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***Department of Foreign Affairs  
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**POLICY STAFF PAPER**

**NO. 94/10**

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**China 2000:  
The Nature of Growth and Canada's Economic Interests**

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(May 1994)

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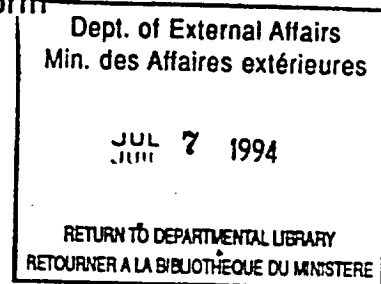
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## Executive Summary

In 1978, China's leadership reached the conclusion that more extensive use of productive factors was not the best means of achieving rapid, and sustainable, economic growth and development. Sustained rapid growth and development would require that the economy be restructured so as to enhance the productivity and the efficient use of resources. To achieve this objective, it was decided to adopt market-oriented reforms. No blueprint for the structure of the economic system on which the reform process would converge was established. Since then, economic reform has involved the relaxation of direct planning controls, the decentralization of economic decision making, increased reliance on markets to set prices and output, the development of nonstate-owned economic entities and an opening of China's economy to the outside world.

The initial conditions under which China entered its economic reform era were very different from those of other reforming socialist economies. China was not impelled to enter upon its reform path because of an imminent macroeconomic crisis. This removed the need for a strong dose of deflationary policy or "shock therapy" to accompany the launching of reforms. China's leadership also faced a set of conditions whereby the economy was well-situated to respond rapidly to improved incentives by increasing output, including in the critical agriculture sector. China also benefitted from the presence of rapidly developing Hong Kong.

China's approach to economic reform is often described as "gradualist". This can only refer to the timeframe for reforms, however, since the transformation of the Chinese economy over the past 15 years has been quite substantial. China's reformers appear to push reforms when the economic, political and social conditions allow or require action. Yet the cumulative impact has been significant and, in many ways, quite radical.

The most important outcome of the economic reform program may be that China has become a much more significant player in the world economy. It should be noted that, even in 1978, trade played a relatively important role in China. By that time, a program to import western technology was already underway. Since 1978, however, trade (exports and imports combined) consistently has grown at rates well above those for GDP. By 1990, trade had risen to over 30 per cent of GDP, making China, by this measure, the most open of all large developing countries, and with a degree of openness more than twice that of India or Brazil. Trade has also helped to raise the level of technology utilized in the country and to expand the flows of foreign direct investment into the country. More generally, output grew at an annual average

rate of almost nine per cent during the 1979-91 period, while significant productivity gains have been registered.

Economic reform in China has altered the structure of the economy significantly, and has had a very positive impact on production and consumption. But much remains to be done. There are seven priority areas for further reform: the state enterprise sector; the financial sector; public finance; trade; prices and markets; environmental sustainability; and the role of the state. Widening and deepening reform of the state enterprise sector and the modernization of the social support system probably will pose the biggest obstacles for Chinese reformers for the balance of this decade.

Environmental problems will also pose a significant challenge to sustainable development in China in the future. Environmental problems in China are more severe than at comparable periods of economic development in most industrialized countries, primarily because of the size of the country's population, and natural resource constraints. They could impair China's potential for economic growth, unless action is taken soon to address both the direct and indirect or underlying causes. Chinese reformers must come to view environmental management as part of the larger process of economic reform and industrial restructuring. Moreover, the continued increase in emissions which generate acid rain and produce greenhouse gases, for example, will increasingly internationalize China's environmental problems.

While all of China's provinces are better off in 1994 than they were in 1980, double digit national real GDP growth rates mask widely varying regional and provincial growth rates. Regional and urban/rural inequalities will widen during the 1990s, and this could generate an increase in the number of incidents of protest and unrest. As long as growth remains widespread, however, the leadership will likely focus on reducing corruption, lowering inflation and promoting job creation.

There would appear to be five key features that contributed to the success of the Chinese reform experience which may have some wider applicability, and which are independent of conditions that are unique both to China and its approach to reform. The agricultural sector had built up a reasonable technical/infrastructural base, but growth was stunted by a lack of incentives. It was thus ripe to respond to radical reform. It also generated the rural savings and surplus labour necessary to launch the next phase of reform, and created a constituency for reform. Secondly, China emphasized marketization rather than privatization. The development of a new non-state sector played an important role in diversifying ownership patterns and in increasing market-based competition throughout the economy. Thirdly, China seems to have had some success in reorienting the bureaucracy, particularly at the local

level. The use of decentralization and the promotion of non-state industry generated a reorientation of the interest of the bureaucracy away from planning goals towards economic performance. Fourthly, the Chinese approach has emphasized export development, and the postponement of full import liberalization until later in the reform process. A relatively high level of advanced technology imports was maintained throughout the reform period, and the external opening led to a foreign investment boom. The unique relationship between China and Hong Kong may reduce the replicability of this element of the strategy. Moreover, the prospect of China's major trading partners tolerating slower reform on the import front while opening their own markets to goods from abroad may worsen in light of slower growth and high levels of unemployment in the OECD area through the rest of the decade. Fifthly, by using the gradual approach, and by not subjecting the state sector to major shocks at any point in time, China has, for the most part, successfully avoided severe social unrest during its transition to date.

The gradual approach has limitations, and China may be approaching its frontier. There is a possibility that the Chinese government may have to abandon its gradualist approach, undertaking its own "big bang" program for reform (in particular, in the industrial and financial sectors). Nonetheless, to date, Chinese policy makers have generally responded to the problems arising out of the reform experience by introducing new, and deepening existing, reforms. This suggests that, as new problems emerge, reformers will respond with more reform, so that deep crises are avoided. The key to sustainability will depend on the solutions that Chinese leaders develop with regard to the unfinished reform agenda.

While China remains a relatively poor country by per capita income standards, it could pass Japan to become the second largest economy in the world early in the next century. China's sheer size in terms of population and its resource endowment suggest that it will continue to increase in importance in world markets. China has become internationally competitive in an increasing number of labour-intensive products. While China does not yet appear to be competitive in more capital-intensive products, monitoring production plans, foreign direct investment flows and exports will help to signal products and industries in which China is becoming internationally competitive. The evolution of state enterprises in China as reform of the industrial sector continues will also influence the competitiveness of Chinese products on world markets.

The time has come for Canada to strengthen its policy of "comprehensive and constructive engagement" in bilateral relations with China. This approach simply reflects the fact that China is a strategically important player in a number of critical issues in both the Asian and world arenas. As a permanent Security Council member,

China plays an integral role in the development of policy at, and the operation of, the UN (including peacekeeping and human rights). We must engage China constructively in international environmental matters. ~~China also has an important role to play in~~ virtually all regional security matters, and will be a cornerstone in the creation of continued and lasting peace in the region. It will continue to be one of the fastest growing economies and export markets into the next century.

Perhaps the key economic and trade components of a policy of comprehensive engagement are the promotion of bilateral business relations (trade, investment and technology cooperation) and working to facilitate China's participation in the new World Trade Organization (WTO). China's membership in the WTO would bring it further into the global economic and trading system, solidify its commitment to a rules-based trading system, help to secure the position of the economic reform minded members of the leadership cadre and encourage continued economic reform. This will be particularly important as China moves through the initial years of the post Deng period and the leadership is forced to deal with the economic problems discussed in section 4 of this paper. ~~Canada should continue to work for China's re-entry into the~~ GATT/WTO fold, both because of the more secure access this will bring for Canadian exports, but also because it will send a strong signal to wavering economic reform efforts in eastern Europe and the FSU. But re-entry must entail clear liberalization commitments on the part of China, including more transparent rules and the acceptance of international disciplines on the actions of Chinese regulators. These commitments will not only help to secure markets for Canadian exporters, but also will limit the scope for arbitrary economic action on the part of Chinese authorities, thereby contributing to broader reform efforts in China.

Finally, Canada currently has neither a Foreign Investment Protection Agreement (FIPA) nor a bilateral Double Taxation Agreement (DTA) with China. In light of present and future Chinese reform in the investment area, and the likely interest of Canadian companies in the Chinese market, Canadian policy makers should closely review the merits of negotiating both a FIPA and a BTA with China over the next two or three years.

## Résumé

En 1978, les dirigeants chinois sont arrivés à la conclusion qu'une utilisation accrue des facteurs de production ne constituait pas le meilleur moyen d'assurer une croissance et un développement économiques rapides et durables. La réalisation de cet objectif passait plutôt par la restructuration de l'économie de manière à relever la productivité et à utiliser les ressources de façon plus efficiente. Ils ont donc décidé d'adopter des réformes allant dans le sens de l'économie de marché. Ils n'ont élaboré aucun plan directeur quant à la structure du système économique vers lequel le processus de réforme allait tendre. Depuis lors, la réforme économique s'est traduite par un assouplissement des contrôles directs en matière de planification, la décentralisation du pouvoir décisionnel sur le plan économique, le recours de plus en plus marqué aux marchés pour ce qui est de la fixation des prix et de la production, le développement d'entités économiques n'appartenant pas à l'État et l'ouverture de l'économie chinoise sur le monde extérieur.

La conjoncture dans laquelle la Chine a amorcé la réforme de son économie différait très nettement de celle qu'ont connue les autres économies socialistes en voie de se réformer. Ce n'est pas l'imminence d'une crise macro-économique qui a poussé la Chine à s'engager sur la voie des réformes. De ce fait, il ne lui était pas nécessaire de mettre en oeuvre une politique déflationniste de grande ampleur ou une «thérapie de choc» qui aurait accompagné le lancement des réformes. Les dirigeants chinois se trouvaient en outre dans une situation où l'économie était à même de réagir rapidement à la bonification des incitations en accroissant la production, y compris dans le secteur crucial de l'agriculture. La Chine a également bénéficié de la présence de Hong Kong, qui se développait rapidement.

On qualifie souvent de «progressive» l'approche chinoise des réformes économiques. Ce qualificatif ne peut s'appliquer qu'au calendrier des réformes, toutefois, car l'économie chinoise a connu, ces quinze dernières années, une profonde transformation. Les réformateurs chinois semblent mener une action vigoureuse lorsque la conjoncture économique, politique et sociale permet ou exige de prendre des mesures. Pourtant, les répercussions cumulées de leurs interventions ont été importantes et, à de nombreux égards, radicales.

La conséquence la plus importante du programme de réformes économiques réside peut-être dans le fait que le poids de la Chine dans l'économie mondiale s'est de beaucoup accru. Il convient de faire observer que, même en 1978, les échanges commerciaux jouaient un rôle relativement important en Chine. À cette époque, déjà, un programme d'importation de techniques occidentales était en cours. Depuis, cependant, le volume des échanges (total des exportations et des importations) croît



constamment à un rythme dépassant nettement celui de la progression du PIB. En 1990, le commerce extérieur représentait plus de 30 p. 100 du PIB, ce qui faisait de la Chine, selon ce critère, le plus ouvert des grands pays en développement, le degré d'ouverture de son économie étant plus du double de celui de l'Inde ou du Brésil. Les échanges commerciaux ont également contribué au relèvement du niveau technologique du pays et au renforcement des investissements étrangers directs en Chine. De manière plus générale, la production a augmenté à un taux annuel moyen atteignant près de 9 p. 100 pendant la période allant de 1979 à 1991, et le pays a enregistré des progrès considérables sur le plan de la productivité.

Les réformes économiques en Chine ont sensiblement modifié la structure de l'économie et elles ont eu des incidences très positives sur la production et sur la consommation. Cela dit, il y a encore beaucoup à faire. Il existe sept domaines prioritaires où d'autres réformes doivent intervenir : le secteur des entreprises étatiques, le secteur financier, les finances publiques, les échanges commerciaux, les prix et les marchés, la durabilité sur le plan écologique ainsi que le rôle de l'État. L'élargissement et l'approfondissement de la réforme du secteur des entreprises étatiques, de même que la modernisation du système de soutien social, constitueront les deux obstacles les plus redoutables que les réformateurs chinois devront surmonter d'ici à la fin de la présente décennie.

Les problèmes environnementaux vont également représenter un défi de taille pour le développement durable de la Chine. Ils présentent un degré de gravité plus élevé que la plupart des pays industrialisés à des stades comparables de leur développement économique, ce qui tient principalement à l'importance de la population du pays et aux contraintes qui se posent sur le plan des ressources naturelles. Ces facteurs pourraient amoindrir les possibilités de croissance économique de la Chine si on ne s'attaque pas à brève échéance aux causes directes et indirectes, ou sous-jacentes, de ces phénomènes. Il faut que les réformateurs chinois en arrivent à situer la gestion de l'environnement dans le cadre du processus plus large de réforme économique et de restructuration industrielle. En outre, l'augmentation constante des émissions causant des pluies acides et produisant des gaz à effet de serre, par exemple, donnera de plus en plus une dimension internationale aux problèmes environnementaux de la Chine.

S'il est vrai que la situation de toutes les provinces du pays s'est améliorée de 1980 à 1994, les taux de croissance réelle du PIB, supérieurs à 10 p. 100 à l'échelle nationale, relèguent dans l'ombre les écarts entre les taux de croissance des différentes régions et provinces. Les inégalités entre les régions ainsi qu'entre les zones urbaines et rurales vont s'aggraver pendant les années 90, ce qui pourrait faire augmenter les protestations et la fréquence des troubles. Cela dit, tant que la

croissance demeurera générale, les dirigeants vont vraisemblablement mettre l'accent sur la diminution de la corruption, sur la baisse du taux d'inflation et sur la création d'emplois.

Cinq grandes caractéristiques semblent avoir contribué au succès des réformes chinoises; il est peut-être possible de les appliquer ailleurs et elles ne sont pas liées à des réalités propres exclusivement à la Chine et à son approche des réformes. Le secteur agricole s'était doté de fondements assez solides sur le plan des techniques et des infrastructures, mais le manque d'incitations entravait sa croissance. Il était donc tout à fait prêt à réagir à des réformes radicales. Il a également généré dans les zones rurales l'épargne et l'excédent de main-d'oeuvre qui étaient nécessaires au lancement de la nouvelle étape des réformes; de plus, il a fait naître un groupe de partisans des réformes. En deuxième lieu, la Chine a privilégié le jeu des forces du marché plutôt que la privatisation. L'essor d'un nouveau secteur non étatique a joué un rôle important en diversifiant les types de propriété et en renforçant la concurrence dans l'ensemble du pays. Troisièmement, la Chine semble avoir connu un certain succès en ce qui concerne le réaligement de son appareil bureaucratique, particulièrement à l'échelle des collectivités. Le processus de décentralisation et la promotion d'une industrie non étatique se sont traduits par une évolution des priorités de la bureaucratie, qui s'est mise à attacher moins d'importance à l'atteinte des objectifs fixés par le Plan qu'à la bonne tenue de l'économie. Quatrièmement, l'approche chinoise a mis l'accent sur la progression des exportations et sur le report de la libéralisation intégrale des marchés d'importation à une phase ultérieure du processus de réforme. Le pays a maintenu un volume relativement élevé d'importations de technologies de pointe pendant toute la période de réforme et l'ouverture sur le monde extérieur a donné lieu à un boom de l'investissement étranger. Le caractère tout à fait particulier des relations entre la Chine et Hong Kong limite probablement la possibilité de mettre en oeuvre ailleurs ce volet de la stratégie. En outre, il se peut que les principaux partenaires commerciaux de la Chine s'accommodent moins bien d'un rythme de réforme plus lent sur le plan des importations à un moment où ils ouvrent leurs propres marchés aux biens venant de l'étranger; cela tient au ralentissement de la croissance et aux taux élevés de chômage que connaîtront les pays membres de l'OCDE jusqu'à la fin de la décennie. Cinquièmement, en suivant une approche progressive et en ne faisant jamais subir de grands chocs au secteur étatique, la Chine est jusqu'à maintenant parvenue, dans une large mesure, à éviter de graves troubles sociaux.

