Chinese Economic Reform from an International Perspective

Lawrence J. Lau, Ph. D., D. Soc. Sc. (hon.)

Kwoh-Ting Li Professor of Economic Development
Department of Economics
Stanford University
Stanford, CA 94305-6072, U.S.A.
November 1999

Phone: 1-650-723-3708; Fax: 1-650-723-7145
Email: ljlau@stanford.edu; Website: www.stanford.edu/~ljlau

The Chinese Economy Today

- East Asia is the fastest-growing region in the world
- China is the fastest growing country in East Asia—10% per annum since economic reform (1979)
- China is one of the very few, if not the only, socialist countries that have been making a successful economic transition from a centrally planned to a market economy

The Transition from a Centrally Planned to a Market Economy

- The meaning of transition
  - Replacement of administrative allocation by market allocation
  - Replacement of administered prices by market prices
  - This covers the allocation of goods, factors, new investments and corporate control

Achieving an Efficient Allocation of Resources through the Market System

- The objective is to achieve the highest and best use of resources through the market system
- The efficiency of the market system depends on achieving the following conditions:
  - Price = Marginal Revenue for every good (and factor) in every sector and every period
  - Price = Marginal Cost for every good (and factor) in every sector and every period
  - The real rate of return on every investment is equal to the rate of discount (rate of time preference) in every sector and every period
- Unfortunately, these conditions are not always automatically satisfied by a market system

The Centrality of Marketization in Chinese Economic Reform

- The essence of Chinese economic reform over the past two decades is the transformation of China from a centrally planned economy to a socialist market economy
- Marketization is central to the reform process
- All other reforms can be viewed as measures to make the market work better
- Prof. Wu Jinglian has been a consistent promoter of "market orientation" in Chinese economic reform, even at the risk of being politically incorrect at times

The Chinese Economic Reform (1979-the present)

- Marketization
  - Goods and Services Markets
    - Goods
    - Services
  - Factor Markets
    - Capital
    - Labor
  - Foreign Exchange Market
  - Asset Markets
    - Tangible assets
      - Productive assets
      - “Non-productive” assets--e.g., residential housing
    - Intangible assets
    - Financial assets, including corporate control
  - Credit Markets
    - Government, enterprises, and individuals
    - Long- and short-term
  - Investment

The Chinese Economic Reform (1979-the present)

- Expanding the Market
  - The Open Door
    - International Trade
    - Foreign Direct Investment
- Promoting Efficiency-Based Demand and Supply
  - Devolution of Economic Decision-Making Power
    - Empowering Provincial and Local Governments
    - Autonomy and Incentive
  - Strengthening of Corporate Control and Governance
    - Professional Management of Enterprises
    - Leveling the playing field (non-discriminatory treatment of all enterprises--national treatment; fair and even-handed and consistent enforcement of laws)
    - Hardening the budget constraint (reduction of moral hazard)

The Chinese Economic Reform (1979-the present)

- Facilitating Entry
  - Creation of New, Non-State-Owned Modes of Organization for Production
    - Agriculture--Abolition of communes; return to a system of individual cultivators with fixed rents and taxes
    - Industry--Emergence of “Township and Village” (T&V) enterprises; (foreign) joint-venture, foreign and private enterprises

Marketization: Domestic Prices

- The abolition of ration coupons (the story of the Chinese “dough and the stale fish) and increased availability of goods through the market
- The acceptance of the concept of the market--the story of Pearl River and Beijing beers
- The prices of all consumer goods and more than 99% of the producer goods are determined in the market (with the exception of within plan outputs of coal, natural gas, and steel)
- Only three agricultural commodities--grains, cotton, and tobacco--remain under the central plan
- The price of low-grade grain is controlled (subsidized)
- The price of energy is at world market levels
  - The prices of oil and gasoline are freely determined in the market
- China has been taken off the “non-market economies” list of the European Union (12/97)

