologies

# Challenges for the future

- Unfavorable demographics
- Corruption, transparency and weak rule of law (guanxi)
- Financially distressed state-owned and state-influenced enterprises
- Domestic and international imbalances

人口总数  
Population

亿人 100,000,000

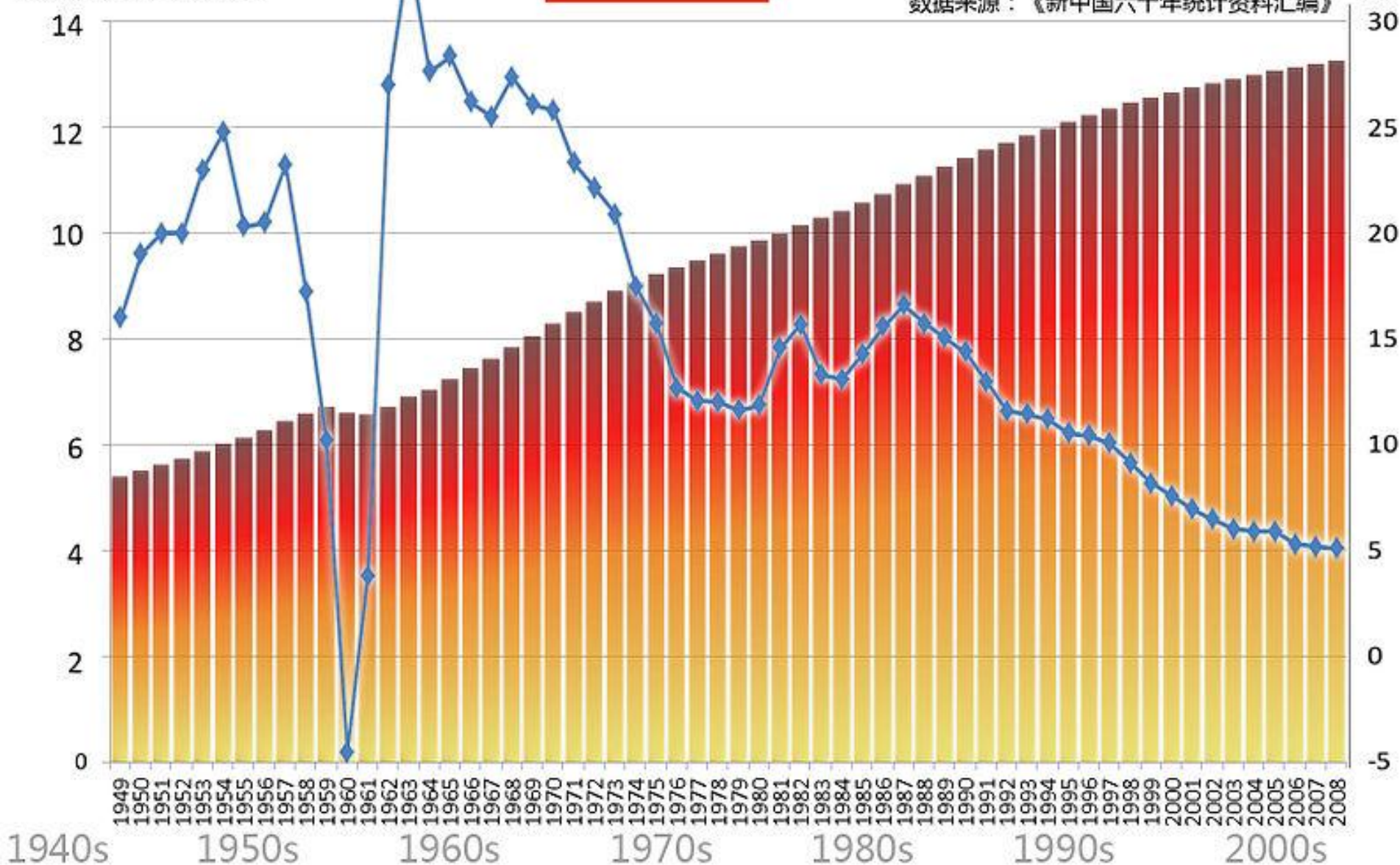