L'approche progressive a ses limites et la Chine est peut-être sur le point de les atteindre. Il se peut que le gouvernement chinois se voie contraint de renoncer à cette démarche et de mettre en oeuvre un programme de réformes de type «big bang» (notamment dans les secteurs industriel et financier). Néanmoins, à ce jour, les

décideurs chinois se sont surtout attaqués aux problèmes résultant de l'expérience réformatrice en mettant en place de nouvelles réformes et en approfondissant celles déjà en cours d'exécution. Cette constatation donne à penser qu'au fur et à mesure que de nouveaux problèmes surgiront, les réformateurs accentueront le mouvement de réforme, de sorte qu'ils éviteront l'éclatement de crises profondes. La durabilité du processus sera fonction des solutions que les dirigeants chinois mettront au point en ce qui concerne le reste du programme de réforme.

Même si la Chine demeure un pays relativement pauvre à l'aune du revenu par habitant, elle pourrait doubler le Japon et devenir, en importance, la deuxième économie du monde au début du prochain siècle. La taille énorme de la Chine, du point de vue de sa population et des ressources naturelles qu'elle possède, donne à penser que son poids sur les marchés mondiaux est appelé à croître. La Chine est devenue compétitive à l'échelle internationale pour un nombre croissant de produits dont la fabrication nécessite une forte intensité de main-d'oeuvre. Elle ne semble pas l'être encore pour ce qui est des produits exigeant une forte intensité de capitaux, mais il est fort possible qu'à force de surveiller les projets de production, les investissements étrangers directs et les exportations, il sera possible de cerner les produits et les secteurs industriels où la Chine est en train de devenir compétitive sur les marchés internationaux. L'évolution des entreprises étatiques du pays, au fur et à mesure que la réforme du secteur industriel se poursuivra, influera également sur la compétitivité des produits chinois sur les marchés mondiaux.

Le moment est venu, pour le Canada, de renforcer sa politique d'engagement global et positif dans ses relations bilatérales avec la Chine. Cette approche témoigne simplement de l'importance stratégique de la Chine à propos d'un certain nombre de questions cruciales sur les scènes asiatique et mondiale. En sa qualité de membre permanent du Conseil de sécurité, la Chine participe à part entière à l'élaboration des politiques de l'ONU et à leur mise en oeuvre (y compris en ce qui concerne le maintien de la paix et les droits de la personne). Il nous faut amener la Chine à jouer un rôle constructif à propos des questions environnementales internationales. La Chine a également un important rôle à jouer dans presque toutes les questions de sécurité à l'échelle régionale et elle sera la pierre angulaire d'une paix soutenue et durable dans la région. Elle demeurera une des économies et un des marchés d'exportation qui croîtront le plus rapidement jusqu'à la fin du siècle et au-delà.

Les volets décisifs, sur les plans économique et commercial, d'une politique d'engagement global consistent peut-être à promouvoir les relations commerciales bilatérales (commerce, investissement et coopération en matière de technologie) et à faciliter la participation de la Chine à la nouvelle Organisation mondiale du commerce (OMC). L'adhésion de la Chine à l'OMC l'amarrerait plus fermement au système

économique et commercial mondial, consoliderait son engagement envers un système commercial fondé sur des règles, contribuerait à raffermir la situation des membres du noyau dirigeant qui sont favorables aux réformes économiques et encouragerait la poursuite de ces réformes. Cet aspect revêtira une importance particulière pendant que la Chine vivra les premières années de l'ère post-Deng et au moment où les dirigeants se verront dans l'obligation de s'attaquer aux problèmes économiques exposés à la section 4 du présent document. Le Canada devrait continuer d'oeuvrer en faveur de la réintégration de la Chine dans le giron du GATT et de l'OMC, non seulement parce que cela procurera un accès plus sûr des exportations canadiennes au marché chinois, mais aussi parce que cette orientation enverra un message énergique aux pays de l'Europe de l'Est et de l'ex-Union soviétique où les réformes économiques sont hésitantes. Toutefois, la réintégration doit être assortie d'engagements clairs en faveur de la libéralisation de la part de la Chine, ce qui comprend notamment l'adoption de règles plus transparentes et l'acceptation des disciplines internationales régissant les mesures prises par les responsables de la réglementation chinoise. Ces engagements, en plus de garantir des marchés aux exportateurs canadiens, limiteront la marge d'arbitraire dans le domaine économique de la part des autorités chinoises, ce qui soutiendra du même coup l'élargissement du processus de réforme dans ce pays.

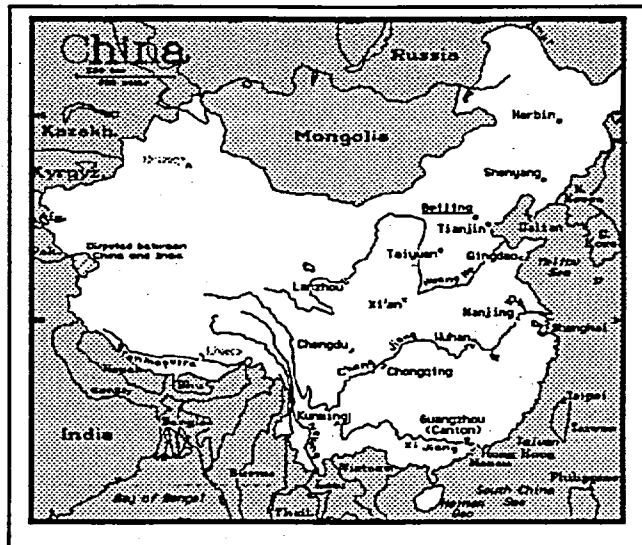
Enfin, le Canada n'a pour l'instant signé avec la Chine ni un Accord de protection de l'investissement étranger (APIE) ni une entente bilatérale de double imposition (EBDI). Compte tenu des réformes présentes et futures en Chine dans le domaine de l'investissement, et de l'intérêt que les entreprises canadiennes porteront vraisemblablement au marché chinois, les décideurs canadiens devraient examiner attentivement les retombées susceptibles de découler de la négociation à la fois d'un APIE et d'une EBDI avec la Chine d'ici deux à trois ans.

*"Reform is China's second revolution and development is the last word."*

- attributed to Deng Xiaoping

## 1. Introduction

In 1981, the Chinese leadership set the goal of quadrupling China's 1980 per capita GNP by the year 2000 in order to raise the people's standard of living to a "relatively comfortable level".<sup>1</sup> The current Chinese leadership is trying to improve economic efficiency in order to sustain economic growth. The development strategy adopted in the late 1970s involved widespread economic reform and opening to the outside world. This paper will examine the issues of how far the Chinese economy has advanced towards those objectives, the major challenges that lie ahead in the 1990s and China's economic prospects as it enters the next century.



The second section of this paper reviews China's reform experience to date. The third section assesses the impact of reforms on the Chinese economy. The fourth attempts to identify the areas where economic reform will require deepening in the 1990s. Section five seeks to draw some conclusions regarding the art of economic reform as practised by the Chinese. The sixth section outlines what the Chinese economy might look like in the year 2000. The final section sets out some final thoughts on the implications for Canada-China bilateral relations. This paper focusses on the economic dimensions of the Chinese reform process. A full understanding would require exploring the nature of political change in China and its interface with economic policy. This work would best be addressed through a separate study.

<sup>1</sup> This goal later was formally adopted by the Chinese Communist Party. Zhao Zhiyang, "Advance along the road towards socialism with Chinese characteristics," *People's Daily*, 4 November 1987, p.2.

## 2. China's Economic Reform: What Has Happened?

### 2.1 Overview of the Reform Process

By 1978, China's leadership had reached the conclusion that more extensive use of productive factors was not the best means of achieving rapid, and sustainable, economic growth and development. On the contrary, rapid growth and development would require that the economy be restructured so as to enhance the productivity and the efficient use of resources. To achieve this objective, it was decided to adopt market-oriented reforms.<sup>2</sup> No blueprint for the structure of the economic system on which the reform process would converge was established. Instead, the leadership adopted a cautious and pragmatic approach.

Although the problems confronting the Chinese economy in the late 1970s were related in part to the dramatic shifts in economic policies that had taken place during the previous three decades, they were in many respects similar to the problems encountered by other centrally planned economies. The problems included an irrational pricing system resulting from the setting of many prices by administrative fiat, an emphasis on product quantity and not quality, and an inefficient and overstaffed industrial sector, which was protected from foreign competition. These shortcomings were exacerbated by biases against individual incentives, markets and labour specialization and mobility. In industry, there was effectively no link between individual productivity and remuneration. The labour market was virtually nonexistent as a result of rigid restrictions on the geographical mobility of labour, the assignment of jobs to labour market entrants, and the system of lifetime employment under which enterprises provided housing, pensions, medical care and other forms of welfare benefits. Other markets, most notably financial markets, were almost entirely absent.

In late 1978, China's leadership announced a program to reshape its economy. Since then, economic reform has involved the relaxation of direct planning controls, the decentralization of economic decision making, increased reliance on markets to set prices and output, the development of nonstate-owned economic entities and an opening of China's economy to the outside world. In the agricultural sector, where reforms began, responsibility for production was transferred from collectives to households, and the mandatory government procurement program for key agricultural products was replaced by a system of contracted purchases which allowed farmers to sell above-contract output in local markets. In the industrial sector, state

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<sup>2</sup> For narratives on China's economic reform experience and prospects, see World Bank Country Study, "China: Reform and the Role of the Plan in the 1990s", World Bank, Washington, 1992; or World Bank Country Study, "China: Between Plan and Market", World Bank, Washington, 1992.

enterprises were given increased, albeit not complete, autonomy over operational decisions as well as more responsibility for their financial position. Cooperatives and individually owned enterprises were allowed to develop until they now generate a significant share of China's GDP. Also, external sector reforms raised incentives for exporters and allowed increased access to foreign resources through direct investment and foreign borrowing.

## 2.2 Fertile Ground for Reform

China initiated its economic reform program facing economic conditions that were very different from those confronting other reforming socialist economies. China was not forced to undertake economic reform because of an imminent macroeconomic crisis. This eliminated the need for a strong dose of stabilization policy or "shock therapy" to accompany the launching of reforms.<sup>3</sup> The decision to launch an economic reform program flowed from a realization that sustained economic growth and development would require improved utilization of resources to increase efficiency and productivity. While the "extensive" growth model had generated overall growth, there had been little improvement in productivity. Personal consumption growth had been limited because of the need to devote increasing levels of resources to investment.

That said, despite the excesses of the Cultural Revolution, and the deaths of Mao Zedong and Zhou Enlai, there was no formal rejection of the socialist system at that time. Reformers, however, were looking to radically change the path being followed to develop China as a socialist state. There was, therefore, an important publicly declared degree of political and ideological continuity linked to economic reform. Each reform step was taken only after reformers had found ideological support for their initiatives. The CCP leadership in a sense "reinvented" itself, or chose to evolve, rather than proclaim systemic rejection. This is another key contrast with the experience in much of the former Soviet Union.

China's leadership enjoyed a situation whereby the economy and the system of government, which already provided local governments with a certain amount of autonomy, were in a good position to respond rapidly to improved incentives by increasing output. The fiscal and external accounts were in broad balance at that time, and the country enjoyed a high savings rate. China would also benefit from the presence of the rapidly developing Hong Kong. The increase in efficiency and output

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<sup>3</sup> For the Central and Eastern European economies in transition, stabilization measures are responsible for much of the decline in output that followed the launching of their respective reform programs.

growth rates that China realized during the reform period was also partly the product of the investment in physical infrastructure that took place in the prereform era.

Moreover, China's leadership faced a situation in the agricultural sector where the immediate benefits of reform would exceed the immediate costs. The commune system of socialized agriculture had achieved a number of the main goals for which it had been established.<sup>4</sup> It had developed rural infrastructure, especially in terms of irrigation facilities and the use of improved seeds and fertilizers. It had created a rural management system, which not only served political and social needs, but also fostered economic support systems, such as input supply and marketing. It had served to foster social aims, such as preventive medicine and the attainment of universal education, through the local (compulsory) mobilization of funds for such purposes. But it had not improved agricultural productivity and had only slightly increased per capita output in quantity, quality and variety.

Agricultural productivity suffered from the absence of alternative, off-farm employment opportunities, a lack of incentives for individual efforts, and prices that were kept artificially low in order to generate a surplus for industrial investment.<sup>5</sup> Thus, prior to reform, the agricultural sector was endowed with reasonable physical, marketing and human infrastructure, but lacked incentives. Concern regarding the potential for an agricultural crisis may have been as important as any other factor in creating the initial impetus for reform. Once individual incentives were introduced, and the role of the state was reformed, it was not surprising that the output response was rapid. It was improved output and productivity which were the aims (and, indeed, the result) of agricultural reforms. Increased savings available for investment and the release of surplus labour were unforeseen, but perhaps even more significant side effects.

China had evolved from an essentially rural, peasant economy in 1949 to one which possessed a significant industrial sector.<sup>6</sup> The share of industry in national income had grown from 20 per cent in 1952 to 49 per cent in 1978. By far the largest share of this industrial expansion was in heavy industry, which accounted for 57 per cent of total output in 1978. This meant that there was a significant and relatively new industrial base on which to build, and that there were widespread

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<sup>4</sup> Peter Harrold, World Bank Discussion Paper No. 180, "China's Reform Experience to Date", World Bank, Washington, 1992, p. 2.

<sup>5</sup> See World Bank Country Study, "China Options for Reform in the Grain Sector", World Bank, Washington, 1991, pp.1-10.

<sup>6</sup> *Ibid.* p.1.



opportunities for light industrial investment once investment decision making was decentralized.

For the most part, China's early industrial development took place through large- and medium-sized state-owned enterprises (SEs). But these large SEs were burdened with excessive workforces and significant social security obligations and were managed in a fashion which rendered them highly inflexible. Thus, when controls were released on small firm creation, the large SEs were not able to react rapidly to new opportunities and squeeze out new firms.

At the time reforms were initiated, moreover, China was not subject to the same degree of central planning as was the former Soviet Union. Only about 500 commodities were under mandatory planning, compared with over 20,000 in the former USSR.<sup>7</sup> In China, local governments always took the primary role in plan formulation and interpretation. This meant that local implementation capacity was fairly well developed, with officials quite able to respond to improved incentives. Concomitantly, China's emphasis on provincial and regional autonomy had bred serious inefficiencies, which offered enormous scope for gains from interprovincial trade.

