1. Introduction

The extraordinary emergence of China during the past three decades has been a hallmark of the global economy, heralding a 21st century world that looks quite different from the previous one. This book serves as an introduction to the economy of China during its reform period since 1979. The aim is to explain China's remarkable transformation from a centrally planned to a more market-oriented economy through the institutional reforms utilised to support such marketisation and eventually global integration. This is a challenging process, as China is not only in transition but is also a developing economy with many of the problems associated with being a primarily rural, poor country.

The theme of the book is that China's marketisation process is one that entails a gradual introduction of market forces into areas of the economy, which also requires both dismantling the structure of the centrally planned economy and developing market-oriented incentives. The creation of various types of institutions to support this process of establishing markets will be examined closely. For instance, these include corporate laws to establish private firms, reforms to the wage structure to incentivise labour productivity, and industrial policies designed to attract foreign investment. China undertook much dismantling of institutions from the centrally planned period, but it also must now build the additional institutional foundations to support a more market-oriented economy. This book seeks to explore the interplay between growth and institutions in China, a topic which is of relevance to China and also to the economic development and growth literature.

The structure of the book covers the transformation of the major sectors in the Chinese economy and the reforms associated with the main economic growth factors, such as labour, capital, and technological innovation. The second chapter analyses China's growth model in terms of transition from central planning, economic development challenges, and eventual integration with the global economy. Institutional reforms have underpinned the gradual marketisation process, and legal reforms look to be increasingly important as China becomes a global player. The next four chapters focus on the reform of the factors that drive economic growth, namely, enterprises, labour, entrepreneurship and capital markets (banking and financial sectors). The latter chapter also touches on China's indirect role in the 2008 global financial crisis as a pointer to future reform. In each of these chapters, institutional reforms are highlighted. For enterprises, the mixture of 'institutional innovations' such as the Contract Responsibility System (CRS) and corporate laws accompany the process of reforming state and collectively owned firms as well as helping to establish privately owned ones and attract foreign investors. In terms of labour and entrepreneurship, reforming the wage structure and dismantling the lifetime employment system fed into the development of a labour market that was driven by supply and demand, and allowed entrepreneurs to operate. Governance of capital markets and the restructuring of the banking system constitute a good illustration of the importance of institutional reforms of markets. The global financial crisis of 2008 provides an unmistakable impetus for further cross-border regulation of international capital markets that involves China as a major economy.

A detailed exploration of the interplay between legal and economic reforms follows in a chapter dedicated to this central quest on as to how laws and markets evolve in China. The subsequent chapter explores the key issue for long-run growth – innovation and patents – covering the domestic and some of the international aspects of the intellectual property rights system. The penultimate chapter turns to the social foundations of growth, including education, pensions, the health system and lingering inequality, as well as poverty. It points to the ongoing institutional reforms in progress to support China's marketising economy in those areas. The final chapter concludes the book with an examination of China's external sector development, namely, policies concerning trade, investment, and exchange rates. An assessment of the impact of China's re-emergence in the global economy is also included. The legal and institutional backdrop was most apparent in the ways that China treated foreign investors early on in its reform period, and the chapter concludes with an assessment of how China will fare in an increasingly rules-based international economic system. Therefore, the book assesses China's marketisation process in terms of how major sectors of the economy have been transformed and the areas in need of continuing reform to sustain its transition and continued development. The gradual injection of market-oriented incentives coupled with institutional reform is the approach highlighted throughout the book.

China's reform path can be roughly divided into three parts: rural reforms in the late 1970s, urban reforms in the mid 1980s and opening up to the global economy, which took off in the early 1990s and culminated in accession to the World Trade Organization (WTO) in 2001. The following provides a brief overview of these pillars of China's transformation as an introduction to the volume and begins first with an analysis of the centrally planned period (1949–78) that provided the backdrop to market-oriented reforms which started at the end of 1978.

1. THE IMPETUS FOR REFORM

The impetus for introducing market-oriented reforms in China stemmed from the structural imbalances that favoured industry over consumption, deriving from the centrally planned economy from 1949 to 1978. Despite the high levels of investment and rapid growth (estimated to be 12.3% in real annual gross domestic product (GDP) growth) in 1978, the Chinese economy by the end of the 1970s had standards of living that were not much better than in the 1950s. In the indicative category of grain consumption, average per capita food grain availability in 1977 was similar to the 1955 level. Average grain consumption of the rural population for 1978–80 was actually lower than that for 1955–57, whereas it was slightly higher in urban areas (Riskin 1987).

