4: Market Transition: Strategy and Process

Since China launched economic reforms at the end of 1978, market transition has extended over more than thirty-five years. China has already spent substantially more time building a market economy than was spent under Maoist socialism. China's economy has been transformed by successive waves of economic reform. Over the years, the content of the reform process has adapted to new challenges and circumstances, and has been continuously reformulated. There have been failures, reverses, and periods of reform stagnation, but what is most remarkable is simply how far China has come toward a market economy, and how the reform process has maintained its relevance as the challenges the economy faces have changed. In November 2013, the Xi Jinping-Li Keqiang administration committed to an ambitious program of renewed economic reforms, ensuring the market-oriented reform will have a prominent position in the policy agenda for the foreseeable future.

China has successfully dismantled the command economy system, and adopted a functioning market economy. China's spectacular economic growth and ascent to the world's second largest economy would be inconceivable without successful market-oriented reforms. Nevertheless, even today, the process of market transition in China is far from complete. Many of the institutions necessary for a market economy are rudimentary, and further market-building and institutionalization are necessary. The broad issues of transition extend into every aspect of the economy today. In this chapter, the focus is on the overall process of market transition. Subsequently, chapters 5 through 21 focus on specific sectors or aspects of the contemporary economy, covering the years since 1978, with that sector viewed within the context of China's transitional economy. This chapter begins by defining the nature and problem of market-oriented reform. It then examines China's reform strategy, the distinctive approach to market transition that differentiated China from other formerly socialist economies. China's reformers brought a distinctive set of assumptions and objectives to the transition process, and these ultimately coalesced into a strategy of gradual transformation. The break-through in rural China is stressed at the beginning because is was the key early success that drove reforms onward, and allowed Chinese reformers to grapple with successively more fundamental issues of transformation. The chapter then advances an interpretation of the overall transition period. Two distinct phases of accelerated, directed change characterize the overall period. The first phase of gradualist, dual-track, decentralizing reforms (1984-1989) developed directly out of the rural successes. The basic purpose of this phase was to begin the dismantling of the command economy while maintaining economic growth, an objective that was substantially achieved. Markets were introduced into nearly every area, ownership was diversified, and competition created, all within the framework of the existing institutions. A second phase of accelerated change occurred between 1993 and 2003 (and especially between 1994 and 1999). During this phase, the emphasis of reform shifted as it became more fundamental and thorough. The main accomplishments were the remaking of the institutional setup to make it compatible with a market economy, the dramatic shrinkage of the state sector, and the creation of conditions to enable fair competition among all market participants. Despite the enormous achievements of this second phase, it cannot be said to have been completed. After 2003, reform slowed and even, in some areas, regressed. The Xi-Li administration after 2013 has declared its intention to initiate a new, third phase of accelerated market transition, but it is still early in the process, too early to for a comprehensive evaluation. While both phases of accelerated reform can be seen to have produced substantial successes, Chinese policy-makers still struggle to improve the functioning of the market economy, while also coping with the immense social changes and problems created by transition thus far.

4.1 What is "Market-Oriented Reform"?

In the early days of China's market transition, there was no need to define terms. All measures that tended reduce the power and monopoly of planners, lower entry barriers, and give ordinary people more decision-making authority and control of resources were steps in the right direction. There were debates over priorities and sequencing, but the general direction was clear. Today, however, China has a distinctive mixed market economy with an extraordinarily powerful role for the state, so the meaning of "reform" may need to be clarified. A reform is a type of deliberate policy measure that changes the rules under which economic actors operate. A "market-oriented reform" is any policy measure that increases the scope for fair competition, either by enabling more participants in a given sector or market, or by making the rules governing market competition more transparent and fair. Thus, measures that reduce the advantages enjoyed by designated "winners" are clearly market-oriented reforms, as are measures that lower entry barriers and permit broader competition. Reforms that make competition more fair can include price reforms which provide equal access to goods at a uniform price, and regulatory reforms that provide rules and procedures that are known, predictable and applied equally to all market participants.

Two points follow immediately from this definition. First, governments adopt many important and positive policy measures that are not market reforms (such as redistribution to the weak or elderly and provision of national security). During the early phase of China's reforms, the shortcomings of the Chinese "command economy" system were so glaring and extreme that market reform dominated the policy agenda, even crowding out social services and defense spending, because it was obvious that survival depended upon reform. However, after the system was stabilized and became more robust, market reforms could not—and should not—necessarily enjoy such absolute priority to the exclusion of all other policy objectives. Indeed, there may be cases where excessive *laissez-faire* creates a need for expanded government intervention even at the cost of measures that are the opposite of market reform. Policies that create a more fair society are not necessarily market reforms, though they can be. Second, the fundamental challenge of reform comes from the asymmetry between the position of current incumbents (designated “winners” of the status quo) and that of potential beneficiaries of reform. Each incumbent—the “loser” of reform, enjoys a large personal return to their privileged position, whereas each of the potential beneficiaries, by definition, earns only the competitive market-based ordinary rate of return if reforms succeed. Second, the reform “losers” have full knowledge of the benefits they will lose, but the reform “winners” are uncertain about what future benefits, if any, they will repeat from the reform process. This is even more the case with the efficiency benefits of reform, which will be diffused throughout the economy and are difficult for any individual to identify and will benefit the young, who have less political influence. The potential losers from reform have better information and stronger incentives than the potential winners, and they are more accustomed to exerting political influence (to protect their rents). Thus, it is difficult to assemble a sufficient coalition in support of reform in any political system.

4.2. The Chinese Approach to Transition

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

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

In contrast, Chinese reformers were driven by a profound sense of crisis, and they were exerting maximum effort toward avoiding further disruptions. The official verdict on the Cultural Revolution was that is "brought the economy to the brink of collapse," and this was not entirely hyperbole. The survival of the system was in question, and China's leaders were consciously trying to mend and strengthen the economic and political systems in order to ward off collapse. Moreover, Chinese leaders saw un-met needs everywhere in their economies. Some needs were unmet because China was poor and under-developed, and others were un-met because the command economy was wasteful: reformers did not make a fundamental distinction between these two types. The command economy had lavished resources on expensive industrial projects while neglecting simple and easily satisfied demands of consumers. Chinese reformers, in essence, decreed that individuals and organizations should be allowed to satisfy un-met needs and earn some additional income and if, in the process, this new activity tended to erode the command economy and had to be exempted from some of its rules, so be it. Chinese reformers lowered barriers and gradually opened up their system; they gave individuals and groups the opportunity to act entrepreneurially and meet market demands. Early reforms created pockets of unregulated and lightly taxed activity within the system. Reformers allowed such pockets to open up because they were seen as contributing to developmental objectives. For example, rural communities were allowed to run township and village enterprises outside the plan because that would contribute to local investment and economic growth. Foreign businesses were allowed to operate freely in Special Economic Zones, because that would increase investment in China and might convince foreign corporations to transfer technology to China. Such policies were seen as contributing to growth while not initially threatening the overall ability of the government to manage and direct the economy.