### 2.3 China's Reform Technique

China's approach to economic reform is often described as "gradualist". This can only refer to the timeframe for reforms, however, since the transformation of the Chinese economy over the past 15 years has been quite substantial. China has not developed a well-defined reform strategy (although the reform framework promulgated during the November 1993 Third Plenum of the 14th Party Congress sets out, for the first time, reform plans for a number of sectors in some detail). Neither has there been a reform blueprint. The development of a comprehensive reform program may be as unachievable as a workable central planning system because of the volume of information that must be assembled and processed. China's reformers appear to push reforms when the economic, political and social conditions allow or require action. Yet the cumulative impact is significant and, in many ways, quite radical. Four themes seem to be consistently identifiable throughout the reform period.<sup>8</sup> They are: gradualism, incremental reforms, decentralization and mutually reinforcing reforms.

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<sup>7</sup> World Bank Country Study, "Reform and the Role of the Plan in the 1990s", World Bank, Washington, p. 36.

<sup>8</sup> *Ibid.*, p. 37.

● **Gradualism**

Reform in any specific sector generally is implemented over time, and usually after experimentation. Generally, policy makers prefer to experiment with reforms in a designated and localized area, usually one of the country's special economic zones. If a reform experiment is deemed to be successful, the reform tends to spread to other parts of the country. This can be the result of a central government decision, or it can be "spontaneous"<sup>9</sup>, as other provinces and localities take up the policies. The same process was utilized to "open" China to the outside world. Even in those cases where gradualism is not feasible, and an immediate change is attempted, the sheer size of the country and the inadequacy of the transport and telecommunications systems make gradualism probable.

The gradual approach (although with often radical cumulative results) generally has allowed China to avoid severe economic shocks, to make mid-course corrections on the basis of the results of experiments, and to develop new or reformed institutions with the implementation of the new systems. Existing administrative systems are initially bypassed and then subsequently dismantled.

Gradualism appears to have two related main drawbacks. One is that economic agents are unable to predict the future regulatory environment with sufficient certainty, thereby leading to sub-optimal investment and other economic decisions. There is also a concern that a failure to introduce reform rapidly increases the probability that reforms will be reversed. There have been such periods of reversal in China, during which the conservative component of the leadership successfully advanced their view that planning could solve the problems that had arisen during the course of reforms designed to address the shortcomings of planning. To date, however, each reversal has been temporary, and overall the direction continues to be forward. It is clear that the new momentum toward enterprise reform evident in 1992 is partly a result of the conclusion reached by China's leaders that, during the immediately preceding rectification program, the instruments of planning had failed to come to grips with the fundamental problems of the state-enterprise sector.

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<sup>9</sup> "Spontaneous" reform takes two forms. First, many central reforms are "enabling", in the sense that they remove central prohibitions. Second, local reforms frequently spread, often from an experiment in one area, and are later sanctioned nationally by the central government. This is often the result of arbitrage pressures, when one province moves faster than a neighbour. This allows for innovation as the reform devolves.

- **Incremental Reforms**

One of the more surprising results of the Chinese reform experience has been the apparent successful utilization of incremental reforms within sectors as interim measures. The two-tier pricing system, which permitted state enterprises to sell above-plan output at market prices, illustrates the government's use of this approach. It has been estimated that in 1989, on average, 38 per cent of an SE's output was sold in markets, and 56 per cent of its inputs was procured in markets.<sup>10</sup> The two-tier price system created a situation in which marginal resource allocation decisions generally were made on the basis of market prices. It also ensured continuity of supply, while market skills were learned.

- **Decentralization**

The decentralization of control by the central government has frequently led to a substitution of local planning for central planning. And, on occasion, decentralization has allowed local governments to operate outside the frontier established by the centre (i.e., push reforms further than the centre had intended), which often led to local decisions that were based on distorted relative prices, and resulted in inappropriate or inefficient local investments. Nevertheless, looking at the reform period as a whole, the determined pursuit of economic development by local governments has definitely induced significant progress and growth.

Decision-makers in all spheres of economic activity have benefitted from decentralization. Enterprise managers make production and marketing decisions; foreign trade corporations select products for export; farmers choose crops; and, most importantly, individuals make many purchasing decisions, although they have much less choice with respect to employment. Reformers have been successful, for the most part, in creating markets while avoiding severe disruption and dislocation. They have done so by balancing the roles of markets and local government control. For example, local governments received the power to administer price controls for most consumer goods in 1986. Their decision pertaining to when controls would be removed became a function of local market conditions. The process moved rapidly in the South, but more slowly in the North-East, where state firms still dominate.

Unfortunately, this approach encourages the trend towards regionalization of the economy since conservative regions of China tend to move slowly in some areas of reform. It also facilitates economic overheating since it allows local governments to pursue an economic growth rate that can exceed the one desired by the centre.

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<sup>10</sup> Ibid, p. 39.

While one can conclude that the microeconomic effects of the decentralization of decision-making have been positive, the macroeconomic impact has not always served the interests of the centre in its efforts to maintain balanced national economic growth and development. Decentralization has led to the development of a constituency that favours further reforms, however, and has fostered a climate for reform initiatives and "spontaneous" reform at the local level.

- **Mutually Reinforcing Reforms**

Many of the reforms undertaken in China have been mutually reinforcing. Reforms in one area often lead naturally to, if not force, reforms in other areas. Either way, reforms in one area frequently lead to pressures for change in other areas. The initial agricultural reforms produced surplus rural savings and labour, which allowed for the rapid expansion of township and village enterprises. The quickly expanding non-state sector gradually exposed the state sector to competition, requiring that state control over SEs be relaxed. This compelled reformers to initiate reforms in the social welfare system, labour market and financial sector.

## **2.4 Major Reform Developments by Sector**

This section reviews the main initiatives that were taken in each major reform area, and the interlinkages, so that the analysis of future reform priorities in section four can be reviewed against the accomplishments to date. The discussion that follows is divided into eight major sectoral areas.

- **Significant Milestones for Reform**

The key decisions taken by the Communist Party and the Government of China with regard to economic reforms tend to become reference points, indicating what economic activity is and is not permitted. The first such decision was that of the 1978 Third Plenary Session of the 11th Central Committee of the Communist Party of China<sup>11</sup> and the resulting Communique which officially launched the reform program, including agricultural reforms and China's opening to the outside world. Reformers only experimented with urban industrial sector reform until the Third Plenary Session of the 12th CCCPC, which adopted the "Decision on Reform of the Economic Structures" in October 1984. This decision led to the acceleration of

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<sup>11</sup> The Communist Party holds a Congress about every five years, and elects a Central Committee. This Central Committee meets in plenary session about ten times between Congresses, to make important decisions.

reforms in urban areas, the development of the two-tier price system, and started the process of decentralizing enterprise management.

Economic reform in China germinated from Deng Xiaoping's espousal of the principle that China must "seek truth from facts" and his belief that decisions should be made pragmatically. It was not supported by Chinese socialist principles, however, until the October 1987 Government Report to the 13th Party Congress: "Advance Along the Road of Socialism with Chinese Characteristics." This report introduced the hypothesis that China was still in the "Primary Stage of Socialism," and showed that multiple forms of ownership and economic systems were acceptable during the early phase of socialism. It was expected that China would be in this stage until well into the 21st Century. It also led to the guideline that "the state regulates the market, and the market guides the enterprises," which has become the basic principle supporting China's development of a "socialist market economy". The 1991 "Outline of the Eighth Five-Year Plan and the Ten-Year Development Program" included a description of China's reform approach for the 1990s, and delineates reform intentions in a wide range of areas. This was the first time that the Plan focused on policy issues as the key to development. These documents form the base upon which the central and local governments are able to build specific reform initiatives.

- **Agricultural and Rural Reforms<sup>12</sup>**

The central feature of the reforms was the break-up of the communes and a return to household-based agriculture. In exchange for the right to farm land on a long-term (15-25 year) lease basis, farmers had to agree to turn over a share of their output, and in some areas particular crops, to the state. This came to be known as the "Household Contract Responsibility System". This was accompanied by a 25 percent (average) real increase in relative agricultural prices. The improved incentives, combined with the fact that China began the reform period with its agricultural sector operating on a reasonable technical basis, elicited a very rapid output response and generated large sums of savings. Pressure for permission to utilize these savings for industrial use grew, resulting in the decision in 1984 to allow local authorities to create township and village enterprises (TVEs).

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<sup>12</sup> For a more detailed review of agriculture reform, see Naoya Wakashiro, "Rural Reform and Agricultural Production in China", in The Developing Economies, Institute of Developing Economies, Tokyo, December 1990, pp.482-502; World Bank Country Study, "China: Options for Reform in the Grain Sector", op. cit.; or Robert F. Ash, "The Agricultural Sector in China: Performance and Policy Dilemmas During the 1990s", in The China Quarterly, No. 131, U.K., September 1992, pp. 545-76.

The rapid growth of rural industry is one of the main successes that China experienced in the 1980s. This growth took place in an enabling environment, but without formal promotion policies, because:<sup>13</sup>

- agricultural reforms generated surplus funds which were available for investment and a pool of labour eager to take up newly created positions;
- the initial industrial structure had neglected the light industrial sector, which small firms could enter, and which offered significant growth opportunities, and potentially the opportunity to earn very high profits rapidly; and
- local governments were committed to local economic development.

In the South, overseas Chinese also played an important role in the development of rural enterprises.

The Household Contract Responsibility System and provision for TVEs were the two key rural reforms of the 1980s. Further reforms, on the pricing/marketing side, were not launched until 1988 and 1991. In 1988, reformers attempted to initiate a new series of price reforms by increasing the prices of nonstaples (sugar, eggs, vegetables and pork), but abandoned the effort in the face of inflationary pressures. But the approach used in this case--converting product price subsidies into wages--was the basis for the grain and oilseeds price reform of 1991 and 1992. This was accompanied by the introduction of wholesale and futures markets in grains. Together, these cumulative reforms suggest that China is moving to a situation where markets will dominate agriculture.

- **State Enterprise Reforms<sup>14</sup>**

While there have been many detailed reforms related to state enterprises (SEs), there have been two basic changes to the system. The first came in 1983-84 when the system of profit remittance to the central government was changed to one whereby enterprises paid income taxes, and shared profits with their supervisory authority. The second came in 1984 when reformers tried to provide improved incentives for profit-making by reducing plan output targets, permitting the sale of

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<sup>13</sup> Peter Harrold, *op. cit.*, p. 11.

<sup>14</sup> For a more detailed discussion of state enterprise reform and the wider issue of enterprise reform, see World Bank Country Study, "China: Macroeconomic Stability and Industrial Growth under Decentralized Socialism", World Bank, Washington, 1990.

above-plan output on markets, and by further decentralizing plan formulation and implementation. This led to a surge in demand for investment funds and rapid industrial expansion in 1985.

The system became more structured from 1986 onwards, as the agricultural contract responsibility system was applied to the SEs under the enterprise contract responsibility system, which set profit remittance and retention rates, investment targets, etc., usually for a three-year period.<sup>15</sup> Further innovations have been made, such as the Bankruptcy Law in 1987, the Enterprise Law in 1988, the use of enterprise groups and the leasing of enterprises, but they are really just a codification or variations of the two aforementioned basic changes. While the central government intended to give plant managers more autonomy, the authority that was devolved tended to congeal around local government and party officials.

Contrary to the general impressions of many, efficiency gains have not been reserved for the non-state sector. By gradually changing the focus of SEs from meeting output targets to meeting financial targets, by specifying financial targets as the main performance criteria of the contracts, and by offering incentives for attaining and exceeding such targets, reform has led to efficiency improvements. Competition from both new and existing non-state enterprises, as well as between SEs, will be the key to ensuring that SEs continue to make efficiency gains.

China's enterprise reform program can best be described as an effort to "marketize" the industrial sector, including SEs, rather than one designed to "privatize" it (the approach many other countries in transition have opted for). Whether or not SEs can operate fairly and effectively in a market system is a key question in the assessment of China's future economic prospects.

#### ● Tertiary Sector Reforms

One of the earlier reforms in China that appears to have been utilized by other reforming socialist economies has been the effective privatization of the commercial sector. This began in 1982 and, by 1985, 75 percent of all state-owned commercial and service companies had been sold or leased to private owners, while new entry was permitted. The state sector remained important in three main areas: wholesaling of a wide range of products, especially agricultural; retailing of commodities under price controls and under the ration system; and operation of major commercial outlets employing large numbers of people, such as department stores. In addition to these

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<sup>15</sup> By 1988, over 90 per cent of all SEs, accounting for over 50 per cent of industrial output, were operating under this system. By the end of 1991, most had signed a second contract.

formal retail channels, local governments have fostered the emergence throughout the country of "free markets" for food and consumer goods, especially clothing, frequently by providing basic facilities such as covered market stalls. Not surprisingly, this proved to be a popular and successful reform.

Concomitantly, the private commercial system has provided a demand for backward linkages to the emerging new industrial sector, and the development of alternative transport systems to deliver small quantities of goods to these outlets. The widening and deepening of the non-state services sector seems set to continue in the 1990s. It will be an important source of future employment creation. These reforms also led to the growth of a constituency that favours the continuation and expansion of reforms.

- **Fiscal Reform<sup>16</sup>**

China has always operated a decentralized taxation system, with the central government relying on provincial taxation bureaus to collect taxes. Changes that have taken place have focussed more on altering the way revenue has been collected and shared, and less on modifying the sources of revenue. The first major change was allowing enterprises to retain a share of their profits. This reduced the burden on the state of having to finance all enterprise investment, and meant that firms had to generate some of the funds they required. This also initiated the shifting of the burden of funding investment to the banking system, which increased as government subsidies to SEs were replaced and augmented by forced lending from banks. The second major change came with the introduction, beginning in 1985-86, of the fiscal contract responsibility system, the third of the four contract systems.<sup>17</sup> Contracts were signed between the central and local governments, specifying the taxes to be handed over to the centre, those to be shared--and in what proportions--and those to be retained. The contract system formalized similar arrangements that were already in place.

These contract systems, which left the central government reliant on profit taxes for revenue and were not adjustable for inflation, led to the centre's revenues being squeezed as the profitability of enterprises was reduced in the face of increased

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<sup>16</sup> For a more detailed examination of this issue, see World Bank Country Study, "China: Revenue Mobilization and Tax Policy", World Bank, Washington, 1990.

<sup>17</sup> The four contract systems are: the household contract responsibility system, the enterprise contract responsibility system, the fiscal contract responsibility system and the foreign exchange sharing contract system.



competition. China's tax or revenue system continues to be based on contracted tax payments and layered indirect taxes. Personal taxes remain virtually unutilized, and there is still no centralized tax collection system. Only minor adjustments were introduced after the major reforms of the mid-1980s. It appears that the government has initiated another round of fiscal reforms, however, with its November 1993 announcement that a value-added tax would be introduced as of January 1994.