Within the state-owned sector which encompassed nearly all of industrial output during the command or administered economy, the general freeze on wages after 1957 and the entry of new workers into the lowest rungs of the wage ladder caused the average wage in real terms to fall 17% between 1957 and 1977. Only a large increase in the labour force participation rate – from 30% of the urban population in 1957 to 55% in 1980 – enabled the average per capita income of wage and salary earners to increase by 62% in real terms within that period. Neglect of 'non-productive' investment caused the small housing space of 4.3 square metres per urban resident in 1952 to decline to 3.6 square metres in 1977 (World Bank 1983).

However, China did achieve numerous economic and technological triumphs, including industrialisation, which had eluded so many developing countries. On the innovation front, these included a large machine-building industry, satellites, nuclear weapons, large ships and giant hydraulic presses, and synthesis of insulin. However, these achievements did not translate into an improvement in the real standard of living, technological advances or improved productive efficiency (Chow 1994; Borensztein and Ostry 1996).

Most of China's industrial growth had come from increases in factors, especially fixed capital, rather than an increase in the efficiency of use of inputs. Even the growth in labour productivity was achieved mainly by increases in the amounts of physical capital per worker. For instance, estimates of the capital-labour index indicate an increase from 100 in 1952 to 373 in 1978 (Riskin 1987). This was due to the structural shifts towards more capital-intensive heavy industries following the Soviet model which were later reversed.

This was the crux of the problem of 'structural imbalance' that required reform. Another part is due to systematic reasons familiar to centrally planned economies, stemming from the deficiencies in the system of economic organisation, planning and management. This tension became a principal theme of the new economic strategy announced at the Third Plenum of the 11th Central Committee in December 1978, which marked the start of the reform period in China (Chang 1988).

Finally, there was also a problem of high urban unemployment which reappeared in 1978. In 1979, the urban unemployed were thought to number upwards of 10 million or about 9.5% of the estimated non-agricultural labour force of 104 million (China's National Bureau of Statistics (NBS) 1999). Before 1976, unemployment was largely avoided, by such means as some 20 million urban residents being sent to the countryside after the Great Leap Forward of the late 1950s and early 1960s. Their return likely contributed to the subsequent rise in unemployment figures. The estimated 17 million youth who were sent out to the countryside from 1966 to 1976 were urban residents (Chang 1988). Moreover, during this period, job placement was handled by the state labour bureaux, which were responsible for placing school-leavers, demobilised soldiers, returned youth from the countryside, and released convicts. The burden on the already disorganised state apparatus resulted in many job-seekers spending long periods of time 'waiting for work'. Enterprises were forbidden to recruit workers and individuals could not seek jobs in compliance with the state's goal of providing full employment. This commitment resulted in general overstaffing (a form of 'disguised unemployment') (Knight and Song 2005). This problem was perhaps exacerbated by a continuing gap between urban and rural incomes which resulted in an oversupply of labour at existing wages. The numbers were dependent to some extent on administrative suppression of the movement of labour through a prohibition on rural-urban migration. Other contributing forces include the favoured sector in China's development strategy being heavy industry, which is capital-intensive.

Therefore, high urban unemployment, stagnating levels of food consumption, deteriorating urban housing conditions, falling real wages, widespread rural poverty resulting from the emphasis on industrialisation in urban areas and sluggish productivity growth – all despite rapid economic growth conventionally measured – could be viewed in the context of the deficiencies of central planning. A reassessment of the structural imbalances and systematic flaws – flaws in the planning, management, and incentive systems under the planned economy – pointed to a number of problems in the economy. These included high levels of capital accumulation, coupled with a lack of efficiency and low levels of consumption. There was a neglect of agriculture and light industry as well as of maintaining living standards. The struggle to overcome these structural and systematic imbalances led to the introduction of market-oriented reforms, whilst retaining a planned portion of the economy consistent with a high degree of governmental control, since unlike other transition economies, China did not embrace marketisation alongside political reform. This became known as the 'dual track' transition path of the Chinese economy, in which a planned segment was maintained alongside the market sector.

2. RURAL REFORMS

Market-oriented reforms started with rural development and liberalisation at the end of 1978, which resulted in the unexpected success of Township and Village Enterprises (TVEs) by the early 1980s (Oi 1999). Farmers became part of a system of residual claimants who could retain returns on their work product after remitting the required portions to the state. This characterised the accompanying liberalisation of agriculture. Once this 'dual track' system, known as the 'household responsibility system' (HRS), was adopted, output grew in rural areas. Agricultural output growth soared, peaking in 1984. This spectacular success caused the subsequent claim that Chinese economic reforms began in the countryside. Reorientation of the economy through this type of institutional innovation increased the share of national income going to households by 10 to 15 percentage points (NBS 1999). National savings and investments remained robust through the 1980s on account of this structural shift. This also minimised the adjustment required by the economy because while government savings was falling, investment was maintained at relatively high levels. Thus, Chinese households helped to maintain macroeconomic stability during this period. And, as a result, China's financial system began to diverge from the standard command economy model, which has low levels of private savings, with subsequent difficulties when governmental revenues declined, and began to resemble the structure of a market economy.

