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OLD CHINA'S
NEW ECONOMY

THE CONQUEST BY A BILLION PAUPERS

T.K. Bhaumik



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T.K. BHAUMIK

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To,
Rupai, Vishal & Shreeya
In gratitude to Bijaya Bhaumik

It was the best of times, it was the worst of times, it was the age of wisdom, it was the age of foolishness, it was the epoch of belief, it was the epoch of incredulity, it was the season of light, it was the season of darkness, it was the spring of hope, it was the winter of despair, we had everything before us, we had nothing before us, we were all going direct to heaven, we were all going direct the other way.

Charles Dickens, **A Tale of Two Cities**
Penguin Classics, 2000, London

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List of Abbreviations

ABOC	Agricultural Bank of China
AIDS	Acquired Immuno Deficiency Syndrome
ASEAN	Association of South-East Asian Nations
ATP	Advanced technology product
Bcm	billion cubic meter
BOC	Bank of China
BOP	Balance of Payments
Bpd	Barrels per day
BPL	Below the Poverty Line
CBRC	China Banking Regulatory Commission
CCP	Chinese Communist Party
CFETS	China Foreign Exchange Trade System
CNOOC	China National Offshore Oil Company
CNPC	China National Petroleum Corporation
CPI	Consumer Price Index
CPPCC	Chinese People's Political Consultative Conference
CPC	Chinese Party Congress
CRS	Contract Responsibility System
DB	Deutsche Bank
EBR	Extra budgetary revenue
EDP	Electronic Data Processing
EDZ	Economic Development Zone
ETDZ	Economic Trade Development Zone
EU	European Union
FAO	Food and Agricultural Organisation
FAI	Fixed Assets Investments
FCS	Fiscal Contracting System
FDI	Foreign Direct Investment
FEDB	Foreign Exchange Deposit Bank
FERQ	Foreign Exchange Rate Quotes
FFEs	Foreign Fund Enterprises
FIE	Foreign Invested Enterprises
FTA	Free Trade Agreement
FTC	Foreign Trade Corporation

GATT	General Agreement of Tariff and Trade
GATS	General Agreement on Trade and Services
GDP	Gross Domestic Product
GFCF	Gross Fixed Capital Formation
GLF	Great Leap Forward
GNPOC	Greater Nile Petroleum Operating Company
GOR	Government Organisational Reforms
HDI	Human Development Index
HRS	Household Responsibility System
ICBOC	Industrial & Commercial Bank of China
IMF	International Monetary Fund
IPO	Initial Public Offering
IT	Information Technology
JVEs	Joint Venture Enterprises
MFA	Medical Financial Assistance
MFN	Most Favoured Nation
MNC	Multinational Corporation
MOFTEC	Ministry of Foreign Trade and Economic Co-operation
MOFERT	Ministry of Foreign Economic Relations and Trade
MOF	Ministry of Finance
NARC	National Administrative and Reforms Commission
NBFI	Non-banking Financial Institutions
NBS	National Bureau of Statistics
NDRC	National Development and Reform
NGO	Non-governmental Organisation
NPC	National Party Congress
NPL	Non-performing loan
OECD	Organisation for Economic Co-operation and Development
OTC	Over the Counter
PBC	People's Bank of China
PCBOC	People's Construction Bank of China
PPP	Purchasing Power Parity
PRC	People's Republic of China
PRS	Profit Retention Scheme
PLA	People's Liberation Army
PSU	Public Sector Unit

QFII	Qualified Foreign Institutional Investors
RCCs	Rural Credit Co-operatives
RCMS	Rural Co-operative Medical Services
R&D	Research and Development
RPI	Retail Price Index
Rmb	Renminbi
SAEC	State Administration for Exchange Control of China
SAFE	State Administration of Foreign Exchange
SCEs	State Controlled Enterprises
SDPC	State Development and Planning Commission
SEM	Socialist Education Movement
SEPA	State Environmental Protection Administration
SEZ	Special Economic Zone
SOE	State Owned Enterprises
SME	Small and Medium Enterprises
SIE	State Invested Enterprises
STD	Sexually Transmitted Disease
TFP	Total Factor Productivity
TIC	Trust & Investment Company
TVE	Township and Village Enterprises
TRIPs	Trade Related Intellectual Properties
TRIMs	Trade Related Investment Measures
USSR	Union of Soviet Socialist Republics
USA	United States of America
USDA	United States Department of Agriculture
VAT	Value Added Tax
WHO	World Health Organization
WSJ	Wall Street Journal
WTO	World Trade Organization

Foreword

Since 1911, the year that saw the end of thousands of years of dynastic rules, China has been constantly on transition, and is still in that mode. The last Ming dynasty was overthrown by the Republicans in early 1911, but the country was simmering within with discontentment, due to the live-wire nature of the remnants of developments that had led to overthrowing of the Ming dynasty. After a short stint of trouble-infested republicanism (1911–28), China had witnessed several years of political turmoil during the Kuomintang rule that threatened the unity and sovereignty of the nation, besides subjugating the people to a state of utter humiliation and penury. By mid-1940s, China and its people were completely exasperated, and the future of the nation was in peril.

