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## The Winds of Change: China's Growing Economy

### Abstract

For three decades after the 1949 revolution, China pursued a strategy of socialist economic development based on self-reliance and the centrally directed allocation of resources. Today, China is the fastest growing economy in the world. China began reform in 1978, just after it emerged from a political crisis started by Mao Zedong's death in 1976. China's policymakers began to recognize the impossibility of traditional methods of economic management and began to overhaul the economic system. After the start of reforms, real growth accelerated markedly. China's GDP has been growing at an annual percentage rate of 9.3% since 1980. (Waters, xiii) This paper will look at China's reforms and how these reforms have affected China's growth in its agricultural, industrial, and trade sectors.

# The Winds of Change: China's Growing Economy

*Tony Johnson & Jennifer Van Dyke*

## I. INTRODUCTION

For three decades after the 1949 revolution, China pursued a strategy of socialist economic development based on self-reliance and the centrally directed allocation of resources. Today, China is the fastest growing economy in the world. China began reform in 1978, just after it emerged from a political crisis started by Mao Zedong's death in 1976. China's policymakers began to recognize the impossibility of traditional methods of economic management and began to overhaul the economic system. After the start of reforms, real growth accelerated markedly. China's GDP has been growing at an annual percentage rate of 9.3% since 1980. (Waters, xiii) This paper will look at China's reforms and how these reforms have affected China's growth in its agricultural, industrial, and trade sectors.

## II. HISTORY OF CHINESE REFORM

### A. Four Phases of Reform

China has had many steps to reform. China's reform can be divided into four phases. The first phase was from 1978-1984. During this time, reform policies were similar to those adopted in the early 1960s to rehabilitate the economy in the aftermath of the Great Leap Forward. The agricultural changes of this phase included price increases, relaxing of rural market restrictions, and the decentralization of farming. Some industrial changes included the re-introduction of the bonus system and experimentation on profit retention by state owned enterprises. In foreign economic relations, preferential policies were conferred on special economic zones with the aim of attracting foreign investment. These zones also acted as laboratories for bolder market-oriented reforms. The second phase (1984-1988) of reform focused more on the urban industrial sectors. Authorities introduced enterprise taxation, linked compensation with productivity, and broke up the monobank system. The

third phase (1988-1991) was a period of frugality. Reforms had been successful in spurring demand and production, which caused double-digit inflation by 1988. Plans for a new round of price reforms were deferred, and there was some reversal of earlier reforms. These measures succeeded in stabilizing prices, but they also resulted in a sharp slowdown of the economy. In late 1990 authorities resorted to stimulative monetary and investment policies to reactivate the economy. The economy began to recover in 1991. In the fourth phase (1992-present) authorities declared an end to the reversal program and announced their intention to accelerate the process of reform. In 1992 the Communist Party formally embraced Deng Xiaoping's view that the market system was not incompatible with the ideals of socialism and called for the establishment of a *socialist market* economy. The country's constitution was amended to delete references to a planned economy and to enshrine the new goal of establishing a market system. The continuing goal of the Chinese government is to develop a democratic economic system within a one-party political system.

### B. Agricultural Reform

During the early years of reform, China focused on changing the agricultural system. Between 1978 and 1984, as a result of reforms, productivity and output grew by an annual average of about 8.8%. These impressive gains can be attributed to both the introductions of improved individual incentives instilled in the household responsibility system and to an increase in acquisition prices. The growth of total agriculture production moderated to an average of about 4% from 1985 to 1991, reflecting a number of factors. Some reasons for the slowdown include less improvement in the relative prices of agricultural products (especially grain) than in earlier years, low investment in agriculture related to infrastructure by farmers (who have tended to invest in housing) and by collectives (which have preferred to invest in Township and Village Enterprises (TVEs)), and the

outflow of the labor force from the cropping sector. Even though growth in agriculture has slowed, reform has been very positive. The large productivity and output gains in the agricultural sector resulted in a decline in rural poverty from 33% in 1978 to less than 11% in 1984. (Bell, 60)

The opportunities provided by the reforms in the agricultural sector led to the development of "side-line" activities in the rural areas and laid the foundation for rural enterprises, or TVEs. TVEs were conceived as a means of absorbing surplus labor associated with rising agricultural productivity. Their dynamic growth was a largely unanticipated phenomenon. Some of the reasons TVEs have been so big are the ready availability of labor, the limited capital requirements, and increased freedom from government controls. Critics are amazed by the growth of TVEs since they are still collectively owned. By 1992 TVEs were estimated to have contributed more than 25% of the country's total exports. (de Menil, 279) TVEs are a successful alternative to rural unemployment.