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

4.3. How Did Reforms Start? The Initial Breakthrough in the Countryside

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

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

At first, reformers had no clear idea how that restructuring of the farm economy would take place. All farmers were compulsory members of agricultural collectives, and reformers did not initially envision that changing, but they were willing to give farmers more breathing space. Reformers at this time were emphasizing the necessity to give enterprises in other sectors expanded decision-making autonomy and better incentives, and the same offer was made to agricultural collectives. Collectives were allowed to experiment with different payment systems for farmers, and better ways of organizing and marketing output. Collectives adopted a wide range of innovative approaches, but eventually began to gravitate toward a radical solution: contracting individual pieces of land to farm households. Farm households took over management of the agricultural production cycle on a specific plot of land, subject to a contractual agreement that they turn over a certain amount of procurement (low price) and tax (zero price) grain after the harvest. This essentially recreated the traditional farm household economy, with the collective reduced to being little more than a landlord. Because it implied such a dramatic reduction in the role of the collectives—everything short of abolition—this policy was extremely controversial. But Chinese leaders decided not to block it, and after 1980, gradually shifted and gave it de facto support. What happened next was quite astonishing. The institution of contracting land to households spread rapidly throughout rural China, and became nearly universal by the end of 1983. Agricultural production began to surge. Helped along by higher prices and the increased availability of modern inputs such as chemical fertilizer, production climbed rapidly through 1984 (Chapter 11). By 1984, grain output surged to 407 million metric tons, more than one third higher than in 1978. There was enough grain for everybody in China. The decades in which China's industrialization had been repeatedly held back by agricultural weakness seemed suddenly to be over; and the centuries of a China fundamentally short of food over as well.

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

4.4. A Two-Phase Framework of Economic Reform

Successful rural reforms also reinforced a certain approach to the reform process. Rural reforms had been achieved with little economic or social disruption, largely because a type of dual-track system had been adopted. When farmers contracted for their land, they agreed to turn over a certain amount of grain to the government: the rest was released to the market. Reformers saw in this experience a model of using contracts to stabilize some crucial pieces of the existing economic system, while freeing up other pieces. The contracts built in vested interests—in this case, the government, and its need to ensure access to grain—while also providing powerful new incentives to farmers, since they kept 100% of the harvest above the contracted deliveries. Reformers sought to extend this approach to industrial and commercial reforms, and in so doing they created a pattern of economic reform that strongly characterized the period from 1978 through 1989. Reform overall was decentralizing, shifting power and resources from the hands of central planners to local actors; while core interests were protected, often through contracts. This allowed entry barriers to be reduced and market forces to grow. By 1993, though, this particular pattern of reform had largely run its course. The market sphere had expanded sufficiently that the economy had “grown out of the plan.” The focus of policy-makers shifted, as it became increasingly necessary to build a firmer institutional basis for the market economy that was developing. Table 4-1 shows the main elements of reform strategy in the two period, laid out to highlight the contrasts between the two periods.

4.5. The First Phase of Accelerated Transition (1984-1989)

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

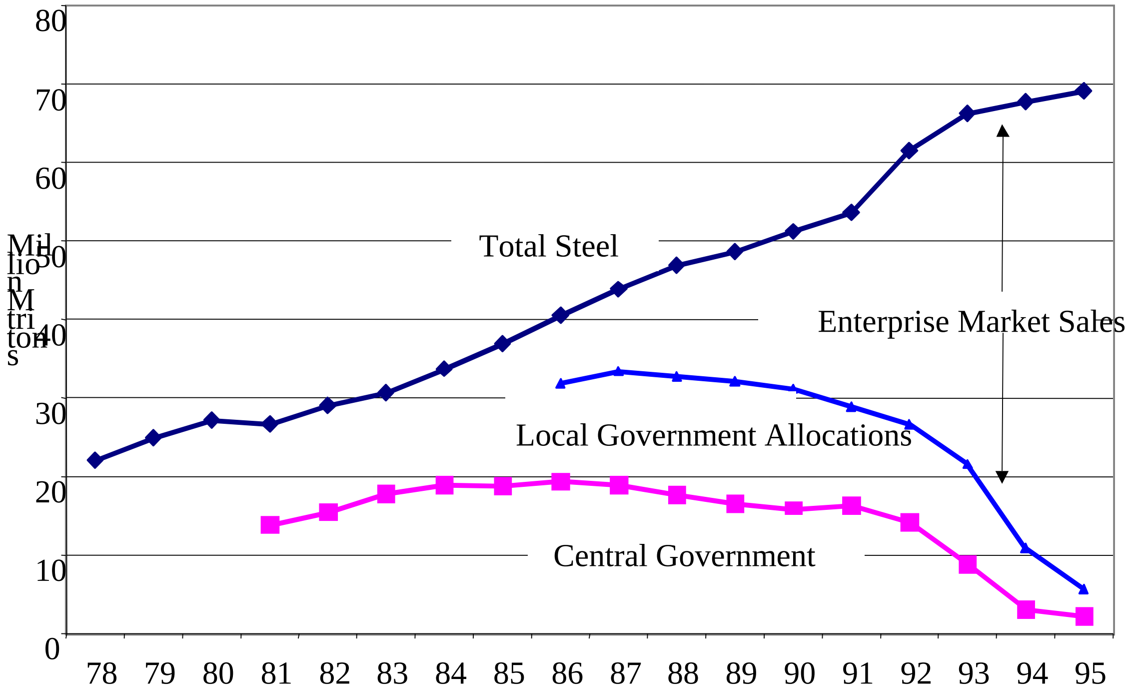
Table 4.1: Contrasting styles of economic reform

1980s reform	1990s reform
Zhao Ziyang: cautious, consensual Decision-making	Zhu Rongji: Rapid, personalized decision-making
Introduce markets where feasible; Focus on agriculture and industry	Strengthen institutions of market economy; Focus on finance and regulation.
Dual-track strategy; growing out of the plan	Market unification, unite dual tracks.
Particularistic contracts with powerful Incentives	Uniform rules: "level playing field."
Entry creates competition, but no Privatization.	State-sector down-sizing; beginnings of privatization.
Decentralize authority and resources	Recentralize resources, macroeconomic control
Inflationary economy with shortages	Price stability, goods in surplus
"Reform without losers."	Reform with losers.