Foundation of the People's Republic of China in 1949 was indeed a historic development. It was like China re-born. In 1949, people were euphoric and excited with the prospect of a truly socialist China. The euphoria had, however, descended into a gloom and exasperation. But 1978 marked the beginning of yet another new phase in the life of the nation, with the introduction of economic reform, woven around the objective of transition to a socialist market economy. By 2011, China is likely to complete this transition in totality. Going by the current trends, while everything in China will retain the omnipresent adjective 'socialist', by 2011 a new China is on the anvil—politically a socialist democracy, economically a socialist market economy and socially a harmonious polity. Those who are familiar with political and economic history of China would understand the full import of developments in the present-day China.

Within three decades, since the beginning of transition in 1978, China has emerged as one of the three most powerful single economies alongside USA and Japan, though not in terms of level of well-being. While destined to be Asia's largest economy in a couple of years from now, it is expected to be the world's largest economy much before mid-21st century. This apart, China is soon expected to be the world's largest trading nation, maybe by the end of the

current decade when its two-way trade is expected to be around USD 2 trillion with about USD 300 billion as trade surplus.

Emergence of China as a high-growth economy has convinced the developing economies that 10 per cent growth is not only achievable, but can be sustained as well. It has instilled a new sense of confidence, everywhere in the developing world. This is one of the most significant contributions of China to the cause of development in the world economy. Questions arise as to the lessons that the developing economies can learn from China's tryst with her destiny. There are, perhaps, several lessons that other developing nations can learn, and much on the subject has been well-documented by many scholars.

There is, however, a subtle lesson that is often missed, and, in it is this: Every nation should do what best suits the nation and its people. China did exactly this. China's growth model is purely indigenous—a stand alone model. It is a different matter that, like those of the East Asian neighbours, China's growth has been largely export-driven and investment-led, but China did not deliberate on the East Asian model. Economic policies and economic growth have evolved simultaneously, in a manner of 'learning-by-doing'. China's story tells us that imitation is not the right course.

Next important lesson from China is that faster growth needs a total commitment to the task of economic development. For a steady growth, there is need for constant monitoring and vigilance. Further, the response system must be flexible enough for the induction of right policies at the right time. Needless to mention, sustained high growth demands efficient governance. One has to appreciate the PRC's commitment to high growth. Economic ambitions of the government dictate not only the domestic politics but diplomatic relationships as well.

However, not all is well with China's growth story. Regional imbalances pose a major problem. Outdated industrial arrangements leading to large scale accidents and loss of human lives, especially in mining, is a matter of serious concern. It will also be interesting to see how long China can resist democracy.

In this backdrop, the present book 'Old China's New Economy: The Conquest by a Billion Paupers' assumes significance.

Yashwant Sinha

Former Union Minister for Finance and External Affairs

Preface

China's remarkable economic success has been a much talked about subject. From an autarkic socialist economy in 1978, China has emerged as one of the most powerful economies of the world in a span of three decades. One may, or may not, call it a market economy. It does not really matter. The fact is that its high growth is here to stay for many more years to come. There is no other country in the recorded history of the world economy that has been able to sustain an almost uninterrupted phase of high growth for such a long period. Some years back, the economists and other China analysts used to doubt the quality of growth, besides questioning the reliability of the growth figures in China. They were busy predicting the imminent burst of the bubble (the high growth), and wondering whether the landing of the economy would be hard or soft. Today, they are silent. Proving all the analysts wrong, the economic growth of China is surging ahead, and the economy itself is growing in size at a galloping speed.

Through its economy, China has indeed set a unique example of a successful transition to a market economy, a task in which the erstwhile centrally planned economies of Eastern Europe, and even Russia for that matter, could not achieve much success. We have no hesitation in saying that it is not Japan but China that has been at the vanguard of the emerging Asian century. The twenty-first century may as well be called the Chinese century. More importantly, China is all set to re-align the existing global economic order. It must be mentioned that economic transition in China is not yet complete; rather, far from it. But as past experience shows, for China, the more the transition, the greater is the case for sustainable growth, and the greater is the intrinsic strength of the economy. A solid giant-sized economy is very much before us, trotting around the global economy.

While the rise of the Chinese economy is widely appreciated, it has, however, given rise to a large number of issues pertaining to the sustainability of growth, many-sided implications for China's

own economy and also implications for the world economy as a whole. Starting from the well-known domestic issues of rising income inequality and regional imbalances, corruption, environmental pollution, etc., to China's external relations, the impact on global commodity prices, etc., a long list of issues have engaged the attention of the government as also the analysts (the economists, the policy-makers and others) all over the world. All these make China the most-studied economy today.

This book is an attempt to understand the achievements of the Chinese economy since the launch of economic reform in the country in 1978. It starts with an overview of the historical backdrop of the reform. It should help the readers to understand why both the government and the people are determined to grow faster. The first two chapters are devoted to an understanding of the historical forces behind the high growth. If we appreciate the past, we should be able to understand why China would continue to stay on a high growth path for several more years to come. For the first time in the history of China, the Chinese have been showing a desperate urge for rapid prosperity, as if they are trying to conquer poverty at any cost. The book then highlights the causes and sources of high growth, and underlines the factors behind the same. Having done that, the book elaborates on the pitfalls and the costs of high growth, suffered by the people themselves, and the government's initiatives to manage the imbalances.

High growth has generated multiple frictions, leading to serious disorders in the social and economic lives of people, and posed numerous challenges before the government. The emerging domestic challenges and the government's response to the same has, in a way, set the economy on course for a new phase of transition, so that high growth can be expected to usher in Xiaokang, that is, a harmonious society—a primary objective of the country's Eleventh Plan (2006–10)—the period at the end of which the transition to a socialist market economy is expected to be complete. The book elaborates the progress towards a harmonious society with a critical perspective. At the same time, the book underlines that China has a larger responsibility of maintaining an orderly development of the global economy. China's high growth should not lead to global economic disorder. Only the Chinese can ensure this.