The TVEs or rural enterprises had become ensconced in the collective organisational structure in the countryside. They were permitted to develop in order to provide inputs for the quite successful agricultural industry in rural areas. TVEs also became vehicles for absorbing surplus labour from agriculture. What was not anticipated were the profound changes they engendered in the economy as a whole. In 1983–84, a short time after the introduction of market-oriented reforms, most communes were abolished (Riskin 1987; Lin et al. 2003). Their functions were divided between townships that assumed responsibility for governmental operations and local economic committees that took over economic management. This permitted the TVEs to become more independent as well as being profit-oriented entities. At their peak during the post-1978 reform period, TVEs accounted for around one-third of industrial output in China.

3. URBAN REFORMS

The next phase of reform was in urban areas. There were three main so-called ‘institutional innovations’ in the state sector that characterised its successful reorientation toward the market in the 1980s and 1990s. They were the Budgetary Responsibility System (BRS), the Contract Responsibility System (CRS) and permitting direct borrowing (Riskin 1987; Naughton 1996; Lin et al. 2003). Since 1980, under the BRS, the central government shares revenues (taxes and profit remittances) with local governments. For local governments which incur budget deficits, the contract sets the subsidies to be transferred to the local governments. This fundamentally reshaped fiscal relations between central and local government. Then, the CRS in 1985 permitted state-owned enterprises (SOEs) to pay a fixed amount of taxes and profits to the state and retain the remainder. In principle, so long as the SOEs deliver the tax and profit remittances specified in the contracts, they are free to operate. Also in that year, state grants for operating funds and fixed asset investments were replaced by bank loans. Local governments and SOEs are allowed to borrow directly from banks. Since 1991, local governments and SOEs were further permitted to borrow from households and other institutions. With World Trade Organization (WTO) accession in 2001, foreign banks were also gradually permitted to extend domestic credit.

The result of the urban reforms is a decentralised state sector where autonomous local governments, SOEs and local state-owned banks (SOBs) have increasingly important roles in determining resource allocation, while central government has become less important, even though ownership has not been fully reformed. Based on China’s experience, it is sometimes argued that a market economy could be compatible with state ownership if managerial incentives were introduced. Decentralisation has occurred in almost all areas of decision-making in production, pricing, investment, trade, expenditure, income distribution, taxation and credit allocation (Naughton 1996). The decentralisation reforms may indeed have improved the technical efficiency of the state sector, but by the standards of allocative efficiency and intertemporal stability, the decentralised state sector is a major institutional cause of macroeconomic instability and of the divergent development of regional economies.

Therefore, decentralisation and institutional innovations within the state sector were important for China’s development in the post-1978 period in urban as well as rural areas. However, the retention of the planned track engendered 'soft' or non-binding budget constraints for SOEs and non-performing loans (NPLs) held by SOBs. Even though SOE inefficiency and unemployment were not concomitant until the late 1990s, it did eventually surface as a major source of difficulty in the Chinese economy. Thus, 'soft budget' constraints, remain perhaps the most difficult issue for reform of the state sector in China.

4. EXTERNAL SECTOR DEVELOPMENT

In 1978, the reform period began when market-oriented measures, which included the 'open door' policy designed to encourage international trade and foreign direct investment (FDI), were implemented. China's approach to economic reforms, though, is and has been gradual as it tends to adopt policies slowly. China's reform programme progressed in a gradualist approach that has also been referred to as 'crossing the stream while feeling the stones'. China's approach is to wait until a particular policy has been successfully implemented in one region before the 'experiment' is extended nationally. As a result, China's 'open door' policy did not move forward until reforms were implemented in urban areas in the mid 1980s and then did not pick up until Deng Xiaoping's game-changing tour of the first-opened southern coastal provinces in 1992. Since then, China has been tremendously successful in attracting FDI and had also become the world's second largest trader some decade and a half later.

The first reforms in the area of FDI policy created what are known as Special Economic Zones (SEZs). SEZs were first introduced in 1979 in the south-eastern coastal provinces of Fujian and Guangdong and located in urban areas (Lardy 1991; Naughton 1996). The SEZs are similar to special customs areas. Foreign invested enterprises (FIEs) received preferential treatment, including up to 50% reduction in custom duties, with respect to corporate income tax and granted duty-free imports. This resulted in extremely rapid growth in these areas due to their attractiveness to foreign investment. Guangdong was the leading exporter among provinces in China by the mid 1990s on account of the successful growth of the SEZ city of Shenzhen on the Hong Kong border and that of the capital city, Guangzhou. Although the SEZs were successful, the Chinese authorities believed that they tended to attract investment in low-technology and light industrial sectors. These were indeed consistent with China's comparative advantage in abundant, low-cost labour. However, China was keen to attract more advanced technologies and the combination of these factors paved the way for future reforms and eventual membership of the WTO.