4.5.1. Dual-track system.

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

Figure 4-2: Steel Production and Planned Allocation



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

4.5.2 Growing Out of the Plan.

The mere existence of the dual-track system is not in itself sufficient to propel an economy in transition to a market economy. In a sense, all planned economies had some kind of dual-track system, because they all had various black and “gray” markets outside the formal planning system. But China planners in 1984 made a broad commitment to keep the overall size of the central government materials allocation plan fixed in absolute terms. Since the economy was growing, this commitment implied a gradual process in which the plan would become proportionately less and less important until the economy grew out of the plan**.** Figure 4-2 shows this process at work with respect to sales and allocation of finished steel, arguably the single commodity most characteristic of the planned economy. Up until 1984, the quantity of steel allocated by central government planners increased in step with production. Unusually in a planned economy, there was also a substantial share of total output allocated by local government planners, which also seems to have been increasing over time. A tiny share of output was sold independently by enterprises. After 1984, though, the quantity allocated by the central government leveled off, and nearly all the increment in output was channeled onto the market, i.e., left to the control of enterprises to sell at the best price they could obtain. In the early 1990s, quantities allocated began to decline in absolute terms, and then dropped precipitously around 1993. After that point, the economy had grown out of the plan. A generally credible commitment to freeze the compulsory plan set in motion a dynamic process that gradually increased the share of non-plan, market transactions in the economy and made the dual-track system into an unabashed transitional device.

The commitment to grow out of the plan crucially altered incentives at the level of the individual enterprise. With their plans essentially fixed, enterprises faced "market prices on the margin." (Byrd 1989). Even those firms with compulsory plans covering, say, 90% of capacity, were in the position that future growth and development of profitable opportunities would take place at market prices. The plan served as a kind of lump-sum tax on (or subsidy to) the enterprise. So long as the commitment not to change it was credible, it really had no impact on any of the enterprise's decision-making. Current decision-making would be based on market prices, and so would profit maximization. In that sense, the plan became irrelevant.

4.5.3 Particularistic Contracts.

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

4.5.4 Entry.

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

4.5.5 Prices that equated supply and demand.

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

4.5.6 Incremental Managerial Reforms instead of Privatization.

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

4.5.7 Disarticulation.

Along with measures to reform the core of the planned economy, Chinese reforms also advanced by identifying economic activities that were the least tightly integrated into the planning mechanism and pushing reform in these limited areas. Early reforms followed a strategy of "disarticulation," in which successive sections of the economy were separated from the planned core. This was clearly not an intentional strategy, but rather one that emerged from the nature of the policy process and from the concern of Chinese policy-makers not to disrupt the core economy. The early establishment of Special Economic Zones is the most obvious example of such policies--export-oriented enclaves were created that had, initially, almost no links to the remainder of the economy. (See Chapter 17) This approach is also one of the reasons that reforms succeeded first in the countryside. Policy-makers realized that it was not necessary that all the countryside be integrated into the planned economy. Beginning with the poorest areas, some regions were allowed to detach from the planned economy. So long as the state could purchase sufficient grain to keep its storehouses full, it could afford to let the organizational form in the countryside devolve back to household farming. Caution led to a strategy of disarticulation.

4.5.8 Initial Macroeconomic Stabilization Achieved Through the Plan.

When China's reformers faced serious macroeconomic imbalances in 1979-81, they used the institutions of the planned economy to cut back investment and relieve pressure on the economy. Rather than combining stabilization and reform into a single rapid but traumatic episode—as in a "big bang" transition—the Chinese used the instruments of the planned economy to shift resources toward the household sector and relieve macroeconomic stresses at the very beginning of reform. This dramatic shift in development strategy created favorable conditions for the gradual development of markets. Inflationary pressures were vented off as supplies grew, rather than being resolved in a quick transition from suppressed to open inflation. In a related fashion, the planning structure was used to provide an initial impetus away from the capital-intensive Big Push strategy, and towards more sustainable labor-intensive sectors. This initial shift towards a more labor intensive strategy was given urgency by the need to provide jobs for a large group of unemployed young people, including many who had returned to the cities from the countryside. Clearly, planning would be an unwieldy and ineffective instrument to carry through such a shift over the long term. But the temporary use of this instrument to lower unemployment tended to preserve stability and solidify support for the reform orientation.

4.5.9 Continued high saving and investment.

Continued high saving and investment were made possible by a gradual takeover of national saving from government by households (Chapter 18), made possible by macroeconomic stability. The Chinese government intentionally reduced its share of GDP during the early stages of reform in order to allow rural and urban households more resources and better incentives. In order to accommodate this “readjustment” of the economy, government investment was reduced and the overall investment rate declined and then stabilized (as visible in Figure 3.1) Fortunately the steady increases in household income and the increasing opportunities in the economic environment led to a rapid increase in household saving. The fact that households were willing to increase voluntary saving was a side benefit to the relatively stable economic environment reformers purchased through gradualist reforms. Rapidly increasing household saving indicates that households believed their assets would be reasonably secure. In turn, household behavior contributed to macroeconomic stability because it offset the reduction in government saving that took place at the same time. Reduced government saving was due to a steady erosion in government revenues, which itself was ultimately traceable to the dissolution of the government industrial monopoly. Total national saving remained high, thereby sustaining high levels of investment and growth. An indirect consequence was a vastly enhanced role for the banking system, serving as an intermediary channeling household saving to the enterprise sector. While this process was relatively smooth, it was difficult for the government to acquiesce in and to manage the decline in its resources, and macroeconomic policy making became more complex and more difficult.

4.5.10 Conclusion of First-Phase Reforms

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

However, the ultimate success of the first phase reform process was not always self-evident while it was ongoing. On the contrary, reform was always contested, and the achievements of reform were constantly subjected to harsh scrutiny from conservatives who were skeptical of reform. One result of this policy competition was a pattern of “two steps forward, one step back.” Reforms seemed to advanced strongly in certain years (1979,1984, 1987-88), and retreat in other years (1981-2, 1986, 1989-90). Relating to these policy cycles, macroeconomic cycles also persisted throughout the reform process**.** Bold reform measures tended to be implemented after stabilization had achieved some success. Reform measures then contributed to renewed macroeconomic imbalances, eventually leading to a new period of macroeconomic austerity. As a result, the outcome of macroeconomic policies was frequently fundamental in determining the success or failure of specific reform initiatives (See Chapter 18). Oddly, this pattern of “political business cycles” mirrors the experience in the socialist economy, but after 1978, however, the expansionary phases were phases of accelerated reform, rather than phases of political mobilization.