From any book on China, the readers would have some expectations. For instance, they would like to know the lessons to be learnt from the experience of China. Although I have not devoted a separate chapter to this, the question has been addressed throughout the book. It is for the readers to draw their own inferences. One can, however, obtain a summarised glimpse in the concluding observations. I hope the readers would find the book useful.

T.K. BHAUMIK

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Undertaking an exercise of the kind that is attempted here required unstinted support of someone all the time was shared the pains of research. I am thankful to Ms Shashwati Ghosh, then an Economist with the Business Analysis Group of the company, for volunteering to provide this vital support. It would have been difficult to finish the job without her help and cooperation. Shri H.S. Bhatia took the trouble of providing the monotonous typing support. My sincere thanks to him for his role. However, the author alone is responsible for any inadvertent mistakes and lacuna in the book.

Introduction

At the outset, let me make a candid confession. Writing on China is not easy. It is fraught with the risk of many omissions and inadvertent mistakes. The primary problem is that since 1978, China has changed dramatically, and with 30 years of transition behind it, developments in the Chinese economy today present a highly complex scenario. On the new fabric, there are still several patches of the old. The economy has developed plenty of dualities, and the society is disjointed. The growth of the economy has taken place much faster than development. The Chinese economy has been growing at an unprecedented high rate of growth, but the overall picture still contains numerous potholes to cause discomfort to the avid China-watchers. Since so much has already been written about the country, there is hardly any aspect of the Chinese people, society, tradition, culture, economy, governance, etc. that has escaped the attention of scholars. There is so much of knowledge about China and its economy floating around us that one would instantly feel discouraged if one were entertaining any idea of writing something on the subject.

I can speak for myself. On any discourse on China, I always find myself learning more, by simply lending my ears without opening my mouth. I acquire my knowledge on the subject simply by listening to the discourses of those who know so much about it. My ability to add any extra drop to the ocean of the already available knowledge is very limited. At the very nascent stage of the daring idea of writing this book, a friend of mine—a seasoned journalist from People's Daily—had asked me in her typical Chinese style, 'What on China you want to write?' Her tone and eyes said everything, and I understood every aspect of it. She was, however, kind enough to promise her support whenever I needed it.

I, however, recognise my own limitations. I haven't spent months and years in China, perhaps not even a week at a stretch. I cannot make claims like 'Only the other day I was in China' or 'Last week I was in Shanghai'. Undoubtedly, I am the least qualified to write on

China. I have, however, always studied the country with interest, kept track of the developments there, and have a particular liking for Chinese literature and history, in which I find resonances of our own feelings. What I understand of China is that its people, its culture and ethos, its economy, in fact, everything that is Chinese is quite enigmatic. China is not a turnip, nor a watermelon, but very much like what it is.

FOUR PHASES AND THE FIFTH

China has had a long pre-historic life, projecting a romantic China, endowed with rich mythological folklores, woven around the Dragon God. The dragon¹ was not always ferocious and demonic, spouting fire from her mouth all the time. Sometimes, it used to visit the favourite and chosen ones in the shape of beautiful young lass in her loaded lustfulness, knocking at the door at midnight. Upon opening the door, the people were, however, not supposed to look at her beauty, but only at her feet. Anyone who dared to look at her full body was instantly ruined. The ancient pre-historic Chinese thus faced such embarrassing problems as their happiness and prosperity depended on the mood of the dragon, that decided and judged everything for them.

The second phase in the life of the Chinese people was also unusually long, lasting a full millennium of successive dynasties that continued to rule China until the first decade of the twentieth century. Despite numerous achievements of the Chinese civilisation, and the rich philosophical teachings of Tao, Confucius and Buddha, the lives of the ordinary Chinese people were full of hardships. In a way, barring the teachings of Buddha, which did not have much of a sobering impact on the ruling elite, the philosophical teachings of the others favoured some kind of a state-people relationship, which, by and large went against the latter. The people were made to go through numerous violent transitions by the successive dynasties, which had major impacts on their lifestyles. The Chinese people of today are not only of mixed races, but also symbolise a cocktail of cultures. Perhaps this is what explains why China and the Chinese are so enigmatic, and so different from their typical Asiatic counterparts.

The third phase of China's history, spanning over 38 years, began with fall of the Manchu Dynasty in 1911 and ended in 1949. The change-over from the age-old dynastic rule to that of the Republicans, and subsequently of the Kuomintang, was extremely painful on several counts. For the first time in its history, the proud people of the Middle Kingdom were exposed to the might of the rough and tough imperialist West, and the people had practically lost all their traditional moorings. Strictly speaking, China was not fully colonised by Japan, but the people of China had to undergo extreme humiliation and torture at the hands of the Japanese. The hooliganism of the warlords was also at its worst during this period. By the end of the 1940s, when the Chinese Communist Party (CCP) had established the People's Republic of China (PRC), the country was bleeding like never before, the economy was devastated and the people had become paupers.