### **C. Industrial Reform**

After the government's success with agricultural reforms, the government began to focus more on the industrial sector and ownership issues. In the period after 1978 there was rapid growth in industrial output due to reforms. During this time the government began experimenting with income taxation to replace a direct profit transfer to the budget. The government also began to expand the use of the shareholding system. The aim of this measure was to separate the roles of the state. No longer would the state function as both the owner and the management of the enterprises, they would only be the manager. (Tseng, 50) These reforms helped increase productivity in the industrial sector. The average annual growth rate of gross industrial output reached 15%. (Lo, 1) However, closer analysis reveals that the most significant impact of industrial growth came from nonstate-owned enterprises (including TVEs), individual enterprises, and foreign funded enterprises.

The reason that state-owned enterprises (SOEs) did not show as much growth is that they are more than just places of employment. SOEs perform welfare functions, such as housing, medical care, and education to their employees. As a result, they continue to remain unprofitable, but unable to fail.

### **III. PRESENT REFORM**

Today the industrial sector is again going under reform. On Sept. 12, 1997, President Jiang gave a groundbreaking speech to the 15<sup>th</sup> Party Congress. In this speech he announced that the state sector "is in for a wrenching downsizing" (Clifford, 118). Jiang wants to change most of China's 305,000 state companies into shareholder-owned corporations and begin opening them to foreign competition. While this will mean a lot of unemployment and bankruptcies for the "iron rice bowls" in the short run, in the long run the country will benefit from it. "The state-owned industrial sector remains characterized by overstaffed and inefficient enterprises producing goods of sub-standard quality." (Bell, 86) Many critics fear that this new plan will lead to mass unemployment and unrest; but the fact remains that the government cannot afford to sustain these SOEs. The state sector is unable to compete with the more dynamic non-state industrial sector, so reform must begin.

There is a group that is immediately benefiting from Jiang's announcements for reforms. This group is the entrepreneurs. Since President Jiang Zemin's announcement in which he affirmed that all businesses would be treated equally as long as they met basic requirements- such as paying taxes and supporting the government- entrepreneurs have been expanding their businesses. The country has seen its first private companies list on the stock market and measures taken to limit government fees. "In the past the private sector was secondary to the state sector, but now it's on an equal footing," says Ding Ningning, director of a think tank at the government's Development Research center. That marks the first time since the Communist Party-led state sector was founded in 1949 that private entrepreneurs officially have equal status. (Johnson, A18)

### **IV. EFFECTS OF REFORM**

China's reforms have raised 200 million Chinese out of poverty since 1978. However, China still has a long way to go. There are still 300 million people in China that live on less than a dollar a day. (Clifford, 119) The largest reduction in poverty took place during the first half of the 1980s. Since then

there has been little progress on this front, despite strong growth in rural output. This is because the once-and-for-all-benefits of agriculture reform have been reaped, and TVEs, which are the main source of continued growth in rural areas, have not developed in remote areas in which poverty is largely confined. Since there is still growth in China and little has been done to decrease poverty recently, then income disparity is increasing.

China's rise in inequality has largely been driven by differences in growth between regions and between urban and rural areas. For example, the southeastern coastal area has been growing at an annual rate of over 13%, compared with the national average of 8.5%. The growth in central China, on the other hand, has been around 6.5%. This uneven growth has created resentment and some dissent in the country. In 1993 there were farmers riots due to the income gap. A farmer's annual net income is only 770 yuan, about \$135. This is about 40% of an urban resident's income. (MacDonald, 116) This situation has bred resentment and frustration about the government's policies. So although the country is growing, it is not growing at the same pace; the rich (entrepreneurs) are getting richer, and the poor (farmers) remain poor. Income disparity is a result of the development of Special Economic Zones, which increased the integration of China into the world's economy.

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## V. HISTORY OF TRADE

Beginning in the early reform era, one of China's major goals of policy reform was its integration into the world's economy. Every year since this reform began, China's trade turnover has increased considerably, with the exception of 1982. Exports and imports both expanded at an annual average rate of over 16 percent. Economic reforms within China also caused important changes in the direction and commodity consumption of trade, especially with

China's exports. China began opening its doors with the SEZ experiments, known as "Special Export Zones". Later in the reform movement, the main function of the SEZ's was officially altered from "Special Export Zones" to "Experimental field of reform policies". These SEZ's were one of China's major policies used in their "feeling the stones across the river" approach. Furthermore, these policies for integrating the Chinese economy into the world economy had a large role in dismantling the central planning system. The central planning system had always tried to follow set procedures to keep its control over the economy. Beginning in 1984, many Chinese industries (specifically those involved in foreign trade) began filing complaints about the central planning inefficiencies in handling applications and performing its management functions. Many firms criticized the excessive control and red tape of the planning system, and blamed it for missed opportunities in the world market. Eventually, many of

the planning offices and planning procedures were phased out as a result of all the criticism and complaints. As China realized the threats of being left out of international markets it began to adjust its economic system to more effectively handle world competition. By the end of 1988 most of China's provinces had adopted the SEZ's and a more relaxed central planning system in some form or another. China's trade liberalization was very beneficial for the whole country. It brought in foreign trade and investment, helped to create jobs, reduced the need for foreign loans, and created a class of people who could see the positive changes as a result of a more open economy.