China's further trade liberalisation measures, leading up to membership of the multilateral trading body, the World Trade Organization, in 2001, set the stage for its opening. Over the period 1990–2000, Chinese manufactured exports grew by 16.9% per annum, compared with 10.3% for the rest of East Asia, and its world market share tripled from 1.7% to 4.4% (Lall and Albaladejo 2004). China's share of the global export market grew even faster after 2000, accounting for over 7% of world merchandise exports after WTO entry.

Manufactured goods comprise around 90% of its merchandise exports (Lall and Albaladejo 2004). China has emerged as the largest exporter of manufactured products in the developing world. The growth of its manufactured exports has been among the fastest achieved by developing countries, and they are not, as sometimes thought, based only on cheap labour. The exports span a broad range of technologies, so reflecting an impressive range of competitive strengths, and are diversifying and upgrading with amazing rapidity.

Moreover, despite the lack of full convertibility of its capital account, China in the 1990s had become the second largest host country for foreign direct investment after the US, the eighth largest capital supplier in the world, and the largest among developing countries (not including flows through Hong Kong, which reverted to China in 1997) (World Bank 1997). The stock of FDI is impressive, although there is some dispute over the figure on account of 'round tripping', whereby capital leaves China and returns to take advantage of foreign capital concessions. The ten biggest investors contributing to its impressive inflow of FDI are Hong Kong, the Virgin Islands, Japan, South Korea, the United States, Taiwan, Singapore, Western Samoa, the Cayman Islands and Germany. The top two sources of funds were from Hong Kong, a conduit for investors from Europe, Asia and the US, and the Virgin Islands, used as a channel for Chinese money 'round tripping' to qualify for various tax perks given to foreign investors.

However, WTO accession for China required numerous forms of trade liberalisation and reciprocal entry into the domestic market. China reduced the number of products subject to non-tariff barriers (that is, quotas and licences) from an estimated 1200 in the early 1990s to approximately 200 a decade later. The pace of tariff reform was also rapid, with rates at less than 20% across the board following a significant tariff reform in 1997. Three more tariff reforms preceded accession in 1999, 2000 and 2001, so that average rates were nearer to 15% with the lower tariffs in manufacturing. The reduction in tariffs required by accession were not as severe as a result. An important feature of China's trade regime has been the provision of exemptions or reduced rates for goods imported for production of exports and direct investment, which accounted for about 60% of imports in 2000.

As with all WTO members, China moved toward a regime based on tariffs, so quotas, licences and designated trading were to be phased out. State trade of commodities is still permitted, though, subject to WTO rules. China agreed to be bound by all industrial and agricultural tariffs, so that the average tariff on manufactured goods was reduced to 6.95% and 17% on agriculture upon accession. Notably and specifically regarding textiles, China became integrated into the General Agreement on Tariffs and Trade (GATT) Uruguay Round on textiles and clothing. By 2005, all existing quotas on China's exports of textiles and clothing ended, and by 2008, any special textile safeguards also came to an end. It coincided with the phase-out of the Multi-fibre Agreement at the start of 2005, which had previously allocated quotas for output to different countries. As such, China's anticipated gain in market share was considerable, perhaps as much as 50% of the US market. However, subsequent safeguards against Chinese exports of textiles and clothing were imposed by the US and Europe, while smaller exporters such as Bangladesh were threatened, leaving this area still less than fully liberalised. Therefore, although there remain issues concerning agricultural products and access to China's domestic market, the general outlook is that of an economy which is quickly opening its borders and becoming all the more globally integrated. Indeed, within a few years of joining the WTO, China had become the second largest trader in the world and among the top three trading partners of the European Union and United States.

5. CONCLUSION

This brief overview of the Chinese economy highlights the gradual and piecemeal fashion of economic reforms. The major waves of reforms in the late 1970s, mid 1980s, early 1990s and early 2000s have culminated in an economy that is increasingly market-oriented. This book will delve into the major aspects of growth, transition and development to give a fuller picture of the economy of China.

As China is expected to become as important an engine of growth in the world as the United States over the coming decades, understanding the nature of its marketisation process and the fragilities in its institutional system are more important than ever before. No longer a country for specialist investigation, China has arrived on the global stage as an economy that needs to be analysed and assessed in order to gain a general view of the global economy.