The fourth phase consisted of China under the CCP rule, with Mao Zedong at the helm of power. China was virtually colonised by Mao's Communism, which he loved to call China-type socialism—a socialist China that was ironically described as 'Paradise on Earth'. In reality, it was the Mao dynasty, under which the Chinese people underwent a great painful transition—from rational human beings to a socialist people devoid of any individual freedom. In China under Mao great hopes were crushed. Earlier, people had never entertained any hopes. They were always resigned to fate, and derived succor only from their superstitions and faith². Under Mao, they were made to forget all superstitious beliefs and surrender to his authority. The last decade of the Mao-era was an era of great nightmares, when people lived under constant fear, and were suspicious of even their own shadows. Such was the trauma of the Cultural Revolution.

During its fifth and current phase, China has been evolving, since 1978, into a 'New China' that the world is talking about—a 'New China', that is an emerging global power, politically as well as economically. Right from the advent of its history, the Chinese people were reduced to penury and China was a glittering house with paupers as its inmates. Now as the country is traversing the road to transition to a market economy and the paupers are in search of prosperity. It is predicted that China would be the largest

economy by 2030, but in the garb of its socialist market economy, whatever that means. The world is already wondering: what will be the next phase of China's development?

AN ANECDOTE

There is an anecdote related to my interest in China. The decade of the 1960s, when I was in my teens, was the worst for India and its economy. Things were particularly bad in my home state, West Bengal. The social fabric in my hometown, Asansol, a leading industrial town in Asia in the 1950s but a decaying industrial town in those days, was steadily degenerating with the closure of factories and rising joblessness. As young people were passing out of schools and colleges only to face joblessness and a bleak future, petty hooliganism was fast developing into rampant gangsterism. In my late teens, I had a lot of gangsters for a company. Also, around that time, the state was in the midst of an unsettling political transition. By the end-1960s, the flight of capital from the state was in full swing, thanks to the militant trade unionism.

One summer evening in 1966, I along with a few others of my age, had to spend a couple of days in police custody in our locality. We thought it was due to the presumed offence of gossiping and loitering around a roadside tea stall, which, in those days, was a usual pastime for teenagers like us. We were remorseful, but our remorse had turned into outrage, when we were told what our crime was. The police, we were told, had spotted us carrying hand grenades. Since we had never seen hand grenades by then, a friend wanted to see the things he was carrying. In return, he was given a hard slap on the face, harder than what a boy of his age could bear.

While behind bars, we were visited by several of our well-wishers from the neighbourhood. For some of them, those were opportune moments to give us an orientation on the inequities in our society, the oppressive and exploitative characters of the capitalists, and the meaning and relevance of the class struggle, besides many more 'red' topics of the day. Even as we were waiting to join the working class, we were advised to unite. In those moments, we were eager listeners. We had to be. At least, the sermonisers

were sympathetic and upset by the fabricated accusation against us. They assured us that they would do their best to free us, and stand by us during the court proceedings that were to follow. They were true to their word, and duly honoured their assurance. We were eventually released on bail.

AN APOLOGY OF THE IGNORANT!

However, we could not escape the free schoolings that were rampant in the name of social consciousness programmes. Since the court took a long time to settle the case, we did not dare to escape the free tutoring. We were not too desperate to do so either. The lectures were exciting enough, and used to take place in a charged atmosphere. It was during those orientation programmes that we were given first-hand education on communism and its ideals, and specifically, the paradise of socialism in Mao's China. Incidentally, the period of the 1960s and the early 1970s saw the height of the Cold War, and the ideals of communism were freely circulating in most parts of the world, and especially in my part of the country. The propaganda machinery was highly active, and the materials used to spread this propaganda were highly subsidised.

We were told of the many heroic adventures of Mao Zedong, Ho Chi Minh, Che Guevara, Fidel Castro and many others. 'Haven't you heard of Mao Zedong?' was an oft-repeated question. I should have been ashamed of my ignorance and lack of knowledge, if I didn't know that 'China's Chairman was our Chairman' or that 'Power grows out of the barrels of guns.' The world over, the working class, we were told, was busy in attempts to break and smash the black and tainted hands of the exploiting capitalists. Their struggle had been a continuing one, and would continue forever. We should do that, if we were not already. As I had vowed to be a socially conscious and politically knowledgeable person, it is since then that I began to follow the developments in China, reading every piece of Mao's writings. In West Bengal of the time, this was almost a requisite qualification, if one aspired to go through college and university education.

This was in the mid-1960s, when the international economic order itself was in for a dramatic change. In the Asian panorama,

the Vietnam War was at its dizzy height, and Ho Chi Minh's heroic resistance of the American invasion had won him great applause. South-east Asia, as a whole, was unstable and suffering from a strong feeling of insecurity borne out of tensions of the Cold War, and its own internal political disorders. In the Far East, while Japan was quietly acquiring economic strength and building competitiveness of its economy, others such as South Korea, Taiwan and Hong Kong had settled down to the task of economic development. China was in total isolation, and undergoing a traumatic socialist transition, the pangs of which were reverberating within the country and were being silently suffered by the people. In the world outside, and particularly in India, there was little awareness of what was happening in China. Whatever information was given out to the outside media and the visiting scholars was that of a self-proclaimed 'paradise' in the country during the nefarious Cultural Revolution. The invited foreigners were only made to see what the leadership under Mao wanted them to see—a rosy picture of socialism with Chinese style, the revolutionary achievements of its economy, the paradise of its communes, etc. Perhaps it was this fabricated picture of communist China that made a section of the Indian intellectuals wish that China's Chairman could become their Chairman as well.