- **Financial Sector Reforms<sup>18</sup>**

Like most other socialist economies, China had developed a banking system designed to provide credit to support the efforts of firms to satisfy plan output targets. This has been one area where a planned sequencing of reforms over time has been followed. The program was initiated in 1984 when the Industrial and Commercial Bank was created to handle commercial banking operations after they were separated from central banking functions. These latter activities remained under the purview of the People's Bank of China. In 1987, reformers hoped that the creation of two new universal banks would introduce more competition into the banking sector. Reformers also attempted to encourage financial innovation, first by decentralizing authority to create non-bank financial institutions in 1987, and secondly, by forming new capital markets, essentially for secondary trading of government bonds starting in 1988-89 and for trading in shares, beginning officially in 1991. This gradual deepening of the financial sector has, in fact, been fairly rapid, often occurring ahead of the development of the centre's institutional capacity to supervise and manage it. The financial deepening of the economy is what enabled China to sustain monetary expansion of close to 20 per cent per annum throughout the 1980s without either revealed or repressed inflation.

The commercial banking system remains 100 per cent state-owned and operated, with a considerable share of total lending influenced by the state through direct intervention to support its industrial policy, and seemingly only a relatively small proportion of total lending decided by banks on purely commercial grounds. The People's Bank has made some progress in reducing unauthorized lending and fund-raising activities. In 1993, the leadership announced that three "policy banks" (Export-Import, Construction and Agriculture) would handle lending in support of government policy, allowing the country's other banks to operate on a more commercial basis. But, until firms and banks are made fully responsible for their financial results, and hence are more sensitized to the costs of funds and returns to capital, it is difficult envisaging an efficient financial system developing.

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<sup>18</sup> For a more detailed discussion of this issue, see World Bank Country Study, "China: Financial Sector Policies and Institutional Development", World Bank, Washington, 1991.

The People's Bank continues its efforts to improve its monetary policy tools, including its ability to influence interest rates, conduct open market operations and utilize minimum reserve requirements. As long as the central bank must resort to printing money to finance government deficits, inflationary pressures will persist and will preclude monetary discipline. Further reform in this area, then, also remains one of the major items on the unfinished agenda.

- **Foreign Trade<sup>19</sup>**

Foreign trade may be the area that best exemplifies the "Chinese model" of gradual reform and the use of incremental partial reforms. When reforms in this sector were initiated, there were 15 foreign trade corporations (FTCs) operating under an all-encompassing mandatory trade plan. China has decentralized the authority to create foreign trade corporations, greatly reduced the scope of the trade plan, and permitted local decision makers to retain foreign exchange. The number of FTCs jumped to 1,500 by the end of 1987, when the next two initiatives were launched. Sectoral reforms saw certain sectors (garments, electronics and certain agricultural products) essentially jettisoned from the central plan (and, therefore, from access to subsidies), but permitted high foreign currency retention rates. Secondly, the fourth contract system, which dealt with the sharing of foreign exchange between the central and local governments and the level of "support" from the centre, was implemented. As the authority to create FTCs was devolved further, their number increased to more than 5,000 by 1990. The third round of trade reform took place in January 1991, when the second set of trade contracts was put into place. Central government subsidies for exports were eliminated and local foreign currency retention rates were increased yet again to as high as 75 per cent.

The emphasis of trade reform has always been to promote exports to finance the purchase of imports needed for modernization, particularly technology and equipment. As such, the import sector has never been seen as a source of competition by domestic firms. China has succeeded because it has allowed, if not promoted, competition in the export sector, made constant improvements in incentives to attract exporters, and increased the level of openness to foreign traders, especially from Hong Kong. While import liberalization was left to last, imports of raw materials, intermediates and other inputs for exports have been open from the start, especially in the assembly industries of electronics, toys and garments. Now that China is once again seeking to resume its seat in the GATT, the fourth wave of trade

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<sup>19</sup> For an expanded narrative on this issue, see Nicholas R. Lardy, "Chinese Foreign Trade", in The China Quarterly, No. 131, U.K., September 1992, pp. 691-720.

reform can be expected to focus on liberalizing the import regime and making it more transparent.

- **Foreign Direct Investment<sup>20</sup>**

Industrial reforms were initiated with the opening of China to foreign direct investment following passage of the joint venture law in 1979, and the opening of the first four Special Economic Zones (SEZs) in 1980. This aspect of the opening of China to the outside world followed a recognition by the leadership that China could not rely solely on its own resources if it wanted to catch up with the rest of the world in terms of technology. Thus, the importation of foreign technology and management techniques and their financing by overseas capital became an important aspect of China's reform and development efforts from the outset. This led to the first wave of foreign direct investment in China in 1985. Nevertheless, the early approach, focussing solely on export-oriented industries, severely limited the volume of FDI.

Major modifications were introduced by the "22 Articles" in October 1986, which paved the way the following year for opening foreign exchange swap centres, thereby removing the most serious constraint: China's attempt to force joint ventures to achieve self-sufficiency in foreign exchange. These "Articles" were further improved in 1990, when regulations were introduced to limit administrative interference with the operation of joint ventures. This led to the second wave of FDI in China starting in 1988.

China is currently experiencing a third, and by far the largest, wave of foreign direct investment. It is largely the result of an increasingly aggressive open door policy, the product of Deng Xiaoping's 1992 call for faster economic reform. Foreign investment in retail sales, transportation and communications, trade, management consulting, insurance and other tertiary industries, previously banned, is being liberalized in stages. In addition, investment in banking and real estate, previously allowed on an experimental basis in some coastal regions, is now allowed in cities across the country. Second, while the Chinese government continues to be quite selective in approving domestic sales by foreign-invested manufacturing firms (approvals generally reflect the priorities of China's industrial policy), the restrictions on the rates of domestic sales are being eased. Technology-intensive and capital-intensive firms, and joint ventures established in conjunction with state enterprises,

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<sup>20</sup> For a more detailed examination of this topic, see Zafar Shah Khan, World Bank Discussion Paper No. 130, "Patterns of Foreign Direct Investment", World Bank, Washington, 1991; or Y.Y. Kueh, "Foreign Investment and Economic Change in China", in The China Quarterly, No. 131, U.K., September 1992, pp. 637-90.

continue to have the most success in securing access to the Chinese market. Third, Chinese policy makers are trying to open up more regions of the country to foreign investment, reflecting the current strategy of accelerating development in coastal areas, and promoting the development of the Yangtze and border regions. Many inland cities have been designated as open cities, and increased authority over foreign investment decision-making is being devolved to local authorities.

The role of the overseas Chinese communities, particularly those in Hong Kong and Taiwan, cannot be over-stated. Almost three-quarters of all foreign investment in China comes from or via Hong Kong. The adoption of the "one country, two systems" policy, which led to the signing of the Sino-British accord in Hong Kong in 1986, has permitted a remarkable integration between the economies of China and Hong Kong. While the regulations allowing FDI created an enabling environment, the Hong Kong factor explains much of the success to date of the open door policy.

- **Labour and Social Welfare Benefits Reform**

It would appear that Chinese reformers have left social welfare system reforms until last in the hope that they could delay, if not avoid, a number of potential urban social and security problems as long as the enterprise-based social safety net remained in place. As a result, the main reforms in this area have been preparatory manoeuvres. First, since 1986, all new state enterprise employees have been hired on contracts rather than for life and, theoretically, they can be fired. Approximately 20 per cent of all state workers are now employed on contracts. Second, the percentage of workers employed outside the state sector has increased, as the number of non-state enterprises has mushroomed. Moreover, in this sector, compensation tends to be based on a piece-rate system, and non-wage benefits (i.e., housing, health and pension benefits) either are non-existent or are far below the levels provided to SE employees. Reformers are trying to utilize the rapid growth of the non-state sector to marginalize the role of firms as the primary source of social welfare benefits. As the role of the state sector is reduced, the share of workers ultimately affected by the breaking of the iron rice bowl will decline.

The government has experimented with changes to the social welfare system in China, but it is only recently that it has begun to initiate changes on a nation-wide basis with respect to items such as housing, social security and health financing. The government must facilitate the development of a salary and wage system that is essentially monetary in nature to replace the current one which leaves the state firm responsible for providing a number of non-wage benefits to workers. These benefits serve to tie the worker to his or her enterprise. The development of a vibrant labour market requires that the contract system that was implemented as a first step in the

breaking of the iron rice bowl, be matched by the creation of a system of social services that is provided independently of the firm. Given the potential for social instability that reform in this area could generate and because reform would loosen the state's control over labour mobility, the Chinese government can be expected to continue to move forward cautiously. That said, reforms in this area are necessary to create an environment in which labour is mobile and willing to change jobs, which in turn is vital to the continued restructuring of state enterprises.

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The reform experience of China to date exhibits a definite trend towards marketization of the economy, and the gradual development of rules-based systems, although reformers still have some distance to go before the transformation is complete. Reforms have progressed the furthest in areas that reformers believed would have the smallest negative impact on the operations of state enterprises. As a result, the biggest challenges now facing reformers would appear to lie in the areas of enterprise reform, as well as financial and fiscal reforms.

The November 1993 Third Plenum of the 14th Party Congress set out, for the first time, details indicating the path that China will take to establish a "Socialist Market Economy" by the year 2000. SEs will increasingly operate on a commercial basis and, while the government will maintain holdings in many enterprises, it plans to withdraw from managing their operations. The remaining components of the dual-track pricing system will be eliminated. Wages will be determined by market conditions. Major tax reform will be implemented, led by the implementation of a value-added tax as of January 1994. A social security system that is not delivered by SEs will be created. Financial markets will be developed and the urban property market will be reformed further. Banks will operate on a strictly commercial basis, and the People's Bank will eventually function autonomously. Finally, the transformation of government activities to focus on macroeconomic policy, infrastructure construction and the creation of an overall environment conducive to economic development will continue.

We will probably see a number of specific reform initiatives in the next 12-18 months, as reformers move to push measures through while Deng Xiaoping remains alive. But implementation will be a lengthy and difficult process. Section 4 below will review the nature of the unfinished reform agenda. But first, the results of China's reform efforts to date are reviewed in section 3.

### 3. The Impact of Reforms

This section attempts to assess the impact of China's reform quantitatively. The reform measures undertaken to date are reviewed in the light of four standards: the impact on output and consumption; gains in productivity; the changing role of the state; and openness to the outside world. China's reform program appears to have delivered results. This does not mean that China has chosen the optimal, or first-best, set of policies. Nonetheless, the numbers show a strong response to reforms. The reform program has led to rapid economic growth resulting from efficiency gains produced by the opening to the outside world and the growing role for the market.

#### 3.1 Expansion of Output and Consumption <sup>21</sup>

China has experienced relatively strong economic growth for most of the period that it has been under Communist rule. Between 1965-80, real GNP grew by about 6.4 per cent per annum. This may not be surprising, given that the government has ensured that more than 30 per cent of nominal GNP was invested annually. But growth rates and welfare gains have accelerated since the initiation of economic reforms. The highest growth rates of the reform period were experienced between 1982-88, with growth rates being significantly lower during each of the adjoining periods, although China has again experienced strong growth since 1991.

Table 1 provides several indices which illustrate growth rates over the reform period. A GNP growth rate of almost 9 per cent per annum--and per capita GNP increasing 7.8 per cent per annum--provided a sustained increase in output over this period. This growth in output was relatively balanced, particularly early in the reform period, as agricultural output responded to the new incentives. Not surprisingly, the services sector saw the most rapid growth.

While output had grown during the pre-reform period, there had been only modest increases in private consumption per capita. There was little if any increase in real wages over the period prior to 1979, with most of the growth in household income coming from an expansion of employment. The availability, however, of basic consumer goods, durable goods and housing improved over the reform period.<sup>22</sup> The rapid growth in output translated into a very significant change in the standard of living in China. This was possible because the reform period focussed on intensive

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<sup>21</sup> See Joseph C. H. Chai, "Consumption and Living Standards in China", in *The China Quarterly*, No. 131, U.K., September 1992, pp. 721-49.

<sup>22</sup> Peter Harrold, *op. cit.*, p. 19.

development rather than extensive growth, and thus rapid gains in total factor productivity.

**Table 1: Output and Consumption Gains in the Reform Era**  
(average real growth rates per annum in constant 1980 prices)

|                                 | <u>1979-91</u> | <u>1979-83</u> | <u>1984-88</u> | <u>1989-91<sup>1</sup></u> |
|---------------------------------|----------------|----------------|----------------|----------------------------|
| GDP at market prices            | 8.8            | 7.7            | 11.7           | 5.7                        |
| Agriculture                     | 5.4            | 6.3            | 5.1            | 4.6                        |
| Industry                        | 10.2           | 7.7            | 14.3           | 7.4                        |
| Services                        | 10.2           | 9.8            | 14.3           | 3.8                        |
| Total Expenditures              | 8.5            | 7.3            | 11.7           | 5.1                        |
| Total Consumption               | 8.1            | 8.2            | 8.6            | 6.9                        |
| Private Consumption             | 7.8            | 8.2            | 8.3            | 6.2                        |
| Gross Domestic Fixed Investment | 9.5            | 6.8            | 17.8           | 0.2                        |
| Public Sector                   | 9.2            | 5.8            | 17.8           | 0.2                        |
| Private Sector                  | 10.3           | 9.0            | 21.1           | -5.4                       |
| Imports of GNFS <sup>2</sup>    | 12.2           | 9.7            | 19.5           | 4.2                        |
| Exports of GNFS                 | 15.3           | 16.4           | 16.8           | 10.8                       |

Source: World Bank Country Study, "China: Reform and the Role of the Plan in the 1990s", op. cit., Table 1.7, p.191.

Notes:

1. Figures in this column generally would be higher if statistics for 1992 and 1993 were included. During this period, China's leadership was trying to implement a policy of retrenchment. Deng launched his latest reform push which initiated the current round of rapid economic growth in January 1992. Real GDP growth rates of approximately 13 per cent in each of 1992 and 1993 would push the first figure in the last column to 8.6 per cent.

2. GNFS = goods and nonfactor services.

Welfare gains are reflected in sharp reductions in the measured incidence of poverty during the reform period. The proportion of the population below the poverty line in China declined from 20 per cent in 1981 to less than nine per cent in 1990, although no real improvement has taken place in this regard since 1984.<sup>23</sup> The reduced incidence of poverty during the early years of reform largely reflected the initial gains from agricultural reforms. Extreme poverty in China continues to be

<sup>23</sup> World Bank Country Study, "China: Strategies for Reducing Poverty in the 1990s", World Bank, Washington, 1992, p.4, Table 1.2.

predominantly a rural phenomenon. In 1990, the incidence of abject poverty was approximately 11.5 per cent of the rural population, and 0.4 per cent of the urban population. Nevertheless, it would appear that approximately 125 million people emerged from poverty during the 1980s.