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

4.6 The Tiananmen Interlude

During 1988-89, one of the severe cycles of macroeconomic imbalance described in the previous section led to a serious political crisis. A bout of severe inflation fed urban discontent in 1988-89. Inflation, though ultimately short-lived, eroded real incomes for many urban dwellers and joined with anger at corruption and arbitrary privilege, as well as rising expectations about political and economic change, to form an explosive mix. All these feelings were powerful motivating factors to students who poured into Tiananmen Square in central Beijing to mourn the unexpected death of Hu Yaobang, who had been an important reformist leader, widely admired because of his willingness to fully rehabilitate more than a million Chinese who had been scapegoated and persecuted by either the Anti-Rightist Campaign or the Cultural Revolution. A volatile mixture of expectations and grievances fueled extravagant hopes and massive disillusionment, and led to months of demonstrations in China’s main square. Reformist leader Zhao Ziyang refused to order the military to clear the square by force. Ultimately, Zhao was ousted, and conservative leaders ordered the military into the square. Hundreds were killed, many of the most influential reformists in the government were sidelined or exiled, and the course of China's reform was forever altered.

After the Tiananmen Square political crisis, a period of conservative ascendancy followed, between 1989 and 1991. The conservative attempts to roll back reforms were a complete failure, however, and are today often forgotten. Urban inflation, that had seemed so corrosive in 1988, was in fact quickly controlled, and market forces corrected other imbalances in the economy with a speed that surprised conservatives and left planners far behind. As it became clear that the conservatives had no viable economic program, their support among the Communist Party elite began to crumble. Ultimately, the economic reform process survived the crisis at Tiananmen, and market transition resumed after two years of backsliding. Economic reforms were able to survive because of the broader dynamics of the reform process. Economic issues, to be sure, contributed to the social crisis leading up to the Tiananmen debacle, contributing to a sense that the government was failing to honor an implicit social compact with urban residents. At the same time, contractionary policy measures taken to curb inflation were already starting to bite into economic growth, hit incomes in the emerging entrepreneurial sectos, and cause expectations of the future to be revised downward. In this difficult short-term environment, the sense that political promises had been betrayed and political reforms were running off the tracks fueled a powerful sense of disillusionment and protest. Yet from a long term perspective, it is more striking that it was very rare for a major social group to suffer significant economic losses during the 1980s. The dual-track strategy meant that the position of workers in state-owned enterprises (SOEs) was protected. The resulting pattern has been labeled "reform without losers," (Lau, Qian and Roland). Rural residents gained from the dissolution of collectives, improved agricultural prices, and the rapid growth of non-agricultural production in the countryside. Urban residents either gained because they were able to exploit new niches in the economy, or because their economic position was protected by continuing government support for state enterprises. The broad enjoyment of the benefits of reform—and the absence of a group clearly disadvantaged by reform—meant that reform was still widely popular, despite the debacle at Tiananmen Square.

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

4.7 The Second Phase of Accelerated Reform, 1993-2003

A new phase of accelerated market-oriented reform developed organically out of the earlier phase. Zhu Rongji was brought from Shanghai and made Vice-Premier in 1991, and with the strong support of Deng Xiaoping assumed overall control of economic policy-making in mid-1993. He was thereafter the dominant voice in economic policy, and was elevated to Premier in early 1998. Zhu presided over a phase of accelerated reform that lasted until he stepped down as Premier in 2003. The contrasts between this period and the preceding one were shown schematically in Figure 4-1.

Why was this second period of accelerated reform so different from the first? A part might be traced to Zhu's decisive personality, which led him to take quick personal decisions, sometimes overriding serious opposition. Another part is explained by the fact that the successes of the first period of reform had created a more diverse and resilient economy, enabling tougher and more comprehensive policies to be implemented without too much disruption. Most fundamental, however, was that by Zhu's time the economy faced a new type of challenge: a crisis of state capacity. The "reform without losers" approach of the 1980s had required the central government to steadily surrender control over resources in the economy. The most direct evidence of this declining control was the steep drop in budgetary revenues, discussed below. By 1993, it was feared that this decline threatened the government's ability to achieve its most basic goals; worse, there were fears that the decline was simply out of control. This particular type of crisis provided a new impetus for reform: even the most conservative official could see that something needed to be done. At the same time, the challenge demanded that reform take place along with a restructuring of core macroeconomic relationships. This was not a reform combined with drastic macroeconomic stabilization—as in a "big bang" transition—but as in a "big bang," reforms had to be combined with stabilization. This was the challenge that shaped the second phase of accelerated reform.

At the "Third Plenum" of fall 1993, which followed the 14th Party Congress endorsement of a "socialist market economy" the previous year, a comprehensive blueprint for the next phase of economic reform was adopted. Unusually for China, this blueprint contained almost all the key measures actually carried out by Zhu Rongji over the subsequent six years. However, it was by no means a sure thing, and there was always uncertainty about what reforms would be adopted. In the end, not every measure in the reform blueprint was adopted, but many were; and all of the major reforms that were actually implemented can be traced back to this reform document.

The reform blueprint was not tightly sequenced. Although all the reform measures were clearly inter-dependent and made up a coherent total package, individual reforms were conceived of as relatively separable. Reforms in major sectors rolled out sequentially, but at a rapid pace, between the end of 1993 and 1999. After 1999, the pace of reform slowed, but did not stop: major reforms continued to emerge through 2003. Because of the inter-dependence of reform and macroeconomic restructuring, certain aspects of the reform agenda clearly had to come first. These measures can be thought of as pre-requisites to the overall package: they involved some institutional reforms themselves, but they were also important for establishing a foundation on which a sound macroeconomic policy could be constructed. These measures included market unification, fiscal re-centralization, and (moderate) macroeconomic austerity. Having established a firm macroeconomic foundation, reformists then moved to regulatory and administrative restructuring in key sectors: the banking system, the tax system, the system of corporate governance, and the external sector (which eventually led to membership in the World Trade Organization.) These reforms achieved substantial systemic change in each of these areas. The outcomes of this new policy regime were equally striking: a shift from inflation to price stability; a dramatic downsizing of the state enterprise sector; emergence of a much larger, robust private sector, and the shift to a "reform with losers." Zhu Rongji's policies were consistently associated with stronger, more authoritative government institutions, and more decisive policy-making.