They had little idea of what Mao was doing to his country and its people. The Great Famine of 1959–61, primarily a social catastrophe and caused largely due to the callous attitude of Mao and many of his inefficient party colleagues, caused the starvation deaths of around 30 million Chinese, besides the loss of potential births of about 45 million people. I still wonder: 'How could we wish China's Chairman to be our Chairman?' But let me leave the issue here. This book has nothing to do with this question.

THE NEW PARADIGM

China has moved far ahead since the days of Mao's Cultural Revolution. Ever since the death of Mao Zedong and the arrest of the infamous Gang of Four, both in 1976, China—its politics, economy, the people, and even the value system—has changed completely. Today's China is a capitalist China, with little, or no trace

of communism. The change has not been easy. There were factions within the CCP favouring the re-working of the ideals of Mao. It was Deng Xiaoping's political and administrative dexterity that finally brought about the change-over. Moving forward, China had even abolished the post of Chairman in favour of a 'Premier'. In its history, several attempts were made to create a New China. Mao Zedong too had the dream of making a New China. But the real progressive New China is emerging only now, with a socialist market economy as its vanguard.

It is widely perceived that this New China would be the world's largest economy by 2040 or so. Its awe-inspiring economic rise is what the world is watching today. Never before has the economic rise of any country aroused so much admiration as well as concern—admiration because the economic rise of China is now tilting the established balance of global economic power in favour of Asia, and has kindled new hopes in the developing world. Concern is because of China's competitive prowess that no other country can match. Further, with its continued high growth, China is gobbling up natural resources at an unprecedented and alarming rate.

Since the launch of economic reforms in 1978 and its opening up to the outside world, the Chinese economy has been growing at an average annual rate of nearly 10 per cent. Since 2003, China's Gross Domestic Product (GDP) has been growing at the rate of over 10 per cent. All predictions of the hard, or soft, landing of the economy have been proved wrong, and the economy is seemingly well-poised for continued high growth for many more years. As has been mentioned at the beginning, China has changed dramatically from an autarkic socialist economy to a market economy. While the establishment of a socialist market economy is the ultimate goal, the preoccupation has been more with the 'market' than the 'socialist' aspect of the economy. Prolonged high growth has been an outcome of this transition. Rapid integration with the global economy is yet another hallmark of China's economic transition.

Sustained high export growth has earned the country the reputation of the fastest growing exporting nation, but unlike its counterparts in neighbouring East Asia, China's domestic economy has been also absorbing products from all over the world. Growing exports, along with growing imports, have pushed China's

trade/GDP ratio to over 65 per cent of the GDP, which, incidentally, is unusually large for the world's most populous nation. For a large country with a giant-sized domestic market base, it is natural to derive growth from the domestic market, but China has been an exception.

With an export turnover of over USD900 billion in 2006, China was the third single largest exporting nation, after USA and Germany. Its surplus trade vis-à-vis the US and the EU, which has also been growing steadily, has been, however, the cause of several trade frictions, inviting numerous trade defence measures applied against it. A major determinant of US-China economic relations, for instance, is the size of the surplus of trade, favouring the latter. Another issue, following from the growing trade surplus, is the issue of the real exchange rate of the yuan (China's currency). China's foreign exchange reserves, amidst (so far) low inflation, made a strong case for a substantial one-time appreciation of the yuan. And this was what Washington (and Brussels too) was trying to convince Beijing about.

At the same time, since the launch of economic reform, and particularly since the mid-1990s, China has been the most favoured destination for global investors, who have played key roles in the economic transition of China. It is true that the ethnic Chinese, located in Taiwan and Hong Kong, have been major investors in China, but the US, the EU and Japan are also large investors. Foreign investors have made several important contributions to the Chinese economy, but mention can be made of four important ones.

First, the foreign investors, or the foreign-invested enterprises (FIEs), have helped China achieve high export growth, contributing over 50 per cent of their total export earnings. Second, and this follows from the first, the FIEs, through their export-oriented manufacturing, have helped project China as a manufacturing powerhouse, besides motivating local enterprises in the private sector. The third major contribution of far-reaching significance has been the development of modern broad-based industrialisation, especially in the field of high-tech industries. Implicitly, and this is the fourth point, it has amounted to rapid modernisation of the economy.

The FIEs, however, did not contribute to the development of basic infrastructure. On its part, the government too did not expect it of them. Infrastructure investments, crucial for modernisation and rapid growth, were made entirely by the state (the local and provincial governments) and the state-owned enterprises (SOEs). While the state was focused largely on the development of economic infrastructure, the FIEs had helped project the globalising face of China. It may not have been a matter of strategic partnership, but the state-FIEs partnership has been uniquely complementary. In its drive for modernisation and faster growth, China has made good use of the opportunities in the global economy, all to its advantage.

High growth, however, has not been without its pitfalls or shortcomings. Indeed, there have been several severe pitfalls. High growth has generated multiple dualities, namely rural-urban, coastal-hinterland, rich-poor, etc. Poverty may have been nearly abolished, but stark economic inequalities have surfaced on several fronts. In terms of the distribution of income, China, with a Gini coefficient value of 0.44³, is the most in-equitous economy in the world. A substantially large percentage of the population still suffer from acute economic insecurity and its many attendant problems. In other words, high growth has generated its own set of problems.