In the mid 1970's, Deng Xiaoping began developing a strategy to open up China's economy with the exports of coal, petroleum, and petroleum products. Between 1977 and 1985, exports of petroleum products and crude oil more than tripled. China went from exporting only 11 million metric tons to more than 36 million metric tons during this time. In the 1980's, China's exports of manufactured goods also

rose significantly. However, the share of these goods as a part of China's total exports changed little because of the increased exports of petroleum products and an increase in agriculture exports due to the large increase in farm production during the late 1970's and early 1980's. In time, the increasing exports of petroleum were discovered to be much less beneficial than originally believed. China soon found that its economic growth was being restricted by domestic energy deficiencies. At that point China began to shift away from reliance on petroleum exports, toward products it had a comparative advantage in. This comparative advantage was in labor intensive manufactures such as apparel, footwear, textiles, toys and sporting goods. The share of China's total exports that were accounted for by these types of labor intensive products grew from 29.6 percent in 1985 to 40.2 percent by 1990. This coincided with the decrease in exports of crude oil and refined petroleum that reached their peak in 1985.

China's composition of imports also changed during the first decade of reform. The share of primary commodities in China's total imports fell from a little over a third in 1980 to about a seventh in 1993. This was largely due to imports of agricultural products only increasing slightly while total imports quadrupled. The percentage decrease in food and agricultural imports was a result of the dramatic growth in China's agriculture output. The increase in imports came largely from industrial products, which rose from 65 percent in 1980 to 86 percent by 1993. During that time, China began a massive importation of machinery and transportation equipment that possessed higher levels of technology than they were capable of producing.

China was one of the first socialist countries to shift its trade away from centrally planned trade with other socialist countries, toward countries with market economies. Throughout the 1950's China was connected very closely in its trade with the Soviet Union, and to a lesser extent with Eastern Europe. More than 3/4 of China's imports were from these socialist countries and 2/3 of China's exports were shipped to these countries during this time period. China's split with the Soviet Union in 1960, was the beginning of its shift away from trade with the socialist countries. Hong Kong seemed to be China's foot in the door to the market economies that it shifted to. In

fact, as one of these market economies, the United States acquired a growing role in the final destination for Chinese exports. The U.S. share of exports from China rose from a few percent of total exports in 1978 to 30 percent by 1992. In monetary terms, U.S. imports rose from about \$30 million to almost \$26 billion in this time period. The increase was a result of several factors, including: the sheer size of the U.S. economy, its relative openness to imports, China's labor intensive goods being in high demand in the U.S. and China's most favored nation status.

## **VI. TRADING WITH THE UNITED STATES**

### **A. Trade Deficit**

In the early 1990's, many critics of China's trade policies believed that China was engaged in a mercantilist strategy. They charged that China was employing various plans to promote exports while limiting access to its own domestic market. This view was particularly prevalent in the U.S. where trade deficits continue to grow rapidly. By 1991, the U.S. trade deficit with China was 12.7 billion dollars, second only to Japan. This deficit has stimulated demands in the U.S. that China improve its intellectual property protection and liberalize access to its domestic market. Every year since 1983 the U.S. has incurred a growing trade deficit with China, and by 1995 the deficit was more than 36.7 billion dollars.

### **B. Intellectual Property**

Under the original U.S. - China bilateral trade agreement of 1979, China agreed to provide copyright, patent, and trademark protection to foreign goods imported into China. However, China's compliance with the agreement was not actually instituted until the mid 1980's when the U.S. began to press the issue. Even then there were still serious shortcomings. After six more rounds of negotiations, China agreed to implement many laws that would increase intellectual property protection, starting on January 1, 1993. The major areas affected were pharmaceutical, chemical, software, and music. Although China set up a legal structure to adhere to international standards, enforcement of the laws still remains partial in some cases. China has installed a specialized intellectual property rights court in Beijing, but China continues

to be a major producer of pirated CD's and computer software. The United States is still dealing with the issue at this time.

### C. Trade Barriers

Market access is the other major problem that the U.S. faces in its trade with China. The United States and China began bilateral discussions in the mid 1980's to improve access to China's domestic market. However, the imbalance continued to widen, and the U.S. initiated more formal discussions in 1991. The U.S. objective was to persuade China to reduce the number and severity of administrative barriers they imposed on U.S. imports. Initially the trade talks in 1991 were unproductive. Only after the U.S. government composed a list of 3.9 billion dollars worth of Chinese imports that would be subject to prohibitive tariffs, did China reach an agreement with the U.S.. On October 10th 1992 the far-reaching agreement was signed. The Chinese had agreed to reduce 90 percent of all its import restrictions over 5 years time. Although it has required continued and difficult bilateral negotiations, China has by and large lived up to its part of the agreement.