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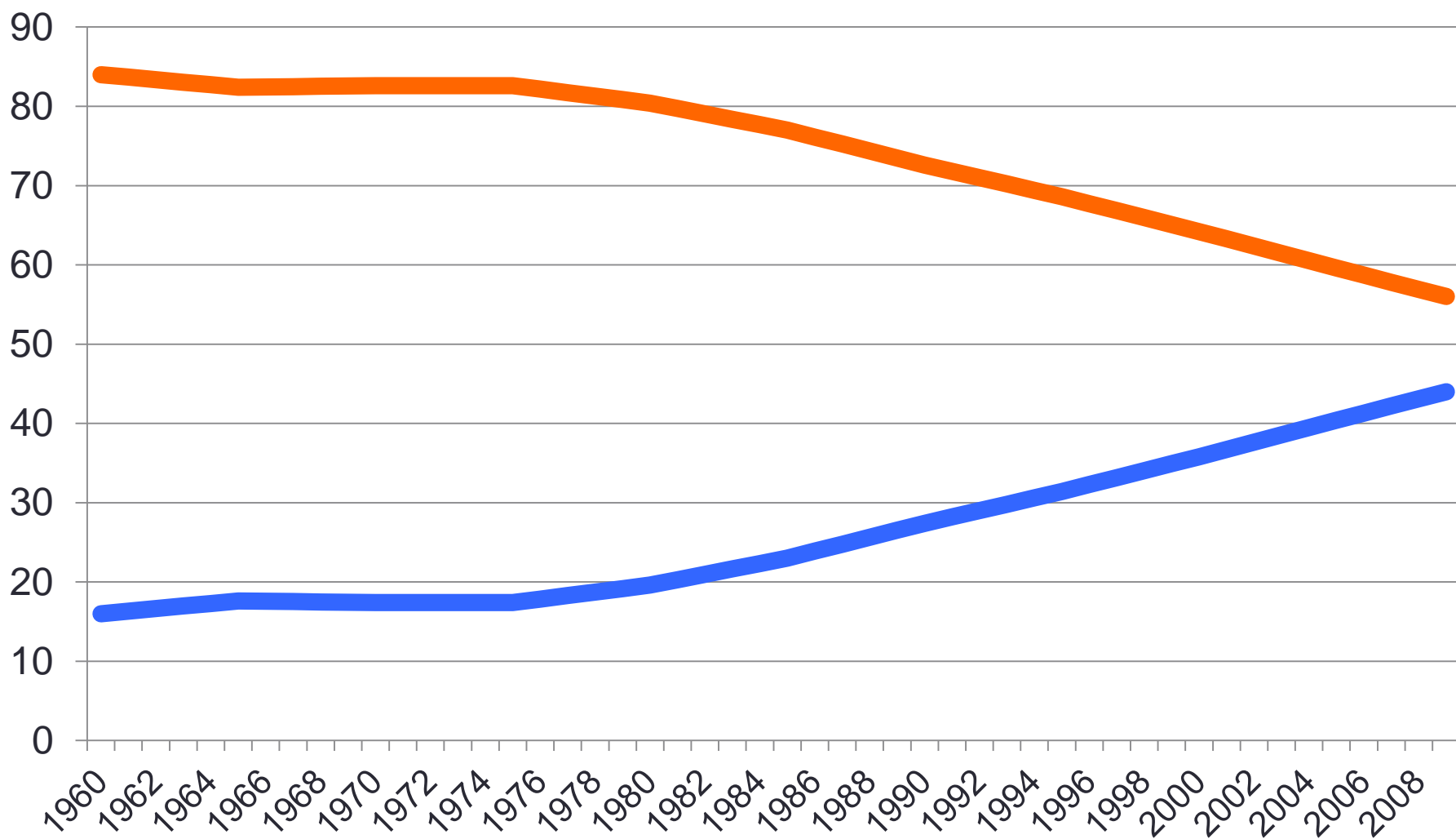
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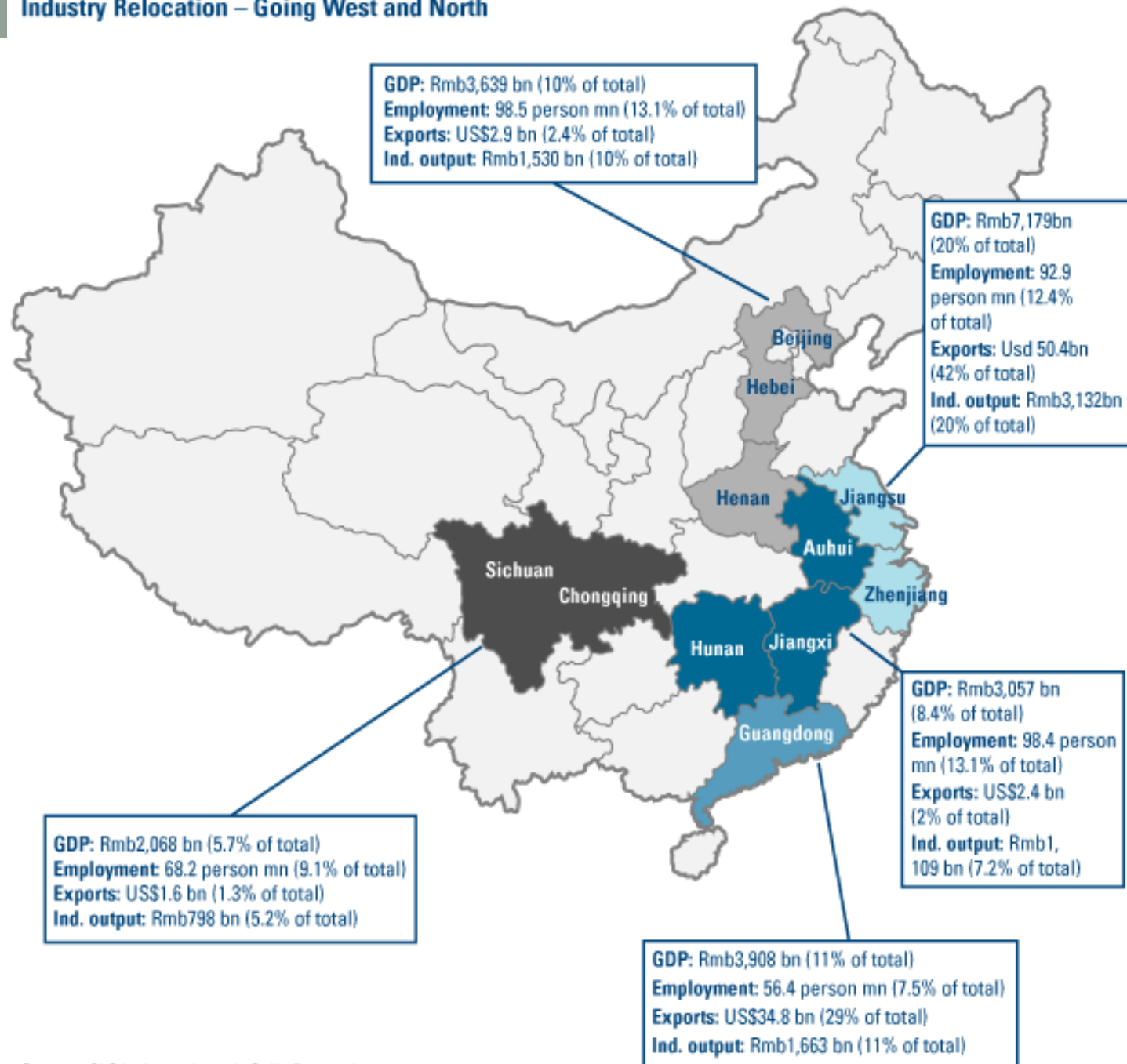