Truly speaking, even after three decades of economic reforms, China is half-way through its transition to a socialist market economy. Its growth has been more than what was expected, but development (if one does not confuse it with the pace of development of infrastructure, glittering shopping malls, the number of cars on the road, and so on) has been, by and large, sidelined. With growing income inequalities between regions, between people and between villages and towns, China is steadily stepping back into an in-equitous social and economic order, which has prevailed throughout its history. Besides the widening income and/or consumption inequality, economic transition has also been synonymous with rising corruption. It is estimated that as much as 15 per cent of the GDP is lost due to the loss of government revenue. These apart, continued high growth has thrown up several other issues of far-reaching significance relating to the sustainability of what China has achieved. With a remarkably high rate of GDP growth for three

decades at a stretch, there are threats of food insecurity, water crisis, and environmental and ecological disasters, among others.

ABOUT THE BOOK

This book is about my personal understanding of developments in the Chinese economy ever since the launch of economic reform in 1978. I have narrated the developments the way I have seen and understood them. After nearly three decades of sustained high growth, it is appropriate to capture the developments thus far, because China is very much into the next phase of its capitalist development. The same country that was once annihilating, the capitalist in-roaders is now itself a capitalist inroader, competing with the established and matured capitalist economies. The leadership in China is loath to use the phrase ‘capitalist economy’, and would like to develop a brand value around the chosen goal of a ‘socialist market economy’, the meaning of which is debatable. What is beyond debate, however, is that China wants to be a developed market economy at the earliest.

For the purpose of the book, we take the core objective of China’s economic reform as a transition to a market economy—a transition of the erstwhile socialist economy to a fully developed market economy. The unfolding of developments since 1978 is essentially an unfolding of this transition. The prefix ‘socialist’ is merely an adjective, and perhaps a form of rhetoric too. Much water has flown under the bridge since the transition of China’s economy began. The economic landscape in China has changed completely. It is a different matter that China is still a low-middle income economy, with a per capita GDP of around USD 2,000, and has a long way to go before the most populous economy changes itself into the most advanced economy as well. This book captures the developments that have shaped modern-day China between 1978 and 2006, when, despite its international stature as the fastest moving low-middle income economy, China is the fourth largest economy. However, the book provides a short glimpse of the past, in order to enable the reader to appreciate the significance of the changes that have taken place.

CHAPTERISATION

Chapter 1 provides a capsule of the historical setting in China, and is meant to give an idea of the evolutionary process that China has passed through. Starting with the Shang dynasty, the chapter ends with the breakdown of the dynastic rule during the early years of the twentieth century and subsequent developments that led to proclamation of the People's Republic of China in 1949. The chapter describes the developments that saw China emerging from a pastoral agrarian society into a proto-feudal and subsequently a feudal-mercantile order. It captures the priorities and pre-occupations of the ruling dynasties as well as the ruling elite that shaped the tradition and culture of the country from time to time. The objective of this chapter is, however, different. It is meant to describe what history meant for the average Chinese. History always comes to us in diluted versions. The ruling elite decides what people should learn from it. It requires discerning minds to arrive at a dispassionate understanding of history. I do not know how the present generation Chinese would feel about, or describe, their history. When judged entirely from the economic point of view, and/or economic life of the people, the history of China is a history of the economic oppression of the people and their occasional revolts.

The victory of the Mao Zedong-led communist movement is a testimony of this. The collapse of the Ming Dynasty in 1911 was followed by over three decades of chaos and political disorder. The old order had collapsed, attempts to establish new order were fumbling, and the identity and future of China were uncertain. For the people, poverty was in its extreme and ugliest shape. People did not mind selling a girl child for as little as 10 kg of rice. Starvation and malnutrition were rampant. While there was hardly any semblance of governance, nature was equally tyrannical and often hurled severe disasters upon the people.

With this setting, Chapter 2 is about China under Mao Zedong, that is, the economic life of the Chinese people under Mao. When the PRC was proclaimed, there was great excitement, and the people were euphoric, hoping for an end to all their sufferings in the socialist paradise that communism was supposed to create.

Little did the people know what was in store for them. Soon excitement had turned into disappointment, and disappointment into disillusionment, as time passed. The Mao-era was an era of the worst catastrophe of the twentieth century for the people of China. In his Foreword to the book, *Private Life of Chairman Mao* by Zhisui Li, Andrew J. Nathan wrote, 'No leader in history held as much power over so many people for so long as Mao Zedong, and none inflicted such a catastrophe on his nation.' This chapter is devoted to an understanding of what had happened to China and its people under Mao.

The seeds of change were sown immediately after the Great Famine of 1959–61, when, for the first time, cracks were seen within the CCP. The Cultural Revolution had worked like fertilisation of the seeds and the germination began to take place soon after the arrest of the Gang of Four in the month following the death of Mao and with the second-time rehabilitation of Deng Xiaoping. Economic reform was set in motion in 1978. Chapter 3 is a narration of the circumstances within the Party in the immediate post-Mao period, and the struggle for change. For Deng Xiaoping, things were far from easy. The party had literally fractured itself on the issue of direction and pace of reform. This chapter is about the trials and tribulations in the country, and how reforms were pushed through during the initial phase of reform that covered the decade of 1978–79.

The second phase of economic reform was the period of the 1990s, when the objective of economic transition was articulated and adopted by the party as a new credo: Socialist Market Economy. The debate had almost subsided, and China had set sail in the direction of a socialist market economy, with the target of reaching the destination by 2011. Chapter 4 deals with the initiatives undertaken by the leadership for the purpose of the defined transition. China's bid to seek accession into the World Trade Organization (WTO) had considerably accelerated the pace of reform since 1994, when accession negotiations were in full swing. The chapter ends with the obligations undertaken by China as a WTO member country, following its formal accession in 2001.