### D. Most Favored Nation Status

China's most favored nation (MFN) status is still a hotly debated subject. MFN status can only be granted to a non-market country, if the President of the United States issues a waiver certifying either that the country does not restrict emigration, or that providing MFN status will probably result in increased emigration. Once MFN status is awarded to a non-market economy, it must be renewed annually by the President. In China's case, this occurs on July 3rd each year. However, this can also be over-ridden by the U.S. Congress. China was first granted this status in 1980. Since then the U.S. has used the renewal option as leverage to improve China's human rights,

limit the spread of nuclear weapons, and to increase the openness of China's market to U.S. goods. If we should choose not to renew China's MFN status, there are numerous estimates as to its affect on China's trade with the U.S. Obviously there would be a retaliatory decrease in exports to China from the U.S.. In addition, 1993 estimates by Hong Kong's government conclude that a loss of MFN status would reduce exports to the U.S. by 34 to 47 percent. Another obvious result would be increased prices for U.S. consumers, either from a lack of competition or from tariff costs passed-on to consumers. U.S. tariff rates for countries without

MFN status are 5 to 10 times higher. Toys, for example, jump from a 7.4 % tariff to a 55 % tariff when MFN status is revoked. As a requirement of 1993's renewal of China's MFN status, the U.S. made a list of areas that China needed to improve on. These improvements were, "the respect of fundamental human rights as recognized in the Universal

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Declaration of Human Rights, allowing freedom to emigrate and travel abroad, providing an accounting of and releasing those imprisoned for the peaceful expression of their political views, ending forced abortions and sterilizations as family planning policies, ceasing religious persecution, ensuring that prisoners are not mistreated and have access to medical care, protecting Tibet's religious and cultural heritage, and ending the jamming of 'The Voice of America Broadcasts'". (Lardy, 126) There are many positives and negatives of continuing to extend most favored nation status to China. Only time will tell the ultimate decision of China's most favored nation status.

## VII. CHINA'S FUTURE

What is China's future? Many believe that it will be the next super power. This leaves some Americans with a queasy feeling. "Most Americans see

China as a one-party totalitarian state that delegitimized itself by turning its tanks on its own people at Tiananmen Square and is now using cheap labor to threaten American jobs.” (Zuckerman, 84) However, Americans must avoid stereotyping China by memories of its past. Today, China is changing. With the world-wide collapse of Communism, China's leaders know that they must continue economic growth to remain in power. That means integration with the world economy, even though it will shrink the role of the state. China is slowly progressing away from Communism. Unquestionably China is much freer today than it was two decades ago when reforms began. “All social controls have been dramatically reduced, enabling people to pursue their lives, their livelihoods, and their interests largely unimpeded by state interference.” (Zuckerman, 84) I expect that in the future, China's political system will begin to change.

A clue to China's future can be seen in Hong Kong. Hong Kong, with its world contacts, entrepreneurial skills, and trade links for China's economic development, is China's gateway to the rest of the Western world. It has been over 100 days since the changeover and little has changed. None of the short-term disaster scenarios for Hong Kong under Chinese rule have come true- no outspoken politicians thrown in jail, no newspaper offices boarded up, no confiscation, and no suppression. China has been so careful to avoid even the appearance of interference that it has resorted to symbolism to reinforce the point. “Prince of Wales” is still seen on the British military's former headquarters, now the base of the People's Liberation Army. “There is a total lack of interference in our affairs,” says Raymond Chi'en, a trading company executive and advisor to Tung Chee Hwa, the Special Administrative Region's chief executive. “I thought surely there would be some attempt at influence.” (Kahn, A18) Even though China has not interfered in Hong Kong, Hong Kong has avoided any real test by sticking closely to Beijing's thinking on sensitive issues. Hong Kong hopes to lead China into the next century by acting as a model of how China should be. China knows not to interfere in Hong Kong because the whole world is watching China's movements and not only would there be a negative impact in Hong Kong, but China's foreign trade and international relations would also suffer.

When Deng Xiaoping died, many people won-

dered if China would continue reform. Jiang Zemin has indicated that reform will indeed continue. In his recent visit to the United States he indicated that he understands that the key to economic reform is joining the global economy, and to do so he must stabilize China's international relations. So Jiang is a favorable leader to the West. Believers of human rights must give China time to reform. “A China devoted to economic enterprise will be freer and more peaceful.” (Zuckerman, 83) And as China becomes more dependent on the international economy it will become more likely to play by the world's rules. China should not be looked at as a threat to the world, but instead as a new market with endless possibilities.

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