4.7.1 Pre-Requisites

4.7.1.1 Market Unification.

By the early 1990s, the dual track system had served its function. Figure 4-2 shows that after 1991, allocation of materials (in this case, steel), after having been kept constant for several years, dropped off rapidly. By the end of 1993, material balance planning was abolished altogether. The orthodox planning system disappeared with barely a whimper, scarcely noticed. Particularistic contracts with individual enterprises were also allowed to lapse. Those contracts had always involved a two-sided agreement, covering supply and financial relations. Now one side of the contracts had become obsolete (delivery of within-plan output), while the financial side was in conflict with the impending fiscal and tax reforms, which were high on the reform agenda and necessary in order to restructure macroeconomic fundamentals.

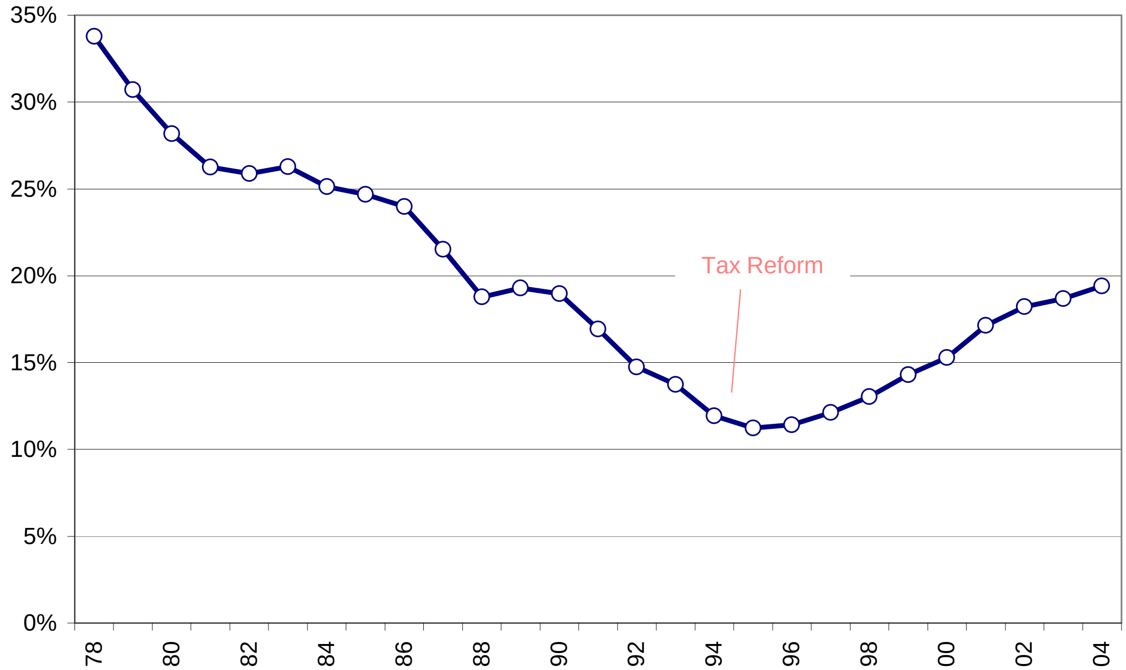
4.7.1.2 Re-Centralization.

It seems paradoxical that centralization could be a main tenet of reform in the second reform era, when decentralization had been a key part of the first era of reform. In fact, though, it was essential that the new stage of economic reforms provide adequate resources for the central government to carry out its essential functions. During the first period of reform, the motivating force behind decentralization had been the need to introduce markets and incentives into the system. The decline of budgetary revenues was driven primarily by the inexorable erosion of the old system in which state enterprises raised revenues from their monopoly position. More generally, fiscal decline was also the logical result of a transition strategy that stressed decentralization of authority and benefits, and releasing resources from government control to the marketplace. During the second period, the central government needed to strengthen its regulatory and macroeconomic management functions. In order to do so, it also needed to establish an adequate and reliable source of finance revenues, which it was able to do. Figure 4-3 shows the outcome, a fundamental turning point in 1995. During the course of over 15 years of reform, China's fiscal position had eroded significantly, dropping from 35.8% of GDP in 1978 to only 11.2% at their low point in 1995. At the end of 1994, fundamental fiscal reforms were implemented which greatly increased the central government's share of revenues and, even more importantly, restored robust growth to fiscal revenues. These fiscal reforms involved far more than just a strengthening of central government revenues, and they are discussed in detail below and in Chapter 18. For now, it is sufficient to say that they provided a new, broader tax base for the economy, and led to a steady revival of government budgetary collections.

4.7.1.3 Macroeconomic austerity.

Macroeconomic austerity was both a short-term and a long-term necessitiy. In the wake of Deng Xiaoping's "Southern Tour," the existing discipline exerted by planners over credit and money collapsed, leading to a credit bubble, a gold rush mentality of speculative investment and financial excess, and a surge of inflation. An effort had to be made quickly to break this inflationary momentum, and this occurred when Zhu Rongji was given authority over economic policy in mid-1993 and subsequently assumed the position of governor of the central bank as well. This abrupt shift began a necessary financial crackdown, and ultimately signaled the beginning of a new macroeconomic policy regime. Still, it took a prolonged period of monetary restraint to put an end to the inflationary surge. It was not until 1997 that price stability was finally achieved (See Chapter 18). The shift to a moderately restrictive macroeconomic policy was an essential pre-requisite to further reforms, in particular, for making public enterprises responsible for their own profits and losses, and providing them with a “hard” budget constraint. Tough macroeconomic policies created conditions under which corporate governance reforms could support restructuring driven primarily by market forces

Fig. 4-3: Budgetary Revenue Share of GDP



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4.7.2 Regulatory and Institutional Restructuring

Zhu Rongji presided over a new institutional and regulatory approach to economic reform. The new reforms were regulatory in the sense that they introduced new rules (and new prices) that at least in principle applied equally to all economic actors. There was more focus on creating and regulating competition as a force for economic change, and less on direct government action in managing productive enterprises. By the 1990s with the economy having “grown out of the plan,” the most important tasks were to improve the legal and regulatory environment, create a “level playing field” and reduce some of the most obvious distortions in the economy. At the core of this program were dramatic institutional reforms in four core areas of the economy: fiscal, financial, ownership and corporate governance, and external sector. Each of these is discussed in more detail in a separate chapter. The commitment to this new direction was strongly signaled at the end of 1993, when important measures were established effective January 1, 1994, including a new fiscal system, and a new foreign trade system.