Chapter 5 is about China's modern economy, as it evolved since the launch of economic reform in 1978, and its many-sided

achievements. An attempt has been made to highlight the structural changes in the economy alongside its implications, the growth pattern followed by the economy, and the factors that have contributed to this achievement. The chapter also highlights the shortcomings of economic reform and their manifestations in the form of several stark dualities, which tell us that in the pursuit of faster growth, developmental dimensions were perhaps kept on the sidelines. Chapter 6 is largely an extension of Chapter 5, but it specifically deals with certain areas of the emerging crisis, emanating from the growth pattern pursued so far. These are hard-core developmental issues that relate to the larger question of sustainability of growth. Only a couple of issues have been highlighted, but they are serious enough and need urgent attention.

More importantly, these issues have larger connotations for the global economy as a whole. As things stand today, there are seeds of global disorder in many of these issues. Chapter 7, a small chapter, talks about the concern of the leadership about the existing growth pattern, its fallouts and consequences. The government in Beijing is concerned, so much so that the entire Eleventh Plan is about the imperative of establishing a harmonious society during the course of 2006–10 which is the Plan period. In China, five-year plans do not quite symbolise a typical traditional planning for growth. The NDRC, the body responsible for the formulation and implementation of the Plan, never sets targets, nor does it allocate resources. It simply sets out the guidelines and the principles. But then the things work, and work better. For instance, the Tenth Plan (2000–05), was a remarkable success. All its objectives were achieved much before the Plan period. It can be expected that the Eleventh Plan will be a similar success. What this means is that by 2010, we will most likely see a more harmonious progressive society. To what extent the adjective 'socialist' will be achieved we do not know, but the economy was already galloping at an annual growth rate of nearly 11 per cent.

There is, however, another issue that need to be considered. This is that China's domestic economy is highly globalised and China's high growth, especially its high export growth, has a tremendous influence on the global economy. The question that arises is about the impact of China's economy on global trading and economic

order. The responsibility of the leadership in Beijing cannot end with the establishment of a harmonious domestic economy. It has a responsibility to the global economy as well. China has the responsibility of maintaining many balances in the existing global economic order. Is China feeling responsible enough? These and several other issues are discussed in Chapter 8.

NOTES

1. Dragon in the Chinese mythology has a special place encompassing religion, culture and society. It is depicted as a reptilian monster possessing magical and spiritual qualities.
2. The superstitions and faith are all centered around and related to swings of the moods of Dragon God in its various manifestations.
3. Gini coefficient is a measure of income inequality. Higher the value of the coefficient, greater is the inequality.

One

Historical Backdrop

The Womb that Conceived Modern China

The history of China, dating back to the semi-mythological Shang dynasty¹ (1700–1027 BC), is about 3700 years old. China, as we know it today, has undergone an unending process of evolution, encompassing all facets of life, and leaving in its trail an extremely rich heritage of culture, art, science and tradition. The richness of China's culture, tradition, philosophy, and, to some extent, even its economic and commercial achievements of the past are too well-known to be mentioned here. It would not be an exaggeration to say that old China had been bedecked with many shining jewels.

A vast country, with a large population throughout its history and rich endowment of resources, China was not really a backward society even in its pre-industrial stage. Its economic structure was undoubtedly agrarian, as was the case in the whole of Asia and especially in the neighbourhood of the Middle Kingdom, but overall it was a self-sufficient economy. The manufacturing activities of China, influenced both by the lifestyle of the ruling elite and the requirements of the military, were represented by its traditional handicrafts industry that had achieved excellence in skills and application of technology, almost right from the ancient ages.

China's political history, however, had been monotonously tortuous, with boundless repeat performances of uprising and rebellion. It had taken several centuries of intermittent efforts on the part of several dynasties to unify China. The story of the country has thus been one of violent changeovers from one dynasty to another, accompanied by continued civil strife, which was perpetrated by the provincial and local warlords. Managing

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and controlling the warring tenacities of the provincial governments and frequent invasions of the nomadic people from across the northern borders always occupied the attention and energies of successive dynasties. Until the twentieth century (when the last Manchu dynasty was overthrown by the Republicans), China's history has been one of rise and fall of dynasties, with each change taking place through bloody battles and a deluge of destructions. Starting with the Shangs taking over from the Heas to the Manchus overthrowing the Mings, it has been the same story. The changes in the twentieth century, namely, the rise of the Kuomintang and the final victory of the Communists in 1949, have not been any different.

China has had a painful political history. And yet, amidst chaos and turbulences, disunity and fragmentations, a sparking civilisation emerged, which was inspired during the early stage by discoveries and ideas from other external (mainly Egyptian) civilisations, and subsequently by the philosophical ideas of LaoTse (who spread Taoism), Confucius and Buddhism. Of the philosophical ideas, Confucianism, by virtue of its emphasis on pragmatism, greatly shaped the quality of governance and established an obedience-based hierarchical and patriarchal social order in the country.