### 3.2 Increased Productivity

It appears that China experienced significant gains in total factor productivity (TFP)<sup>24</sup> in all sectors of the economy during the reform period. Table 2 summarizes the some of the results from recent studies.<sup>25</sup> The TFP gains mirror the pattern of reform which focused on agriculture during the first half of the reform period, and on industry during the subsequent phase. Initially, the agricultural sector enjoyed rapid productivity gains. But, as the effects of restoring production incentives played out, productivity increases dissipated. Conversely, TFP growth in industry did not increase significantly until after 1984. Nevertheless, while TFP growth accounts for most of the growth which took place in agriculture, industrial growth was more dependent on the increased use of inputs. Prior to the reform period, China had experienced little, if any, increase in productivity.<sup>26</sup>

These changes in TFP over time are supported by more conventional measures of efficiency gain.<sup>27</sup> The accumulation/national income ratio (the Chinese equivalent of a capital/output ratio, given the absence of GNP data before 1978) rose from 3.79

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<sup>24</sup> Total factor productivity growth can be defined as the increased production attributable to improvements in the efficiency of all inputs combined and not just labour alone. It is measured as the part of a country's output growth that is not attributable to mere increases in the quantities of inputs such as labour and capital. TFP represents the share of output attributable to innovation and other influences that enhance the productivity of those inputs. Information on TFP growth indicates the portion of labour productivity growth that is attributable to innovation and, residually, the share that can be credited to investment.

<sup>25</sup> These results confirm earlier results from Chinese researchers. They found TFP growth of 3.39 percent per annum during 1980-84, and 4.46 percent during 1984-88, although such growth turned negative during the 1989-90 rectification program, and results for the 7th Five Year Plan (FYP) period were below those for the 6th. See Li Jingwen, et. al, "Analysis of Economic Growth in China", Institute of Quantitative and Technical Economics, Chinese Academy of Social Sciences (1991), cited in Peter Harrold, op. cit., pp. 20-1.

<sup>26</sup> See Perkins, "Reforming China's Economic System", in The Journal of Economic Literature, June 1988. One study cited showed a decline in combined agricultural and industrial TFP of -1.41 percent during 1957-65 and a gain of only 0.62 percent per annum during 1965-76

<sup>27</sup> Peter Harrold, op. cit., p.20.



in the first decade (1953-59) to 4.30 in 1960-69, and to 5.39 in 1970-78. During the 1978-88 period it fell to 2.38, however, despite the surge in investment during the reform period. Only during the slower growth period of the 1989-90 rectification program did the capital-output ratio again increase.

**Table 2: Productivity Gains During the Reform Period**  
(Percent growth per annum unless stated)

| <u>Productivity Indicators</u> | <u>1980-88*</u> | <u>1980-84*</u> | <u>1984-88*</u> | <u>1989-91</u> |
|--------------------------------|-----------------|-----------------|-----------------|----------------|
| <u>State Sector</u>            |                 |                 |                 |                |
| Growth                         | 8.49            | 6.77            | 10.22           | 5.3            |
| TFP growth                     | 2.40            | 1.80            | 3.01            | n.a.           |
| Use of materials               | 4.31            | 3.72            | 4.90            | n.a.           |
| <u>Collective Sector</u>       |                 |                 |                 |                |
| Growth                         | 16.94           | 14.03           | 19.86           | 10.5           |
| TFP growth                     | 4.63            | 3.45            | 5.86            | n.a.           |
| Use of materials               | 9.70            | 8.30            | 10.85           | n.a.           |
| <u>Agriculture</u>             |                 |                 |                 |                |
| Output growth                  | 6.12            | 7.71            | 4.13            | 4.6            |
| TFP growth                     | 6.44            | 9.52            | 2.60            | n.a.           |
| Land under cultivation         | -0.13           | -0.38           | 0.12            | 1.2            |
| Use of fertilizers             | 6.75            | 8.20            | 5.33            | 8.3            |

Source: Statistical Yearbook of China. (\* Cited in Peter Harrold, op. cit., p. 21.)

The lack of factor mobility in socialist economies allows the state to set profits by manipulating the price system. Profits can then vary widely between sectors, as can the returns to factors of production in different uses. On the other hand, a convergence of returns could signal increased marketization. The returns to labour in the collective sector increased to 55 per cent of those in the state sector in 1988 from less than 50 per cent in 1980.<sup>28</sup> Concomitantly, returns to capital in the collective sector declined from 69 per cent in 1980 to 54 per cent in 1988. This suggests that reform in China may be forcing the economy to behave in ways similar to those of market economies.

<sup>28</sup> Ibid., pp. 22-23.

### 3.3 An Evolving Role for the State

The main objective of economic reform is to reduce the government's role as economic decision maker, and develop its capability to manage the policy environment in which decision makers operate. Table 3 provides a number of indicators related to the role of government in the economy. It appears that the government's role has changed significantly. In 1978, 81 per cent of all industrial output was generated by SEs operating within the planning system. In 1991, the share of SE output in total industrial production had fallen to 64 per cent. This is the result of the growth of marketization and the non-state sector<sup>29</sup>, not privatization. The exceptional growth rates that the non-state industrial sector has experienced have caused that sector's share of total industrial output to expand quickly. SE output has been growing quickly as well, but at a rate that is only one-half that of non-state enterprises. It should be noted that small, incremental changes, if pursued consistently, can over time add up to major structural reforms.

Table 3: Changing (Declining) Role of the State

|   | 1978 | 1984 | 1988 | 1991 |
|---|------|------|------|------|
| <u>Government Finance</u> <sup>1</sup> (% of GNP) |      |      |      |      |
| Revenues  | 34.4 | 26.4 | 20.7 | 18.6 |
| Expenditures                                      | 34.1 | 27.9 | 23.2 | 21.1 |
| Deficit   | 0.3  | -1.5 | -2.5 | -2.6 |
| Financing (% of GNP)                              | -0.3 | 1.5  | 2.5  | 2.6  |
| Domestic  | -0.3 | 1.2  | 1.7  | 2.0  |
| People's Bank                                     | -0.3 | 0.6  | 0.6  | 1.4  |
| Nonbank   | 0.0  | 0.6  | 1.1  | 0.6  |
| Foreign   | 0.1  | 0.3  | 0.8  | 0.6  |
| Financing (% of total deficit)                    | 100  | 100  | 100  | 100  |
| Domestic  | 125  | 82.9 | 65.6 | 75.2 |
| People's Bank                                     | 125  | 42.9 | 23.5 | 53.9 |
| Nonbank   | 0.0  | 40.0 | 42.1 | 21.2 |
| Foreign   | -25  | 17.1 | 34.4 | 24.8 |

<sup>29</sup> While all collectives and TVEs are defined as "nonstate", many should also be described as being "publicly owned". Consequently, while many TVEs should be viewed as being similar to private enterprises, others more closely resemble local state enterprises. The role of the entrepreneur is critical in the former, and local government in the latter.

Industrial Output (% shares)<sup>2</sup>

|            |      |      |      |      |
|------------|------|------|------|------|
| State      | 81.4 | 73.6 | 64.1 | 63.8 |
| Collective | 18.6 | 25.0 | 32.3 | 29.3 |
| Township   | 5.2  | 7.7  | 20.1 | 21.3 |
| Other      | 0.0  | 1.4  | 4.4  | 7.0  |
| Light      | 42.8 | 49.6 | 49.9 | 48.3 |
| Heavy      | 57.2 | 50.4 | 50.1 | 51.7 |
| Large      | 25.7 | 26.2 | 28.6 |      |
| Medium     | 18.3 | 18.6 | 18.7 |      |
| Small      | 56.0 | 55.1 | 52.7 |      |

Financing of SEs Investment<sup>4</sup>

|                               |      |      |      |      |
|-------------------------------|------|------|------|------|
| Government's Budget           | 37.7 | 39.0 | 15.1 | 10.8 |
| Retained profits <sup>5</sup> | n.a. | n.a. | 35.3 | 37.1 |
| Bank loans                    | n.a. | 15.4 | 23.7 | 27.7 |
| Foreign Investment            | n.a. | 2.2  | 8.7  | 8.2  |

Notes:

1. Source: World Bank Country Study, "China: Reform and the Role of the Plan in the 1990s", World Bank, Washington, 1992, Table 1.7, p. 191.
2. Source: World Bank Country Study, "China: Macroeconomic Stability and Industrial Growth under Decentralized Socialism", World Bank, Washington, 1990, Tables 6.4 and 6.5, pp.135-136.
3. 1987 figures.
4. Source: Peter Harrold, op. cit., p.23.
5. Retained profits and extrabudgetary operations of local governments.

Provinces with high-productivity levels, such as Zhejiang, Jiangsu and Guangdong, tend to have higher ratios of non-state enterprise output to total industrial output than do the lower productivity provinces, particularly those in north-west China, which had the lowest productivity.

Fiscal reforms mean that investment is now financed primarily via retained profits and bank loans.<sup>30</sup> In 1978, when SEs remitted profits to the centre, about 40

<sup>30</sup> Until SEs face a hard budget constraint, the shifting of the financing of state enterprise investment to the banking system may just be transferring the problem from the government's balance sheet to those of the banks.

per cent of their investment came from the budget. By 1991, this had declined to 11 per cent, with most of this change coming after 1984. While the state continues to influence investment through its approval mechanisms and via the banking system, it no longer plays a significant direct role. Most investment undertaken via the budget is in infrastructure. As the role of the state in financing investment has declined, the banking system has played a larger part in mobilizing savings for investment.

### 3.4 Increased Interaction with the World Economy

The most important outcome of the economic reform program may be that China has become a major player in the world economy. That said, trade was an important component of China's development plan even prior to 1978, via its program to import western technology. Since 1978, however, trade (exports and imports combined) consistently has grown at rates well above those for GDP. By 1990, trade had risen to over 30 per cent of GDP, making China, by this measure, the most open of all large developing countries, and with a degree of openness more than twice that of India or Brazil.<sup>31</sup> China typically runs trade deficits. It has recorded trade surpluses only in the years immediately following the macroeconomic rectification programs of 1981 and 1989. By the end of the 1980s, more than one-half of all Chinese exports were generated by non-plan activities.

The strong export growth that China experienced in the 1980s was heavily supported by government backed export incentives, including foreign exchange retention, tax rebates and direct subsidies on planned exports (see section 2.4 Major Reform Developments by Sector-Foreign Trade for a further discussion of this issue). The most important may have been intervention in the exchange rate and foreign exchange markets. The exchange rate, which initially played almost no role in determining/influencing China's trade flows since foreign exchange was allocated by administrative fiat, stood at Y 1.72/U.S. \$1 in 1978, but now is at Y 6.34/\$1. This is despite the fact that China has only experienced approximately 30 per cent more inflation than the U.S. during this period. Consequently, there has been a significant depreciation of the real effective China/U.S. exchange rate.<sup>32</sup>

The rapid growth of volumes traded on the swap markets reduced the government's ability to fully manage the exchange rate. The turnover on the parallel

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<sup>31</sup> Although it would not alter the conclusion, these statistics should be viewed with some caution. GNP may be somewhat underestimated, and trade statistics include the full value of exports based on processing of imported inputs, which tends to exaggerate the true role of trade in the economy.

<sup>32</sup> In fact, taking 1980 as 100, the real effective exchange rate index at June 1991 was only 34.6.

market increased from US\$4 million in 1987 to an estimated \$18 billion in 1991, accounting for about one-third of all transactions. It has been the growth in this market which has forced the government to realign the official exchange rate periodically since 1987, to the extent that the differential between the official and swap market rates was gradually reduced from approximately 100 per cent in 1988 to less than 10 per cent, and to take the decision to unify the rates under a market-based system as of January 1994. The unification of the official and swap market rates of the renminbi is a prelude to the eventual convertibility of the currency on the current account.

**Table 5: Trade in the Chinese Economy, 1978-90**

|            | <u>1978</u> | <u>1984</u> | <u>1990</u> | <u>1992</u> |
|------------|-------------|-------------|-------------|-------------|
| Exports    |             |             |             |             |
| \$ billion | 9.75        | 26.14       | 62.09       | 85.0        |
| % of GDP   | 4.7         | 8.4         | 17.1        | 19.4        |
| Imports    |             |             |             |             |
| \$ billion | 10.89       | 27.41       | 53.35       | 80.6        |
| % of GDP   | 5.2         | 8.9         | 14.2        | 18.4        |

Source: China Custom Statistics and EIU, Country Report on China/Mongolia, 1st quarter 1994, U.K. p.4.

Trade has also helped to raise the level of technology utilized in the country. Machinery and equipment imports have accounted for about one-third of all imports over the last ten years, accounting for about 7.5 per cent of all investment, and about 15 per cent of all investment in equipment. While the modernization and upgrading of equipment remains a priority in many sectors of the economy, it must be assumed that there are a number of industries where capital equipment obsolescence is no longer the primary obstacle to international competitiveness.

Finally, China's reforms and increased openness have had a major impact on the flows of foreign direct investment into the country. Official statistics indicate that, during 1978-90, contracts covering more than 29,000 joint ventures had been signed, with a contracted value of US\$45 billion. Approximately one-half of these, bringing FDI valued at roughly \$22 billion, have commenced operation. Annual net direct foreign investment figures have been increasing rapidly in the 1990s, and are

of the same magnitude as inflows of each of official and commercial borrowing. Some 70 per cent of all foreign investment flows into China enter via Hong Kong, as does more than one-third of all trade. China is now the destination for about 10-15 per cent of all direct foreign investment flowing into low- and middle-income countries, and is surpassed in Asia only by Singapore.<sup>33</sup>

The increased flow of foreign direct investment into China includes a component that is actually investment by domestic Chinese firms. This "round tripping" reflects efforts by Chinese firms to access the preferential treatment accorded to foreign investors, as well as attempts to bury assets through an off-shore connection. Chinese investors channel their investments through foreign intermediaries, generally located in Hong Kong. The exact size of this flow is unknown. As 1997 approaches, however, these Chinese investors may begin to look farther afield for investment platforms.<sup>34</sup>

#### **4. A Look Ahead At the Unfinished Process of Reform**

The success of reforms will become increasingly contingent upon the ability of the government to maintain a stable macroeconomic environment if decision-making is further decentralized and planning controls are relaxed. The centre's inability to develop indirect macroeconomic controls largely is the result of a centre-provincial conflict that has developed because efforts by the centre to develop and maintain macroeconomic discipline are viewed by the provinces as initiatives designed to impede the decentralization of decision-making that is needed for increased efficiency. Nonetheless, when all else is said and done, macroeconomic management, even with indirect fiscal and monetary levers, requires that the tools remain firmly in the hands of the central government.

Economic reform in China has altered the structure of the economy significantly, and has had a very positive impact on production and consumption. But much remains to be done. There are seven priority areas for further reform: the state enterprise sector; the financial sector; public finance; trade; prices and markets; environmental sustainability; and the role of the state. Widening and deepening

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<sup>33</sup> For a more detailed discussion of this issue, see Zafar Shah Khan, World Bank Discussion Paper No. 130, "Patterns of Foreign Direct Investment in China", World Bank, Washington, 1991.

<sup>34</sup> See C. Fred Bergsten and Edward M. Graham, "Towards an Asia Pacific Investment Code: Issues and Options", Institute for International Economics, 1994, p.3. For an expanded discussion of this issue see, Nicholas Lardy, "China in the World Economy", Institute for International Economics, Washington, 1994, forthcoming.

reform of the SE sector probably will pose the biggest obstacle for Chinese reformers for the balance of this decade.