4.7.2.1 Fiscal and Tax System.

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

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

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

4.7.2.3 Corporate Governance. A large-scale effort to restructure the state-owned corporate sector was begun with the passage of a Company Law at the end of 1993. The Company Law provided provisions for all state-owned enterprises to gradually reorganize as limited-liability corporations, with clarified corporate governance institutions. These provisions have been only gradually implemented, but have slowly transformed the organizational structure of the Chinese public sector (Chapter 13).

Systematically restructuring corporate governance was combined with selective listing of state-owned companies on China's newly opened stock markets, which grew significantly during the late 1990s (Chapter 19). Together these measures changed the structure of China's large state-owned companies, and created a demand for government regulation that had not previously been evident. With implementation of a Securities Law in July 1999, the China Securities Regulatory Commission (CSRC)'s branches became operational nationwide, thus forming a centralized and unified network of securities supervisors. At the same time, a host of new central government agencies were established to deal with other types of regulatory oversight, including, for example, the State Intellectual Property Office and the State Administration of Technical and Quality Supervision. China began to make progress toward a regulatory state.

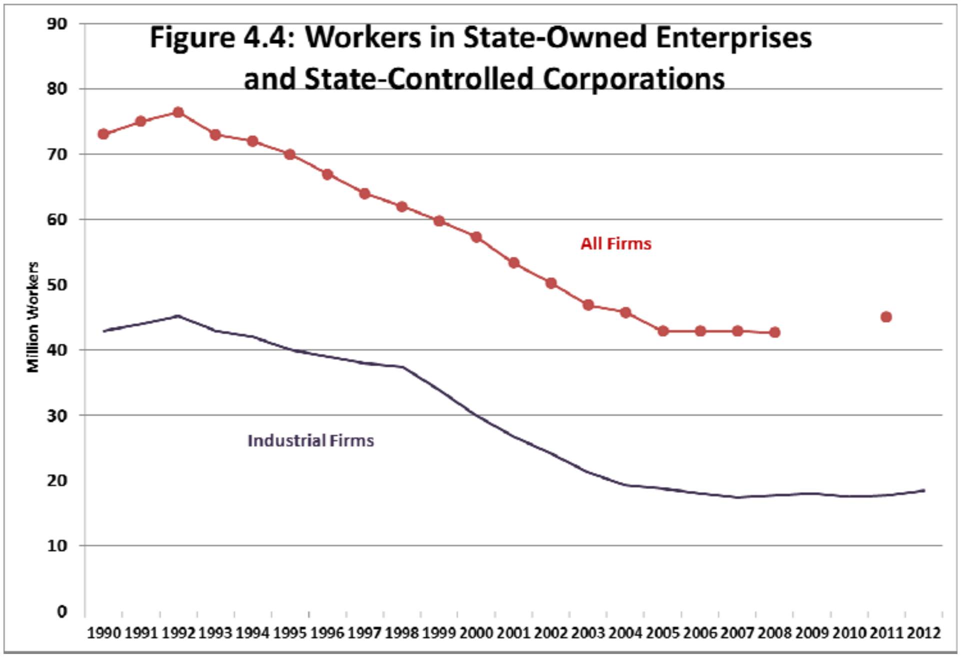
4.7.2.4 External Sector: Membership in the World Trade Organization (WTO).
Extensive foreign-trade reforms were passed at the end of 1993 that unified China's foreign exchange regime, devalued the currency, and established current account convertibility. These were important steps forward that, Chinese authorities expected, would clear the way for membership in the World Trade Organization. As it turned out, an arduous process of negotiation and compromise was required before China finally acceded to the WTO in December 2001. WTO accession involved Chinese acceptance of an extraordinarily broad range of regulatory undertakings, designed to allow China to harmonize with international standards. At the same time, and even more fundamentally, WTO accession implied an important further step in the degree of openness of the Chinese economy, and the extent to which foreign goods and companies could compete in China (Chapter 16).

4.7.3 Outcomes

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

4.7.3.2 State Enterprise Restructuring and Downsizing.
From the mid-1990s, Chinese authorities began to cut the formerly close ties that bound government and state-owned enterprise. Public firms faced increased product market competition and pressure, on the one hand, and reduced access to funding from government banks, on the other. Gradually, state-owned enterprises moved towards a significant restructuring and downsizing, encouraged by the government. State enterprise

restructuring has meant converting vaguely defined public ownership into more explicit, legally defined ownership categories, sometimes involving privatization. Following the Fifteenth Communist Party Congress in September 1997, local government officials were given an almost free hand to proceed with state sector reforms that included bankruptcy, sales and auctions, mergers and acquisitions. Through the first fifteen years of yerfrom, from 1978 to 1992, state firm employment had continued to grow in absolute terms (though it declined as a share of total employment). As Figure 4-4 shows, after 1993, state enterprise employment began to decline dramatically. Total employment declined from 76 million in 1992 to 43 million in 2005 before levelling off. The 43 million figure includes almost 20 million workers who were reclassified out of traditional state-owned enterprises and into joint stock and limited liability corporations, so long as the government retained a controlling ownership stake. Thus, employment in government-



controlled enterprises of all types declined by 33 million over ten years. Some of those workers were in privatized firms, but the large majority were laid off or placed in early retirement programs. Overall, state enterprise employment declined by 43%, and employment in government-run industrial firms declined even more, declining 61% from 45 million in 1992 to its low point of 17.4 million in 2007.

Given the decentralized nature of the Chinese economy, the progress of state-owned enterprise (SOE) restructuring depended on the incentives facing local governments, which “owned” the majority of SOEs. In fact, SOEs had already ceased to be “cash cows” on which local government officials could draw: Industrial SOE profits were 15% of GDP in 1978, but fell below 2% of GDP in 1996-97. Local governments began to rethink the value of possessing their own SOEs, and increasingly concluded that they derived few advantages from local state ownership that could not be achieved just as well from a generally prosperous local economy.

4.7.3.3 Growth of the Private Sector and Privatization.

The Chinese government has never unambiguously embraced privatization, and continues to avoid the term in favor of vague circumlocutions such as “restructuring.” However, privatization, often in the form of management buy-outs has become common in the TVE, collective and state-owned enterprise sectors. More generally, a series of policy shifts have given gradually increasing recognition and legitimacy to private business. Indeed, the rise of private business is perhaps an inevitable consequence of a policy shift toward a level playing field. By the end of 2004, the urban private sector, without counting foreign-invested firms, employs about twice as many workers as the traditional state sector: 55 million, compared to under 30 million in SOEs.