Marketization: Foreign Exchange

- Unified exchange rate since 1/94
- Interbank market in foreign exchange established 4/94
- Current account convertibility since 12/96
- Exporters permitted to retain 15% of foreign exchange proceeds as of 10/97
- However, full capital account convertibility unlikely in the near future

The Open Door Enhances Efficiency and Welfare

- China's open door policy and accession to the World Trade Organization can be viewed as the integration of two previously segmented markets--China and the rest of the World
- The combined aggregate consumption possibilities set for both markets include the sum of the aggregate consumption possibilities sets of the individual markets
- However, it is not clear that everyone in both markets will be better off compared to the status quo ante (the issue of distribution and compensation)
- It is possible to show that there is at least one mechanism that will ensure that there will be no losers resulting from the integration of the markets--e.g., if domestic trade must be completed prior to opening up for international trade

Perfecting the Market System: What More Can be Done?

- Removing barriers to flows of goods and factors
  - The equivalent of the inter-state commerce clause of the U.S. constitution
- Enhancing competition
  - Regulation of natural monopolies
  - Abolition of administratively created monopolies
  - Formulation and enforcement of anti-trust laws
- Facilitating exit
- Increasing availability and reliability of information--reducing information asymmetry and uncertainty
  - Standardization and quality grading and assurance
  - Accounting standards
  - Transparency
  - The role of the internet
- Policing the market--discouraging moral hazard
  - Enforcement of contracts
  - Prosecution of fraud

The Role of Ownership and Corporate Control and Governance

- Incentive compatibility
  - The principal-agent problem--the interests of the shareholders may conflict with the interests of the management
- Strengthening of corporate control and governance
  - Professional Management of Enterprises
  - Hardening the budget constraint (reduction of moral hazard)
- Responsiveness to unfavorable outcomes
- State access to, and control and use of resources--the substitution between explicit, direct and implicit, indirect beneficial ownership

Perfecting the Market: Externalities, Economies and Industrial Organization

- Infrastructural investment
- Human resources
- Spillover effects (R&D)
- Coordination externalities
- Monopolistic industries
  - Public ownership
  - Regulation
- Imperfections and incompleteness of markets
  - Capital
  - Credit
  - Social safety net

Marketization Reduces Opportunities for Rent-Seeking and Corruption

- Opportunities for rent-seeking and hence corruption exist wherever there is scope for discretionary administrative decision-making (e.g., the granting of monopoly franchises or licenses)
- The example of the elimination of the dual exchange rates--the People's Bank no longer has the authority to allocate foreign exchange at the official (lower) rate and thereby instantly create rents--and there is no incentive for anyone to try to bribe the staff of the People's Bank to obtain foreign exchange at a preferential rate

The Role of Expectations in Market Equilibrium

- Market equilibrium is conditional on the expectations of the economic agents
- The possibility of multiple self-fulfilling rational expectations equilibria
  - Example from the labor markets in Japan and the Silicon Valley
  - Example from the Chinese boom of 1992
- The possibility of “bubbles”

Marketization and Macroeconomic Control

- The more highly developed the system of markets, especially the capital and financial markets, the more effective is the “indire method of macroeconomic control

Marketization and Distribution

- Marketization alone may or may not lead to a desirable income distribution
- The distribution of income in a market economy is dependent on the initial distribution of endowments, including both tangible and intangible (human) capital
- Marketization assures that there is non-discrimination--owners of the same assets (including human or tangible capital) receive the same prices or compensation
- Income may be redistributed through the redistribution of endowments and through a system of taxes and transfers
- The distribution of income is a social compromise between the provision of adequate incentives for economic efficiency and the maintenance of a degree of perceived fairness (for example: progressive or flat income taxes and the social safety net)

Conclusion

- By promoting the market, Prof. Jinglian Wu also simultaneously promotes economic reform
- Prof. Wu Jinglian is not only Mr. "Market Economy"; he should be called Mr. "Economic Reform"