#### 4.1 State Enterprise Sector<sup>35</sup>

The incentives guiding the operations of state enterprises have changed significantly. SEs are reorienting themselves towards making profits and improving efficiency, and away from achieving plan output targets and providing social services. Nevertheless, while the role of the non-state enterprise sector has expanded dramatically, the fundamental structure of the relationships between the state and the SEs, and between the SEs and their workers remains largely unchanged. Enterprises continue to be subjected to excessive administrative interference in their day-to-day operations. The negative consequences of failure remain unclear to managers (they continue to wrack up losses that are a significant drain on the public purse). Workers continue to be assigned to enterprises administratively and to be bound to those enterprises through the housing, health, education and social security systems.

China's leadership remains determined that SEs will continue to play a central, if not dominant, role in the Chinese economy. Since public ownership, in some form, of key enterprises will continue, the reform priority in the state enterprise sector relates to their operation, and not to the issue of privatization. Reformers will have to focus on increasing the autonomy of "shop-floor" decision makers and developing a regulatory and competition framework. Policy makers will have to develop new institutional mechanisms to separate and define the roles of government as regulator, owner and manager of enterprises. Property rights remain vague and business law, for example, does not exist. Both will have to be developed to facilitate the consolidation of a fully functioning commercial environment.

SEs remain protected from the full weight of competition. State enterprises continue to receive favoured access to credit, and entry by non-state and foreign firms into certain sectors of the economy remains restricted, particularly broadly defined defence and security related industries. Finally, enforcement of existing bankruptcy laws remains limited. While the number of mergers taking place is increasing, the merger process continues to be most often the result of administrative fiat.

In November 1993, reformers announced that SEs will gradually be turned into limited liability corporations whose assets will held by both the state and private

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<sup>35</sup> For an interesting narrative on China's industrial sector, see Robert Michael Field, "China's Industrial Performance Since 1978", in *The China Quarterly*, No. 131, U.K., September 1992, pp. 577-607.

shareholders. Nevertheless, wholesale privatization is not yet planned, and public listings will be strictly controlled. Chinese reformers will need to create a regulatory framework that offers SEs incentives to operate like private enterprises, including facing the possibility of bankruptcy. Reforms in this area will have to be closely linked to reforms in the financial sector.

#### 4.2 Financial Sector Issues <sup>36</sup>

The major reforms in the financial sector took place in the mid-1980s and, except for some recent capital market developments, reform in this area appears to have stalled. The government continues to use the banking system to further its own economic objectives. Its use of directed and "policy" lending prevents the banking system from performing the important financial intermediation role of channelling savings to priority, market-selected uses. Directing the banking system to cover the ongoing losses of SEs only shifts the subsidization problem from the government's books to those of the banks, and will eventually lead to portfolio problems for the banking system. Although the financial sector has yet to face a serious crisis, portfolios of banks deteriorated significantly during 1989-91 because of heavy lending to SEs, in the midst of a period of weak economic growth.

The second major problem is the central bank of China, which still has not developed the ability either to regulate and supervise the financial sector or to formulate monetary policy and implement it using indirect instruments. Monetary policy continues to be heavily influenced by, *inter alia*, local officials, and implemented largely by use of direct credit controls.

This suggests that policy makers must address three key issues. The government should develop alternative methods of financing its policy objectives (see 4.3 below). The central bank's technical capability both to formulate and implement monetary policy and to fulfil its regulatory and supervisory functions needs considerable strengthening. Further efforts are required to increase the use of indirect instruments of monetary policy, such as the interest rate structure and the use of open market operations via new instruments, such as short-term treasury bonds.

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<sup>36</sup> See World Bank Country Study, "China: Financial Sector Policies and Institutional Development", World Bank, Washington, 1991.



### 4.3 Public Finance<sup>37</sup>

China's public finance system underwent one major reform in 1983-84--the shift from a profit remittance system to a corporate "income tax" scheme--but only minor change thereafter. The system continues to be based on contracts, which are time consuming to negotiate and subject to administrative discretion. The contracts should be eliminated. The revenue system, which remains dependent on the state enterprise production system, will have to be diversified to introduce a greater reliance on personal income tax and final sales-point taxes, to parallel the conversion of non-wage into wage income. The recent implementation of the value-added tax is a step in this direction.

In recent years, public expenditures on price and enterprise subsidies, which account for one-third of all government spending, have often displaced infrastructure investment and social expenditures. The growing central government deficit has focussed policy makers' attention on the need to address fiscal issues. Fiscal system changes will take time to implement once reforms are formulated.

### 4.4 Trade Sector<sup>38</sup>

China has not only been successful in expanding external trade, but it has also made exporters more responsive to economic signals on an aggregate basis. Nevertheless, external trade continues to be dominated by foreign trade corporations of various kinds, and participation of production enterprises directly in trade is limited. Moreover, the import regime continues to offer a high degree of protection to domestic industry, and thus imports continue to be regarded primarily as a source of embodied technology. This protection is provided by an opaque and unpredictable system of import licensing, and by an uneven tariff structure, albeit with apparent frequent exemptions for key inputs to reduce anti-export biases.

We would expect to see reformers slowly, and probably under continued pressure from China's major trading partners, alter the import regime by moving to a system of management by more indirect control. The new system will likely function under a more transparent and lower level of protection effected by tariffs rather than discretionary import licenses and administrative barriers. We would also expect

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<sup>37</sup> See World Bank Country Study, "China: Revenue Mobilization and Tax Policy", World Bank, Washington, 1990.

<sup>38</sup> For an expanded discussion of this issue, see World Bank Country Study, "China: Trade Reforms" World Bank, Washington, 1994; or Nicholas R. Lardy, *op. cit.*, pp. 691-720.

efforts to reform foreign trade corporations to continue, through a further reduction of their effective monopsony and greater room for the direct entry of production enterprises into export markets.

The current import regime has been matched with a foreign direct investment system which provides lucrative incentives, but which restricts the competitive impact of foreign enterprises in the domestic Chinese market place. We would expect to see the continued opening of the domestic economy to foreign investment, as well as improved efficiency and transparency in the approval process.

The central issues in the development of domestic trade involve problems of industrial organization, industrial restructuring and interprovincial competition. Interprovincial barriers to trade, barriers to entry and the need to relocate industries in accordance with their comparative advantage are as important as issues pertaining to enterprise and price reforms. Unless interregional competition is allowed to integrate domestic markets and import pressures are permitted to keep domestic firms relatively efficient, market determined prices will only result in monopoly and monopsony rents. Thus, measures to promote competition are an important factor in making enterprises more accountable. There has been a tendency, however, for provinces and lower level governments to restrict domestic trade.

#### 4.5 Prices and Markets <sup>39</sup>

While Chinese sources suggest that 95 per cent of consumer goods transactions take place at prices that are not subject to some type of government administration or guidance, the World Bank suggests that the figure is closer to 90 per cent. Approximately 80 per cent of "other goods" transactions take place at prices which are set by some type of market determination. There is little information, however, regarding the extent to which markets determine the prices of services. For example, while the prices of transport services remain under the control of the state, prices for health services, particularly in rural areas, increasingly are being determined by market mechanisms.<sup>40</sup> It would appear, therefore, that most marginal resource allocation decisions now are made at market prices.

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<sup>39</sup> For a detailed narrative on this topic, see World Bank Country Study, "China: The Achievement and Challenge of Price Reform", World Bank, Washington, 1993.

<sup>40</sup> Mr. Shahid Yusuf of the World Bank, who co-authored "China: The Achievement and Challenge of Price Reform" that is cited in the previous footnote, was the source of these figures.

During the pre-reform situation, the planning system could compensate for the price distortions that reduced "profits" with fiscal transfers. The central government, however, no longer has, nor controls, the financial resources to do this. Furthermore, this system led to unbalanced investment and unfair interprovincial income distribution, in addition to obvious microeconomic consequences, such as the wastage of energy.

While most prices are now set by some type of market mechanism, the machinery of government which sets prices has yet to be dismantled. Reform in these areas, therefore, will involve developing new price formulation systems, especially for raw materials and services. This will require not only the lifting of the remaining controls and the adjustment of fixed prices, but also the development of market infrastructure, such as transport and storage facilities, and information systems. It will also require that consumers become more sensitive to prices and price differentials. Consequently, the government should continue to convert price subsidies into wages.

We would, therefore, expect reformers to focus on the removal of remaining price controls for most commodities, usually preceded by upward price adjustment, and accompanied by market infrastructure investments. Priority sectors would appear to be energy, transport and certain raw materials. This would need to be accompanied by the development of regulatory mechanisms and institutions to guard against abuse of monopoly powers (i.e., a competition policy). The remaining consumer price subsidies should be converted to wages, so that state procurement and distribution can be gradually eliminated.

#### 4.6 Environmental Sustainability<sup>41</sup>

Environmental problems threaten to overwhelm the recent achievements China has made in environmental policies and programs, and will pose a significant challenge to sustainable development in China in the future. Economic growth and development and environmental issues are inextricably linked. The structure of the economy, and general economic policies and management, largely determine the nature of environmental problems and the framework for environmental policies and programs in any country.<sup>42</sup>

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<sup>41</sup> For an expanded discussion of this issue, see World Bank Country Study, "China: Environmental Strategy Paper", World Bank, Washington, forthcoming.

<sup>42</sup> Ibid., p. 2.

While Chinese efforts to date have slightly reduced pollution per unit of output during the reform period, these improvements have been offset by the rapid economic and population growth that China has experienced. Environmental problems in China are more severe than at comparable periods of economic development in most industrialized countries, primarily because of the size of the country's population, and natural resource constraints. As a result, they are more likely to cause a severe braking effect on economic growth unless action is taken soon to address both the direct and indirect or underlying causes. In general, until price and enterprise reforms are undertaken more extensively, neither pollution fees nor fines nor administrative regulations are likely to carry sufficient force or be systematically applied to encourage the most cost-effective means to reduce environmental degradation.<sup>43</sup>

The Chinese have identified three pollution problems as being of principal concern. They are: urban water quality, urban air quality and rural industrial pollution. China's coastal waters and rivers are polluted, and both surface and ground waters in many areas are contaminated. Roughly one-third of industrial waste water, which is the predominant source of pollution in most large urban areas, is treated; the share of municipal wastewater receiving treatment is even lower. Increasingly, the quality of drinking water in China's cities appears to be at risk. The problem is acute in rural areas as well. China's Ministry of Public Health estimates suggest that only one in seven Chinese in rural areas has access to safe drinking water. Air quality in China is poor. China remains heavily dependent on coal for energy and fuel. While the average energy intensity of China's industrial sector declined in the 1980s, it remains high (higher than the level of most developing and developed nations). Chronic obstructive pulmonary disease (which has been linked to exposure to fine suspended particulates and sulphur dioxide) was the leading cause of death in China in 1988 (the rate in China was five times greater than that of the U.S.). Township and village enterprises, which use outdated technology, receive much of the blame for rural pollution. The uncontrolled and rapid development of groundwater both for irrigation and municipal use has led to excessive extraction and falling water tables in many areas.

Other pollution issues, such as industrial and domestic solid waste disposal and hazardous and toxic wastes, are becoming increasingly important domestically, and a number are of increasing interest to industrialized economies. These include acid rain, greenhouse gases and ozone-depleting emissions. China accounts for approximately 33 per cent of the total CO<sub>2</sub> emissions emanating from the world's low-

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<sup>43</sup> Ibid., p. 47.

and middle- income countries.<sup>44</sup> Its emissions of carbon dioxide increased at a rate of almost six per cent per annum during the 1980s (global emissions increased at an annual rate of 1.8 per cent during this period, while emissions by high-, middle- and low-income countries increased by 0.5, 2.3 and 5.9 per cent respectively).

Unlike many developing countries, China has a comprehensive set of laws to guide the development of environmental policy, and an array of command-and-control as well as economic incentive tools to implement the laws.<sup>45</sup> China also has an institutional framework for administering, monitoring and enforcing environmental laws and policy in place that could be used as a foundation for designing approaches for dealing with environmental and ecological problems. The environmental protection agency network includes the National Environmental Protection Agency (NEPA), and provincial, county and municipal environmental protection bureaus. NEPA is responsible for all aspects of environmental policy, although it shares authority for certain specific natural resources with other agencies. Authority in conservation issues rests primarily with the natural resources ministries. Most environmental protection policy is implemented at the subnational level. Unfortunately, under the current system, in many situations the government is both the principal polluter and the environmental manager/regulator. As a result, it is often difficult for regulators to carry out objective reviews or assessments of the actions of state entities, or take contrary positions.

The changing division of responsibility between the various levels of governments in China in managing the economy implies that the division of responsibility for managing environmental issues should also be reviewed. Many environmental problems, such as agricultural land degradation, are regional in nature, and might best be addressed at the national or provincial level. The role of local level governments in investment decision-making is increasing, however, and as such, it may be that level of government which should implement environmental management policies.

Chinese reformers must come to view environmental management as part of the larger process of economic reform and industrial restructuring.<sup>46</sup> In the short term, the objective of promoting economic growth, alleviating poverty and protecting the

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<sup>44</sup> World Development Report 1992, "Development and the Environment", World Bank, Washington, 1992, Table A.9, p. 204.

<sup>45</sup> World Bank Country Study, *op. cit.*, pp.5-6.

<sup>46</sup> *Ibid.*, p. 55.

environment, are not always compatible, and governments often confront difficult choices in pursuing them simultaneously. Nevertheless, in the long term they are mutually supportive objectives. Systemic economic reform should be linked to environmental management in three ways. It should improve efficiency to reduce pressures on the environment, make the enforcement of environmental policies more effective by strengthening the operational independence of the regulatory authorities, and increase enterprise profitability and reduce the central government's budget deficit to provide more funds for environmental investments. Reformers also must address the underlying causes of a number of the country's environmental problems, including, inter alia, the failure to establish marginal cost resource pricing, weak institutional incentives and organizations, poor enforcement of regulations and inadequate implementation of pollution control measures. Moreover, a longer-range, more holistic focus would limit the adjustment of environmental priorities with each shift in the winds of public opinion, while a least-cost approach would force China's decision makers to focus on improvements that are the most cost effective.

#### 4.7 The Role of the State

Much has already changed with respect to the role of the state, as it has fostered the growth of non-state enterprises, and yielded control over many prices, revenues and materials. But the role of the state and of planning will have to continue to evolve.<sup>47</sup> Most broadly, the state must continue to focus on elaborating and implementing economic framework laws and regulations (business law, taxation reform, competition law, environmental regulation and enforcement) and to provide a consistent and stable macroeconomic environment. The state may also need to plan and undertake investments in key sectors and regions that may well not be financially viable for other economic entities or in situations where there are market failures, social sectors including health, sanitation and water supplies, and investment in backward or poorly endowed regions to ease somewhat the effects of marginalization.

Social services of one kind or another continue to be provided primarily by the enterprise sector, especially housing, health insurance and pensions. Moreover, because of the emphasis on the development of new enterprises rather than the radical reform of existing ones, the state enterprise system has continued to offer protection against unemployment. There is a new role for the state either in the direct provision of such services, or in the development of a framework for non-state, non-enterprise based systems, such as private pensions and health insurance. Real state

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<sup>47</sup> For a full discussion of this issue, see World Bank Discussion Paper, "China: Reform and the Role of the Plan in the 1990s", World Bank, Washington, 1992.

enterprise reform cannot begin until this burden is removed from these establishments.