4.7.3.4 Reform With Losers.

These momentous changes in transition strategy have broken sharply with one of the key characteristics of reform in the early period. Reform after 1993 clearly imposed significant losses on substantial social groups. Most directly affected were state enterprise workers, who had been a relatively privileged group in the past. Millions have been laid off and further millions have abandoned failing firms. At its peak, the true urban unemployment rate reached 10% (See Chapter 8). Losing job security for the first time since the establishment of the PRC, some state workers suffered precipitous losses in income and social standing. Groups and individuals emerged from this phase of reform less sheltered from competition than in the past, and the short-comings in China’s social safety net were now glaringly obvious. The benefits of transition were more unequally spread among the Chinese population than was the case in the 1980s.

4.7.4 Conclusion to Second Reform Period

The second reform period was a fundamental turning point in China’s development. The institutional framework that governs the Chinese economy today was laid during the second reform period. China made the transition to what is fundamentally a market economy. Many of the subsequent chapters in this book describe and analyze institutions that were created during this period. Moreover, this reform period laid the foundation for the astonishing surge of growth that transformed China in the subsequent decade. By 2003, GDP growth had rebounded to 10%, and it stayed above 10% for five years. This was an astonishing performance that few people anticipated.

The transition strategy employed between 1993 and 2003 was less distinctively Chinese that the approach had been in the 1980s. Economic policy-making in China more closely resembled that in other transitional economies, such as Poland and the Czech Republic, and there is no longer a polar opposition between "big bang" and "gradualist" transitions. As in those transitions, the Chinese paid a cost for deep change. Growth slowed to below 8% in 1998 and 1999, and unemployment soared. To be sure, these costs in China's "growth recession" were tiny compared to the huge "transition recessions" experienced in the former Soviet republics. The creation of a much larger, more diverse, and resilient non-state sector made it possible to absorb these costs much more easily than those transition countries that put privatization and state-sector down-sizing up front in the transition process. However, the nature of the costs was the same, as the down-sizing of the state sector imposed immediate costs that had to be paid in order to get a future efficiency pay-back. Subsequently, reformers in both groups of transition economies had to focus on maintaining stable and consistent fiscal and financial policies, and engage in building a regulatory environment to protect fair and equal competition, reduce corruption, and support an advanced market economy. Even after major breakthroughs, there were still many urgent challenges.

4.8 The Reform Slowdown After 2003

In 2003, a new Hu Jintao-Wen Jiabao administration took over in China. Wen Jiabao succeeded Zhu Rongji as Premier, and immediately became the predominant economic policy decision-maker. Under Wen, the style of policy-making changed rather dramatically, becoming more consultative and deliberate than under Zhu Rongji, and the policy agenda broadened substantially. Economic reform remained high on the formal policy agenda, but it slowly became apparent that the political commitment to introducing new reforms and pushing forward the practical implementation of already adopted reforms had weakened dramatically. Clearly, the shift in practical policy was significantly due to the leadership transition: Wen Jiabao's stewardship of the economy simply did not display the same strong commitment to the principles of economic reform and the willingness (or ability) to invest political capital to push forward reforms that had so characterized the Premiership of Zhu Rongji. Still, the reform slow-down had causes that went beyond simple leadership change.

First, the pace of reform had already begun to slow in the final years of the Zhu Rongji administration. After China agreed with the US on the terms of China's accession to the World Trade Organization—in November 1999—there were, with one exception, no really major new reform initiatives. The sense was widespread that having pushed through major institutional reforms in all four key areas: fiscal, financial, ownership and corporate governance, and external—WTO membership would now cap the transformation, and the task was now further implementation and building the new principles into a comprehensive set of regulations and procedures. The one major exception was the reform and restructuring of the banking system (described in Chapter 19), which was begun in 1998 and basically completed by 2006. This exception "proves the rule" (that no new reforms were launched after 2003), in the sense that the large-scale program was designed under Zhu Rongji, but then executed in the Wen Jiabao administration. The actions under the Wen Administration were in fact the culmination of an almost decade-long effort to clear a crippling burden of bad debt off the books of China's banks. In a sense, it was the last piece of absolutely essential business from the core reform program that had not yet been taken care of: a well-designed reform measure, but also necessary to complete and protect the previous achievements.

Second, it was clear that reforms had intensified serious social problems that now cried out for solution. China's social safety net—traditionally provided by state-owned enterprises—was now in tatters. Whole new populations were emerging—such as rural-to-urban migrants and new small-scale businesses—that were receiving no protections at all. Other kinds of social services—education and health—had been under-funded for years, and now that budgetary revenues were increasing, demanded attention in the search for new institutions and forms to effectively provide a higher level of services. Finally, inequality was soaring. These problems demand attention.

In a related sense, the obligations of WTO membership, which phased in between December 2001 and 2006, created a demand for a new kind of policy-making as well. Chinese policy-makers were nervous about the impact of WTO membership on domestic businesses and, especially, farmers. While scrambling to get into compliance with many WTO provisions, they sought ways to blunt the competitive impact of other provisions. In the industrial sphere, this led to a revival of industrial policies that ended up marking a significant retreat from market-oriented reform. In agriculture, though, this led to a program of tax reductions, direct subsidies, and subsidized service provision that had a major positive impact on rural living standards. Wen Jiabao made clear from the beginning of his administration that his agenda would give a high priority to rebuilding China's public and social services and improving economic conditions in the countryside (Covered in Chapters 5, 11 and 18).

For all these reasons, it was clear that there would be a reform retrenchment after 2003. Market-oriented reform would receive less priority in the short run, and social issues get more attention. What was surprising was that once it lost top billing, the reform agenda was gradually pushed to the background: according to the definition of market-oriented reform presented at the beginning of this chapter, there were no major market-oriented reforms during the Wen Jiabao administration, except for bank restructuring. Most observers expected that reform retrenchment after 2003 would be a dynamic process, including a temporary pause as urgent social issues were addressed, and then a mid-course correction as further reforms took a kinder, gentler path involving greater social protections. Instead, the retrenchment was a static one, leading to a virtual stand-still of new reform measures and a reduced commitment to implementation of existing reforms.

Why did this happen? Most fundamentally, the improved performance of the economy after the turn of the century greatly reduced reform pressure on the leadership. With economic growth accelerating, and budgetary revenues climbing rapidly, the urgency of further market-oriented reform evaporated. Even the state sector, which had been bleeding red ink during the 1990s, returned to profitability in the new century. With policy-makers attention elsewhere, and reform seemingly having little urgency, progress slowed to a crawl. In some cases, reforms just stalled out for unclear reasons. For example, the State Council published an ambitious “Nine Articles” on capital market reform in January 2004, which called for rapid, market-driven expansion in the quantity and variety of equity and debt (bonds) instruments, but none these changes were not implemented. In 2005, Wen Jiabao touted the Tianjin Binhai district as a comprehensive reform zone, including financial liberalization, but the experiment went nowhere. Economic bureaucracies such as the National Development and Reform Commission (NDRC) became more powerful and adopted more conservative positions.