# Rural and urban population share, %





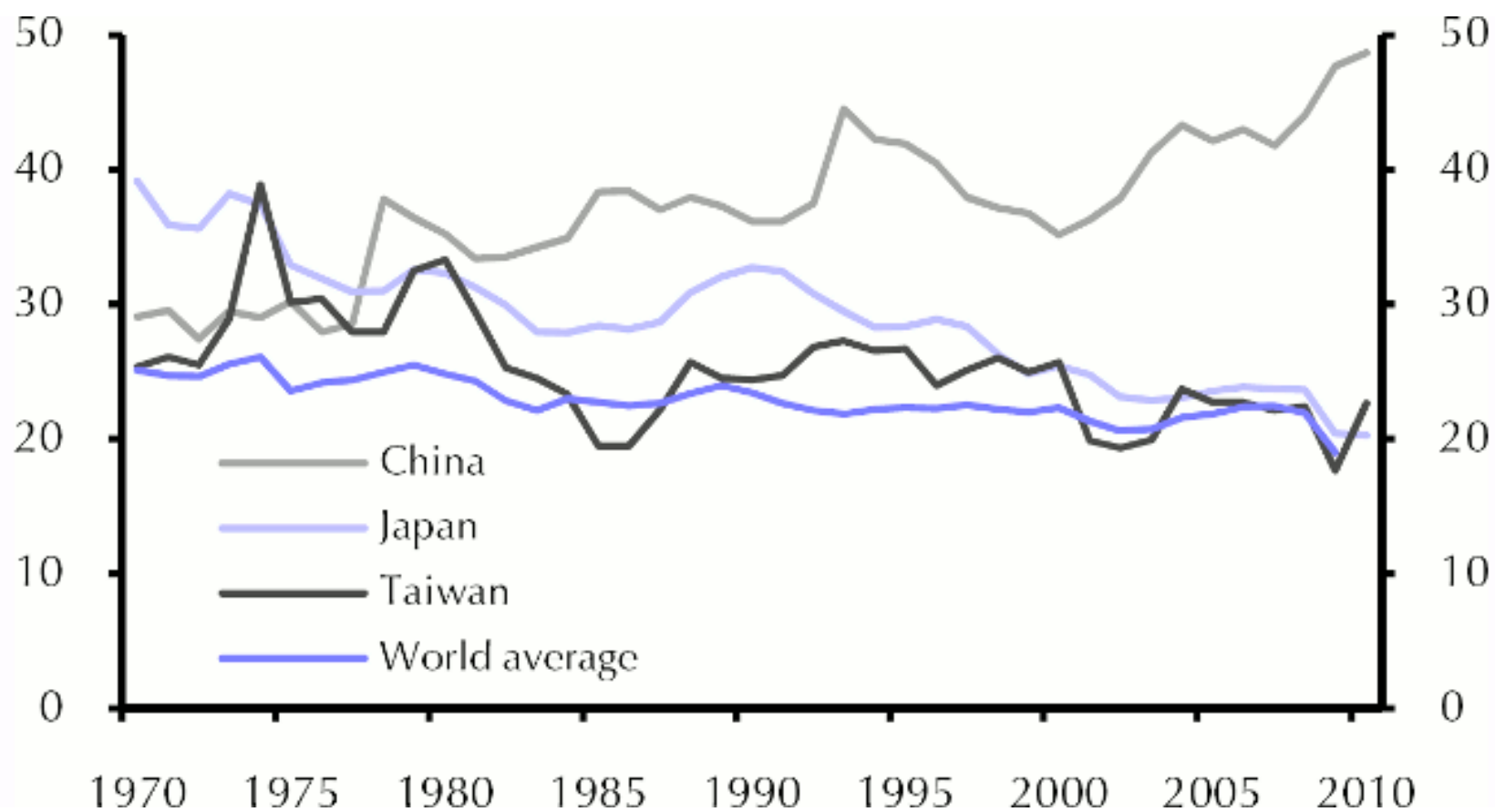
## Industry Relocation – Going West and North



# Imbalances in China's economy

- Momentum of economic growth
  - Economic growth is driven by investments and exports
- Economic distribution
  - Income distribution – gaps in living standards (between urban and rural areas, between state employees and workers, etc.)
- Financial flow
  - Banks overfunded monopolized state-owned enterprises and real estate industry
- Use of economic resources
  - Most of China's economic resources are utilized by government (capital, land and cost of labor are all controlled)

# Drivers of economic growth in China



Investment as a proportion of GDP

# Readings for the next topic

- China's Financial Markets – a Future Global Force? *Deutsche Bank Research*. Current Issues. March 16, 2009.