Finally, while reformers have moved to break the iron rice bowl by providing new state sector employees with jobs on a contract basis rather than for life, virtually no other progress has been made in the area of labour market reform. Most workers continue to be assigned jobs, and movement between geographical areas remains highly restricted. Even movement between enterprises within one geographical area is difficult, because of non-transferability (or non-portability) of accumulated non-wage benefits and housing. While workers can now be fired, at least theoretically, it remains difficult for most to change jobs of their own volition. These suggest three areas of primary focus: conversion of non-wage benefits into wages and the separation of services provided by enterprises; further gradual relaxation of the labour allocation system; and continued attention to the removal of anti-employment policies, especially those that encourage high capital/labour ratios, such as low input prices and interest rates, and policies that discriminate against township and village enterprises.

## **5. The Chinese Way: Some Conclusions on Economic Reform**

It is clear that the Chinese approach has worked well given the initial conditions under which it was launched. This is not to say, however, that the outcome was optimal. Significant resource misallocation persists in the strict economic sense. It must also be stressed that several of the key favourable features of China's initial conditions at the start of the reform process were the absence of a need for harsh macroeconomic stabilization measures, the absence of simultaneous external shocks, and ample room for agricultural growth and industrial development outside the state-controlled system of production. That said, there would appear to be five key features that contributed to the success of the Chinese reform experience which may have some wider applicability, and that are independent of conditions that are unique both to China and its approach to reform.

### **5.1 Key Features**

At the start of the reform program, China had built an extensive industrial base, but was nevertheless fundamentally a rural economy. Moreover, a reasonable technical/infrastructural base had been developed in the agricultural sector, but growth was stunted by a lack of incentives. It was thus ripe to respond to radical reform. These factors supported the appropriateness of the decision to use agriculture as the critical entry point for the reform process. Not only did agriculture respond rapidly, but it generated the rural savings and surplus labour necessary to launch the next phase of reform, and created a constituency for reform.

Secondly, China emphasized marketization rather than privatization. The development of a new non-state sector played an important role in diversifying ownership patterns. The spectacular growth of the non-state enterprise sector has stimulated economic growth and generated employment opportunities. The non-state sector also has put competitive pressure on state enterprises, forcing change in their behaviour, although this process remains far from complete. The emphasis on the creation of new non-state industries suggests the possibility of creating a competitive framework in which state enterprises can be made more efficient without recourse to direct privatization programs, especially if such reform of state enterprises could lead to severe political and social resistance to change overall.

Thirdly, a particular problem for socialist economies is how to change the interest of the Party and the bureaucracy. Bureaucrats, especially at the national level, are among the major losers from reform of the command economy, with loss of power, perks and prestige. Nevertheless, China seems to have had some success in reorienting the bureaucracy, particularly at the local level. The reforms created pressure on planners because they reduced central revenues and the profitability of state enterprises. Although this caused part of the bureaucracy to seek to protect its interests, it also redirected the interest of the bureaucracy towards ensuring that their enterprises were oriented towards profit making. Decentralization and the promotion of non-state industry generated a reorientation of the interest of the bureaucracy away from planning goals towards economic performance (including the military through its control and partial conversion of defence industries). This suited the interests of the Party, which increasingly saw its political future dependent on the achievement of economic success. Thus, the gradual approach to reform offers time to win over sceptics as long as benefits emerge and the depth and breadth of reform continues to grow incrementally.

Fourthly, the Chinese approach has emphasized export development, and the postponement of full import liberalization until later in the reform process, with the important caveats that the external opening did lead to a relatively high level of advanced technology imports and a foreign investment boom. China has been open to a great deal of influence from the outside world in the development of its export industry, particularly entrepreneurial capital from Hong Kong which has raised the standard of export design and quality control. The unique relationship between China and Hong Kong may reduce the replicability of this element of the strategy. Moreover, the prospect of trading partners tolerating slower reform on the import front while opening their own markets to goods from China, the European "countries in transition", or other major developing countries may worsen in light of slower growth and high levels of unemployment in the OECD area through the rest of the decade.



Fifthly, by using the gradual approach, and by not subjecting the state sector to major shocks at any point in time, China has for the most part successfully avoided severe social unrest during its transition to date. The Chinese effort has focused much less on changing old enterprises and more on generating new opportunities and letting these new forces gradually reform the state sector through competition in the market place. Moreover, the postponement of social reforms until later in the reform process has given the government the opportunity to develop over time an institutional framework for a new social security system. The key question, however, is whether China is able and willing now to address the more fundamental issues related to the state enterprise sector and the reorientation of the existing social support system. Nevertheless, it is clear that the approach followed by the Chinese leadership since the late 1970s has avoided to date some of the serious social consequences that could have undermined the case for further reform if rapid structural adjustment had been pursued throughout the economy simultaneously. The government must adopt a constant and increasingly coherent approach to reform over a prolonged period on time. The process requires patience and staying power.

## 5.2 Is the Process Sustainable?

There is some question as to whether or not Chinese reformers can sustain the economic reform program over the medium to long term. Chinese policy makers need to address five issues. First, there is a danger that the Chinese economy could face a financial crisis triggered by the insolvency of some large banks, as they acquire increasingly weak portfolios by funding the losses of state enterprises, with limited capital bases and small loan loss provisions. Second, so long as the still dominant state enterprises remain protected and in control of the commanding heights of the economy, they will never be able to achieve efficiency at internationally competitive levels. Third, the possibility exists that social tensions will mount as increasing provincial autonomy and self-sufficiency lead to a further increase in the growing regional disparities in China. Fourth, while the fight against poverty in China is showing some gains, many persons, including potentially volatile urban populations, are only just above the poverty line. Continued reforms and increasing financial difficulties for the central government could cause the present social safety net to collapse, pulling millions back into poverty. Fifth, there are growing concerns about the environmental sustainability of China's economic growth.

The gradual approach has limitations, and China may eventually reach its frontier. The possibility that one, or a combination, of the five obstacles cited above could force the Chinese government to abandon its gradualist approach, and require that it undertake its own "big bang" program for reform (in particular, in the industrial and financial sectors) cannot be dismissed. Nonetheless, over the reform period to

date, Chinese policy makers have generally responded to the problems arising out of the reform experience by introducing new, and deepening existing, reforms. This suggests that, as new problems emerge, reformers will respond with more reform, so that deep crises are avoided. The approach may be sustainable if China "grows out" of its problems. China's use of "marketization" and the vigorous development of the nonstate sector has proved to be quite successful. That said, the program's sustainability will depend on the solutions that Chinese reformers develop with regard to the unfinished reform agenda outlined in greater detail in section 4 above.<sup>48</sup>

The sustainability of the process is also dependent on continued political stability. Stability requires economic growth, but growth also requires stability. The post Deng period could prove fatal to the continuation of the reform process if decision making grinds to a halt either as the result of covert or overt factional infighting at the leadership level. Presumably, that is why the "reform" contingent in the leadership cadre is attempting to push economic reform as far as possible, and entrench it, before Deng dies.

## 6. China 2000

### 6.1 The Size of China's Economy Today: Depends on Who You Ask

Converting figures from Renminbi to dollars gives a misleading and downwardly distorted picture of the true size of the Chinese economy. The existence of multiple exchange rates prior to 1994 made a true approximation difficult. Moreover, the average level of prices and, more importantly, the relative prices of many goods and services, particularly necessities, are low. As price reform expands, and the use of fixed prices is reduced, the degree of distortion should decline.

While China remains a relatively poor country, the typical standard of living is substantially higher than that suggested by a per capita income of US \$369. The use of purchasing power parity (PPP) exchange rates to make conversions for use in cross-country comparisons is an attempt to account for differences in relative prices.<sup>49</sup>

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<sup>48</sup> See K.C. Yeh, "Macroeconomic Issues in China in the 1990s", in The China Quarterly, No. 131, U.K., September 1992, pp. 501-44.

<sup>49</sup> PPP exchange rates are simply the ratio of prices of a product or bundle of products in China relative to the price of the same product(s) in another country. But the calculation of PPP exchange rates for bundles of products is complex. Systems have to be devised to weigh each product in the bundle and to ensure that the average price for each product represents regional variations, important in the case of a country such as China. Variations in quality should also be taken into account.

Based on the World Bank figures ( the middle of the three multilateral agencies which undertook this type of analysis), China ranks as the third largest economy in the world. Given the differentials in most growth projections for China and the industrialized economies, it would appear that China could pass Japan to become the second largest economy in the world early in the next century, if it can successfully manage the five uncertainties outlined in section 5.2.

**Table 5: The Size of the Chinese Economy**

|                       | At market<br>Exchange<br>Rates | IMF <sup>1</sup><br>PPP<br>Estimates | World Bank <sup>2</sup><br>PPP<br>Estimates | UN <sup>3</sup><br>PPP<br>Estimates |
|-----------------------|--------------------------------|--------------------------------------|---|-------------------------------------|
| 1992                  |                                |                                      |   |                                     |
| Exchange Rate:        | 5.51                           | 1.46                                 | 1.07  | 0.60                                |
| Per Capita Income:    |                                |                                      |   |                                     |
| Renminbi <sup>4</sup> | 2,036                          | 2,036                                | 2,036                                       | 2,036                               |
| Dollars (US)          | 369                            | 1,396                                | 1,907                                       | 3,396                               |
| Size of the Economy:  |                                |                                      |   |                                     |
| Renminbi (billions)   | 2,392                          | 2,392                                | 2,392                                       | 2,392                               |
| Dollars (US billions) | 434                            | 1,637                                | 2,240                                       | 3,990                               |

**Note:**

1. Reported in the IMF's Staff Studies, 1993.
2. World Bank Research Paper, 1993.
3. UN International Comparison's Project studies.
4. Renminbi figures are official Government of China estimates.

## 6.2 China's Economy in the Year 2000

For the foreseeable future, the problem for China's leadership will not be how to promote growth, but how to sustain real growth rates without allowing the economy to "overheat". The leadership will continue to struggle with the issue of how best to maintain political stability. Realizing that stability depends on increasing living standards, they will continue to debate (a discussion that will heat up in the post-Deng era) whether to try to maintain growth rates as high as possible while running the risk of having to brake suddenly, or to try to reduce growth rates to a more sustainable level. In the absence of a concerted effort by the centre to slow the

economy, investment, both domestic and foreign, and consumption spending should remain strong over the medium term. Non-state sector firms and those with foreign investment will continue to record the largest increases in output.

Much has been made of China's shortages of skilled labour, infrastructure, energy and housing, and the restrictive impact they will have on China's growth. By using price reform to trim energy and transport coefficients, by utilizing more fully the capacity created in the prereform era, and by successfully expanding investment in these factors in line with Seventh Plan targets, China has been able to sustain a rate of growth far above what had been anticipated for most of the 1980s and 1990s. While China's overall growth performance to date has belied sustainability concerns, these deficiencies will have important implications for growth and development over the medium term. China's transport and energy systems will soon prove to be bottlenecks that will restrain growth.

China is more likely to have difficulty maintaining exceptional growth rates after the coastal provinces approach the current level of development of the Asian NIEs. The lack of infrastructure in the inland provinces may dampen the interior's ability to sustain rapid growth. Firms looking to supply the domestic Chinese market will be more tempted to transfer production inland in search of cheaper labour, putting considerable strain on existing infrastructure. Firms looking to produce for export may be tempted to look to alternative export platforms, such as Vietnam.

China will continue to run trade and current account deficits for the balance of the 1990s. But this is not unusual for a country at China's stage of economic development. While exports will continue to grow, as will China's share of world exports, imports will probably increase at a somewhat faster pace as China expands its imports of capital equipment. In the absence of a major political upheaval, inflows under China's capital account should largely offset, if not exceed, the current account deficit.

China will re-enter the GATT/WTO before the end of the decade. This will require that Chinese policy makers increase the clarity of economic rules and reduce barriers to foreign investment and imports of goods and services. China could be one of the biggest gainers from the 1994 Uruguay Round agreement because manufactured goods, rather than primary products, make up a large component of its exports. A World Bank estimate<sup>50</sup> suggests that the Uruguay Round agreement, assuming China's re-entry, will boost China's exports by 38 per cent during the next

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<sup>50</sup> Both studies were cited in Business China, The Economist Intelligence Unit, Hong Kong, 7 March 1994, pp.4-5.

Table 6: Chinese Economic Statistics--Projections<sup>1</sup>

|   | 1994 | 1995 | 1996 | 1995-2000 | 2001-10 |
|---|------|------|------|-----------|---------|
| Real GDP growth %                       | 10.5 | 9.0  | 8.5  | 8.0       | 7.0     |
| Nominal GDP US bns                      | 424  | 494  |      | 700       | 1750    |
| GDP (per capita) US\$                   | 350  | 400  |      | 550       | 1250    |
| Population millions                     | 1209 | 1224 |      | 1232      | 1327    |
| Population growth %                     | 1.4  | 1.3  | 1.2  | 1.2       | 0.9     |
| Consumer price<br>% change              | 15   | 10   | 10   | 9.0       | 7.5     |
| Current Account, BOP<br>basis, US\$ bns | -5.8 | -4.6 |      | -4.0      | -2.8    |
| Merchandise Trade<br>US\$ bns           | -10  | -9   | -11  | -6.5      | -5.0    |
| Exports US\$ bns <sup>2</sup>           | 90   | 102  | 115  | 156       | 365     |
| Imports US\$ bns <sup>2</sup>           | 100  | 114  | 126  | 161       | 370     |
| Export growth % <sup>3</sup>            | 13   | 12.5 | 11   | 9.3       | 7.5     |
| Import growth % <sup>3</sup>            | 14   | 11   | 11.5 | 9.5       | 7.5     |
| Share of World<br>Merch. Exports %      | 2.4  | 2.5  | 2.6  | 2.7       | 3.3     |

**Notes:**

1. The figures contained in this chart represent the author's view based on a survey of forecasts (e.g. DRI, IMF, World Bank, EIU).
2. Exports/Imports of goods and services.
3. Exports/Imports of goods.

10 years, more than double the average improvement for developing countries. An OECD study forecasts that the agreement will increase China's GDP by approximately two per cent in the year 2002, more than any other country in the region. The phasing out of the Multifibre Arrangement (MFA) restrictions will reduce the barriers faced by Chinese textile and clothing exports.

## ● Potential Growth Areas: China's Sectors of Comparative Advantage

China rapidly has become a major developing country exporter of manufactures and, with manufactured exports of roughly US \$75 billion in 1993, it now trails only Taiwan and South Korea; its food exports by value are second only to those of Brazil. Since 1979, China's exports have grown at an annual rate of 15 per cent in real terms, while the share of exports in GDP has increased from 6 to 23 per cent. Industrialized countries now purchase about 70 per cent of China's exports, with the share going to the U.S. increasing steadily. Manufactures contribute just over one half of China's total exports, and of manufactured exports, textiles and clothing account for 50 per cent. Textile and clothing exports have recorded the most dramatic growth. In volume terms, China is now the largest single supplier of textile and apparel imports to the U.S.. On the import side, China provides an increasingly important market for intermediate goods, machinery and equipment, for services and for investment.