Subsequently, in 2008-2009, the impact of the Global Financial Crisis (GFC) elicited a vigorous response from the Chinese government (Chapter 19). As in other major economies, the response involved a major short-run expansion of the state’s role in the economy. The Chinese central bank pumped credit into the economy, which given the need for rapid disbursement of funds, went predominantly to state-linked corporations. Corporate bail-outs, justified by crisis conditions, tended to merge into industrial policy initiatives. Budget constraints of local governments were dramatically softened as banks were encouraged to lend to local government funding set up to quickly ramp up new infrastructure investment programs. All these responses moved China even more dramatically from the reform agenda. Moreover, compared to most other countries, China was very slow to unwind these government interventions after the worst of the crisis in 2009 passed.

While the reform slowdown post-2003 is understandable, it is nonetheless surprising. China’s market-oriented reforms brought stunning economic growth, dramatically improved productivity and performance, and extraordinary increases in living standards. How could it be that something so overwhelmingly positive and popular could be valued so lightly by China’s leadership? This question will be studied by social scientists for years. I

4.9 Reform Revival after 2013.

In November 2013, the new Xi Jinping-Li Keqiang administration convened the "Third Plenum" of the 18th Party Congress that brought them to power. The Third Plenum was the obvious opportunity to roll out a renewed program of economic reforms, echoing the reform breakthroughs at Third Plenums in 1978, 1984, and 1993, and the new leadership seized on the leadership possibilities. The Resolution of the 2013 Third Plenum was both a call for a new level of commitment to the principles of market reform and a remarkably broad and wide-ranging listing of areas to be changed. In the months since, a special top-level Leadership Small Group was established to oversee the reform process, and it launched a broad initiative to draw up and implement literally hundreds of reform initiatives in different sectors. This effort marks a clear recognition that the stagnation of market-oriented reform during the previous administration was a serious mistake that will impose real costs on China. As Premier Li Keqiang put it, "reform is like sailing a boat against the current; if you don't make forward progress, you will be pushed backwards." The renewal of commitment is significant. The Resolution itself envisages the creation of a thoroughly overhauled market-based economic system—with a dramatically reduced role for direct government intervention—by 2020.

At the same time, the reform document of 2013 does not have the high level of structure and inter-connectedness that one can observe in its most immediate precursor, the reform document of 1993. The earlier document was ambitious, but also tightly organized around a limited number of critical reforms. By contrast, the 2013 document is more like a to-do list of problem areas. All deserve attention, but it is somewhat difficult to discern the priorities and sequencing. Not everything labeled "reform" is necessarily a market-oriented reform as defined in this chapter. As of late 2015, the implementation process for this reform package had been particularly challenging. Financial reforms have gone ahead powerfully, but subject to destabilization by stock market volatility (Chapter 19). A bold program of fiscal reform was laid out, but the early stages of implementation ran into immediate difficulties (Chapter 18). We should expect a prolonged period of implementation, probably marked by a very uneven pattern of achievement and frustration.

4.10 China's Market Transition: Conclusions

Despite enormous accomplishments, China's market transition is still very much a work in progress. The Chinese transition process continues to face multiple severe challenges. These have changed in content over the years as China has developed a market economy, but have not necessarily become less serious. In the background is the fact that instruments of political control are increasingly in conflict with the multiple independent centers of authority that are the norm in a modern mixed market economy. As China's market economy has become established, and become much more sophisticated, this combination seems increasingly problematic. The development of a regulatory apparatus has been limited by the fact that true transparency, accountability, and oversight run into limits when they touch on the ultimate structure of political power. China's reformers have made numerous efforts to strengthen checks and oversight within the system, but they all ultimately rely on a kind of self-policing by the Chinese Communist Party.

Partially as a result, the transition process faces numerous challenges. Weakness of the financial system, and particularly of state-owned banks, is the problem that has received the most attention. Weak accountability finds its reflection in a trail of bad loans and non-performing assets. Corruption is a serious problem, both in its own right, and because of the way it obstructs resolution of other problems. China's corporations remain mostly weak—years of strengthening corporate governance have improved the situation, but corporate organization remains slack, with limited accountability of managers. Partly because of the large urban-rural gap, China is facing rapidly increasing inequality. Moreover, inequality is increasing within the rural economy and within the urban economy, and regional differences are still large (Chapter 9). Headlong growth has placed tremendous strain on the environment.

Nevertheless, the Chinese experience has many valuable lessons to teach. Those lessons come from a broad view of China's transition, however, and not from specific policies that can be identified and transplanted to other economic environments. After all, the Chinese policy-making process has been extremely complex, and produced dramatically different outcomes in different periods of "gradualist" transition. There is no single "Chinese model" of economic transition. The caution and gradualism captured in the phrase "crossing the river by groping for stepping stones" reflect an approach to the problem of change, rather than a strategy of change itself. The first stages of accelerated reforms were successful precisely because they were effectively adapted to the specific challenges and opportunities provided by China's situation at that time. Second-stage reforms were then dramatically recast and adapted to a whole new set of challenges and opportunities. As McMillan (2004) points out, the lesson is not that a particular policy prescription is the right one, but rather that careful policy-making, firmly grounded in local conditions, has a much better chance of success than prepackaged policy prescriptions. Moreover, policies that give weight to development of social and economic capabilities will be more successful than policies that put a single-minded emphasis on institutional change. As Deng Xiaoping said in the midst of China's transition process, "development is the only hard truth."

Chinese policy-makers used the first phase of transition effectively to build support for further reforms. Following the 1980s "reform without losers," Chinese policy-makers deferred difficult and costly measures as long as possible, but enabled the economy to reap the benefits of new kinds of producers and organizations as early as possible. This is a good strategy, but logically it cannot continue indefinitely. In the second phase, the strategy based on a "level playing field" inevitably signals the end of the "reform without losers" approach. By driving forward equal competition—particularly under conditions of relative macroeconomic austerity—policy-makers now guarantee that there will be a group of "losers." The challenge for China is not only to maintain the social and economic stability that has been a hallmark of transition so far, but also to ensure that the benefits of transition are spread to a wide cross-section of the Chinese population.

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