China's sheer size in terms of population and its resource endowment<sup>51</sup> suggest that it will continue to increase in importance in world markets. If China can effectively utilize its human and natural resources to expand exports, the consequences for both Asian and world markets would be significant. The question is whether China's trade patterns will develop in such a way that it primarily competes with the other countries in the region or whether it will provide opportunities for enhanced regional cooperation and integration.

Analysis of industry-level revealed comparative advantage (RCA) statistics<sup>52</sup> indicates that China has developed a RCA<sup>53</sup> in a relatively broad base of labour-intensive manufactures, which parallels the experience of most of the Asian NIEs.

<sup>51</sup> China is the world's largest producer of tungsten and antimony and a major producer of mercury, tin, graphite, magnesite, anthracite and bituminous coal, iron ore and oil.

<sup>52</sup> For a more detailed review of China's revealed comparative advantages, see Alexander J. Yeats, World Bank Discussion Paper No. 141, "China's Foreign Trade and Comparative Advantage", World Bank, Washington, 1992

<sup>53</sup> The revealed comparative advantage of country  $j$  in the trade of product  $i$  is measured by the item's share in the country's exports relative to its share in world trade. If  $x_{ij}$  is the value of country  $j$ 's exports of product  $i$ , and  $x_{jw}$  is the country's total exports, its revealed comparative advantage index is:  $RCA_{ij} = (x_{ij}/x_{jw}) / (x_{iw}/x_{tw})$  where the  $w$  subscripts refer to world totals. If  $RCA_{ij} > 1$ , this implies that the country has a revealed comparative advantage in the product (i.e., This indicates that the share of product  $i$  in country  $j$ 's exports is greater than the corresponding world share). If  $RCA_{ij} < 1$ , this implies that the country has a revealed comparative disadvantage in the product.

China, however, has not yet developed RCAs in specialized labour-intensive products; but it should have the capacity to achieve a comparative advantage in some of these products as its export profile matures. China's RCA profile also differs from most of the NIEs because it includes a number of natural resource based products. Nevertheless, the profile is heavily influenced by the degree of labour intensity involved in production. China's profile most closely resembles those of Thailand and Indonesia, and differs most from those of Singapore, Malaysia and Japan. China's RCAs for machinery and transport are close to zero, probably the result of the low level of technology utilized by Chinese industry.

Seven of the ten industries for which China recorded its highest RCAs registered declining world trade shares during the 1970s and 1980s, while another two exhibited marginal increases.<sup>54</sup> Whether this will impair China's ability to increase exports will depend on how successful it is in displacing other suppliers and how quickly its export profile shifts out of these products. Moreover, many of the products in which China has a RCA face major non-tariff barriers in industrialized countries.<sup>55</sup> This raises the possibility that protectionist measures by those countries could constrain the continued development of some product lines.

While it appears that China's RCA profile has matured over the past two decades, i.e., its industrial base has widened, its manufactured exports have increased, and its range of exports has widened, it is still at an early stage of evolution. It also appears that China's RCA profile has the potential for significant change, although it is not possible to determine the time frame that will be required. There is no evidence that China's RCA profile is shifting to more capital-intensive products. The changes currently taking place suggest that the base of labour-intensive manufactures in which China has a comparative advantage is widening. That said, surveys of national production plans, as well as foreign direct investment decisions, and monitoring its exports for dynamic increases, may be helpful in signalling products and industries in which China's comparative advantage is changing.

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<sup>54</sup> Alexander J. Yeats, *op. cit.*, p. 21 and Table 5, pp. 19-20. The study looked at industries disaggregated to the SITC three-digit level. China's largest revealed comparative advantages were in prepared vegetables, tea and maté, vegetable oils, explosives and pyrotechnics, woven cotton fabrics, textile products, travel goods and handbags, clothing not of fur, toys and sporting goods and "other" manufactured goods.

<sup>55</sup> *Ibid.*, pp. 31-7.

● **Foreign Investment**

China's development success this decade will be heavily influenced by the willingness of foreigners to invest in its economy. But it will be bidding for investors in an increasingly competitive environment, which includes the countries of Eastern Europe, as well as other Asian and Latin American nations. With lots of options available, investors looking for an export platform will be less tolerant of political risk. This will increase pressures on China's leaders to govern pragmatically. China's leadership realizes that, to maintain power, they must generate economic growth and increase incomes. They seem to appreciate that growth requires stability, and stability requires growth.

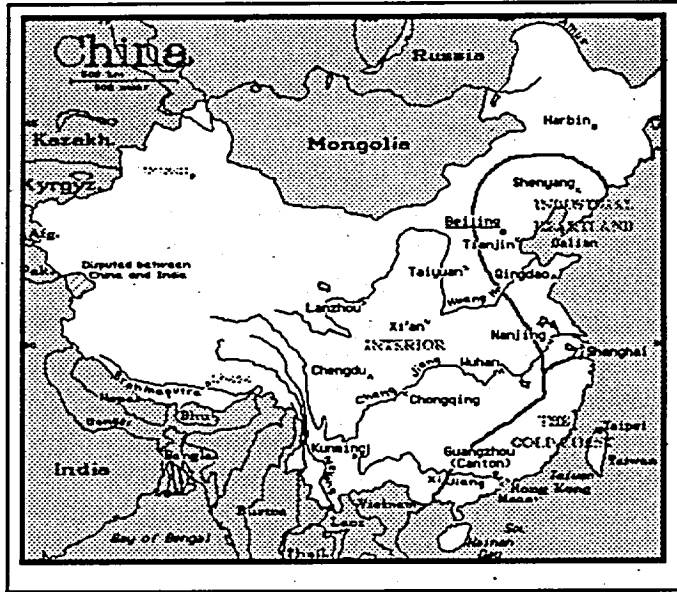
China will likely maintain its efforts to attract FDI in the future, particularly investment which brings in technology or which will increase its export competitiveness. It will continue to welcome technology used in labour-intensive sectors, but increasingly will seek more advanced technology from developed countries to increase the efficiency with which inputs are utilized, to increase the value added in domestic manufacturing and to narrow the technology gap. As China moves to the production of higher value-added goods for export, it will require much more sophisticated technology, at least for the manufacture of certain key components. In many cases, the import of even a few-years-old technology would be a big step forward for China and perhaps appropriate in its present stage of development.

During the balance of the 1990s, we would expect to see China increase the scope for foreign direct investment in the following four spheres. First, the role for foreign investment in the service sector in areas such as banking, insurance and consulting will be increased. An efficient service sector is important for China's overall economic development. Second, China will continue to open up onshore exploration for oil and gas to foreign investors, to increase production both extensively and intensively. Third, the Chinese government will increasingly permit FDI in upstream activities related to large industrial projects to promote the development of feeder industries, to improve the efficiency and quality of products of such industries and to promote their exports. Fourth, the leadership will continue to de-emphasize special economic zones (SEZs) as the destination for FDI flowing into China. While the focus on SEZs was justified in the initial years following China's opening to the outside world, it is now time to try to shift the benefits nationwide.

For the balance of this decade, China should continue to be an attractive destination for investments in relatively labour-intensive industries, especially by Hong Kong, Taiwanese, South Korean and Japanese firms. Despite the plethora of



alternative destinations for foreign investment available to investors (in Asia and elsewhere), China should remain attractive because of its large domestic market, as long as foreign investors perceive that they will acquire access to it. To secure investments that will bring more advanced technology, the leadership will need to maintain a reasonably stable macroeconomic and political environment, continue efforts to speed the construction of physical infrastructure, expend more energy selling China as a relatively safe and lucrative investment alternative and increase the transparency of the regulatory system. If these issues can be addressed, China will be able to attract larger amounts of FDI, increasingly in higher value added and high technology industries.



- **Regionalization to Increase**

While all of China's provinces are better off today than they were in 1980, double digit national real GDP growth rates mask widely varying regional and provincial growth rates. GDP growth disparities, which have been paralleled by varying export and foreign investment growth rates, have led to the development of three regions within China:<sup>56</sup>

- The Gold Coast, comprising Guangdong, Fujian, Shandong, Zhejiang and Hainan, which has benefitted the most in terms of economic growth and development as a result of economic reform.
- The Industrial Heartland, comprised of Shanghai, Beijing, Tianjin, Liaoning and Jiangsu, which has experienced an economic performance since the mid 1980s that has been better than the national average, but not as good in relative terms as prior to the mid 1980s.

<sup>56</sup> See Harry Harding, "The Implications of Regional Inequalities in China", Brookings Institute, 1993.

- Interior China (the rest of the provinces), which has traditionally registered average or poor economic growth, which has benefitted the least from economic reform, and which is falling further behind in relative terms.

This increase in regional inequalities is breeding resentment. Increasing inequality between urban and rural income levels is adding to this dissatisfaction. Regional and urban/rural inequalities could well widen during the balance of this decade, and this could generate an increase in the number of incidents of protest and unrest. As long as economic growth remains ubiquitous, however, the leadership may want to focus its attention on reducing corruption, lowering inflation and promoting job creation. Corruption remains endemic in both the public and the private sector, and the Communist authorities appear less than effective to stop it. With inflation rates in a number of major urban centres now running at more than 20 per cent, more and more urban residents are finding their real incomes declining. And with a population and labour force that is increasing by approximately 15 million people per year, China's leadership will remain hard-pressed to create jobs for both new entrants to the work force and workers displaced from state enterprises as employment in the state sector is rationalized. Between one-quarter and one-third of workers currently employed by SEs could eventually be deemed redundant. Furthermore, the agricultural sector will have to shed as many as 100 million workers over the balance of the decade. The leadership already must contend with a migrant workforce that numbers between 75 and 100 million people. While the incidence of unrest may increase, as long as the leadership can generate growth and raise living standards in all provinces (even if welfare benefits are skewed overall and away from the interior), the probability of widespread and unified unrest related to economic issues should be reduced.

## 7. Implications for Canadian Economic Policy

The time has come for Canada to strengthen its policy of "comprehensive and constructive engagement" in bilateral relations with China. This approach simply reflects the fact that China is a strategically important player in a number of critical issues in both the Asian and world arenas. As a permanent Security Council member, China plays an integral role in the development of policy at, and the operation of, the UN (including peacekeeping and human rights). We must engage China constructively in international environmental matters. China also has an important role to play in virtually all regional security matters, and will be a cornerstone in the creation of continued and lasting peace in the region. It will continue to be one of the fastest growing economies and export markets into the next century.

Perhaps the key economic and trade components of a policy of comprehensive engagement are the promotion of bilateral business relations (trade, investment technology cooperation) and working to facilitate China's participation in the new World Trade Organization (WTO). China should continue to be one of the fastest growing export markets into the next century. Restricted or reduced access to this market would cost jobs and, should Canadian firms become more involved in outward investment, possibly reduce the competitiveness of these firms in both Canadian and world markets. Moreover, while Beijing may be the single pole of political authority in 'greater China', the continued regionalization of the economy will increase the number of nodes with significant economic power. Trade development efforts should increasingly focus on dealing with China on a regional basis. Efforts already underway in this regard should be further strengthened.

In addition to the traditional export target sectors such as telecommunications, transportation, power generation and environmental protection, China's emerging financial markets should present opportunities for Canadian firms. To support its continued economic growth and development, China must develop efficient financial markets, including securities exchanges, bond markets and banking and pension systems. This will provide opportunities for Canadian firms to provide the expertise needed to develop modern financial systems and to invest in, and utilize, these entities.

If Canadians are to participate in the continued growth that is projected for China and the rest of the Asia Pacific region, Canadian firms must be present and active in the region. Moreover, expanding trade with China and the region will increasingly be a function of Canadian firms' ability to penetrate these markets from within the region. That is, direct investment in these sectors may often be the entry vehicle required to ensure increased bilateral trade in goods. Furthermore, a Canadian presence may, over the longer term, increase the prospects for attracting foreign investment to Canada, as firms in China and the region become more familiar with Canadian firms and their capabilities.

That said, government programs must not move too far in front of the interests of the private sector. One must ask why Canadian firms are not more active in China and the Asia Pacific region. Are firms satisfied with their current export activities, or are there obstacles preventing them from penetrating markets in China? The most important "market failure" may be informational. Canadian firms may not be fully aware of the detailed market opportunities that exist in China. As a result, it is up to government to secure and disseminate this information, as well as information on potential alliances (technical and marketing).

On the trade policy front, China's membership in the WTO would bring it further into the global economic and trading system, solidify its commitment to a rules-based trading framework, help to secure the position of the economic reform-minded members of the leadership cadre and encourage continued economic reform. This will be particularly important as China moves through the initial years of the post Deng period and the leadership is forced to deal with the economic problems discussed in section 4. Canada should continue to work for China's re-entry into the GATT/WTO fold, both because of the more secure access this will bring for Canadian exports, but also because it will send a strong signal to wavering economic reform efforts in eastern Europe and the FSU. But re-entry must entail clear liberalization commitments on the part of China, including more transparent rules and the acceptance of international disciplines on the actions of Chinese regulators. These commitments will not only help to secure markets for Canadian exporters, but also will limit the scope for arbitrary economic action on the part of Chinese authorities, thereby contributing to broader reform efforts in China.

While the WTO is the main forum for pushing and prodding China further into the world economic system, the APEC forum can also be used as a venue to learn about the intricacies of the Chinese economic system, to sooth eventual irritants in Canada-China bilateral relations, and to facilitate the resolution of problems in China's bilateral relations with other countries, particularly the U.S..

The global economic, trade and security systems must continue to expand. Furthermore, international institutions and structures do not have the resources to finance the transition of two major countries (the other being Russia) to market economies. One-fifth of the world's population currently is involved in the largest experiment involving economic and social change ever undertaken. China's economic reform program is working relatively well, and the country has become much more open, integrated into world systems and receptive to change. The challenge will be to encourage the deepening of this process, while assisting in gradual social and political change.

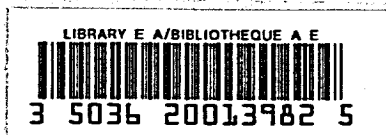
Finally, Canada currently has neither a Foreign Investment Protection Agreement (FIPA) nor a bilateral Double Taxation Agreement (DTA) with China. In light of present and future Chinese reform in the investment area, and the likely interest of Canadian companies in the Chinese market, Canadian policy makers should closely review the merits of negotiating both a FIPA and a DTA with China over the next two or three years.

This paper attempts to describe the economic reforms that have taken place in China to date, to determine the impact the reform process has had on production,

consumption and efficiency, to identify the reform challenges that lie ahead in the 1990s, and to highlight China's economic prospects as it enters the next century. There are a number of issues that have been raised in this paper, or in discussions relating to it, that have significant policy implications and that require further research. For example, a number of reforms have reinstated incentives which in turn have promoted rapid and significant economic growth. The response at the micro level, however, has not always served the centre's interests as they pertain to maintaining a stable macroeconomic environment and balanced economic growth across the country. The issues of macro/micro policy conflict and centre/regional conflict and how they might be resolved are areas that require further research both to identify the policy implications for Canada and to help identify the policy levers most effective in addressing these matters. We also believe that research should be undertaken to determine which region(s) in China will be the rapid growth poles at the turn of the century. Is growth in the Gold Coast region peaking? Will it be overtaken by Shanghai? These are among other analysis.

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