To begin with, mysticism and esotericism prevailed widely in China, whereby emperors were both chosen and discarded by the Mandate of Heaven. The first monarch of China's legendary history was Fu Hsia, who was supposed to have ruled China during 2953–2838 BC and who 'was the offspring of a miraculous conception, and had dealings with the dragons'². Hsia, as the mythology goes, had instructed his people, who lived like animals and ate raw flesh, on how to lead a civilised life and worship spirits³. His successor, Shan-nung (2838–2693 BC), who was worshipped by the latter generation as the god of agriculture, had introduced an agricultural mode of life and the use of herbs for curative purposes. The story goes on, traversing through the mystics, till we come to the era of the Emperor Yu, founder of the Hea dynasty and 'Son of a Star God'. Unfortunately, the latter day offsprings of the Hea dynasty were cruel and licentious, and caused great sufferings to the people. One of the Emperors of his dynasty, for

instance, committed the serious mistake of slaying a female dragon to make pickles out of her slain body. Since the beginning of the Shang dynasty (1700–1027 BC), that displaced the Hea dynasty, and up to the beginning of the twentieth century, Chinese history passed through several phases of transition, which are presented as below with focus on the prevailing political and governmental circumstances.

DIFFERENT PHASES OF CHINESE HISTORY

The Period Starting from 1700 BC and Ending in 206 BC

This period was ruled by the Shang, the Zhou and Qin dynasties, with the last one consisting of only a brief interlude of two decades. While the Shangs had ruled for over 700 years, the rule of the Zhous spanned about 800 years of divided empires (including the Western Zhou and the Eastern Zhou empires). It constituted the longest dynastic rule. Since the end of the Hea dynasty, China took about 1500 years to come out of the overhang of mysticism. While agriculture, hunting, and animal husbandry were the primary economic activities, in what may be called a proto-feudal society, the art of writing had developed during the Shang period. Bronze metallurgy was also in vogue during that dynasty, even as the Shang rulers were largely primitive and crude in their style of governance. Some of the rulers had earned stupendous notoriety for maintaining highly lusticious lifestyles at the expense of their subjects⁴, who were treated mostly as slaves.

In fact, slavery was a rampant social stigma. The last Shang ruler, also a notorious despot, was overthrown by the head of a slave tribe in the Wei Valley (Shaanxi), called Zhou, thereby ushering in the era of the longest dynasty in the history of China. It was during the Zhou period that China witnessed great philosophical enlightenments, especially under the teachings of Confucius⁵, marking an end to the barbaric rules. The philosophical ideas of Confucius sanctified the doctrine of the Mandate of Heaven, implying that the ruler was the son of Heaven and had the divine mandate to govern. It was the duty of the subjects, therefore, to obey the ruler. At the same time, if

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the ruler did not conduct himself well, he was supposed to have lost the divine mandate, in which case overthrowing him was justified. In this sense, uprisings and revolts against the ruling elite perhaps acquired some moral sanctity.

The Zhou era was the golden era in ancient China, during which an obedience-based hierarchical social order took place. There was, no doubt, frequent civil strife, disturbing the normal lives of people, but the rulers also focused on various developmental activities, aimed at laying the foundations of progress. The warring provincial rulers had also realised the importance of economic development as a guarantee for sustained increase in tax revenues, which they needed for financing wars. Besides the introduction of the coinage system, the Zhou rulers undertook large-scale public works for the purpose of flood control, irrigation, canal building, etc., and encouraged the development of iron-based manufacturing activities (mainly to manufacture military equipments but also to facilitate the manufacture of farm implements).

The introduction of coins encouraged the growth of both markets and commerce. Further, the Zhou rulers, at the Central as well as the regional levels, encouraged the growth of a literate class that was needed for better governance. A system of impersonal, but at the same time influential, economic and political institutions came up as a result. More importantly, the growth of a literate class, trained in the Confucian school of political and social ideas, laid the foundation for the development of a class of bureaucrats. During the later Zhou period, this facilitated greater centralisation of power, besides better consolidation of the prevalent disorganised political setting.

The Qin⁶ King, though he ruled only for two decades, built further on the achievements of the Zhous. Much of what is China proper today was unified by the Qins through ruthless expeditions, besides the imposition of centralised rule, functioning of a non-hereditary bureaucracy and standardisation of legal codes. They also connected fortification walls, constructed by various warring states to fend off the barbarians, into the 5000-km-long Great Wall⁷. The Qin dynasty got eliminated with the death of the Emperor in 210 BC. However, the imperial pattern set by the latter remained, more or less, the same thereafter. The dynasty that followed was the Han dynasty (206 BC–AD 200)⁸.

From the Hans until the Sungs (206 BC–AD 979)

During this period, spanning over seven centuries, China passed through violent political upheavals, and lost much of the order that was established by the Zhous and the Qin Emperor. The collapse of the Han dynasty in AD 220 was followed by nearly 400 years of rule by the warlords, ushering the dark age of civil wars and disunity. The Hans, representing the peasant community, had great military prowess. They greatly advanced the territory westward towards the Xinjiang-Uyghur region, and secured the safety of the caravan traffic across Central Asia to Baghdad and Alexandria (the so-called Silk Route), but they were not quite comfortable in managing a centralised structure of governance—a revealed weakness, which was very well capitalised upon by the warlords and contributed to the decline of the dynasty. This decline was also hastened by unceasing invasions of the nomadic tribes from the north. Incidentally, today the bulk of China's population comprises the Hans, who constitute the ethnic majority in the country.

The severity of its political instability was manifested during the period AD 220–979, when China had a succession of overlapping dynasties, each of a short duration. These included the: (i) Periods of Three Kingdoms (AD 220–280), (ii) Jin or Tsin dynasty (AD 265–420), (iii) Northern (AD 386–581) and Southern (AD 420–589) dynasties, (iv) Sui dynasty (AD 581–618), and (v) Tang dynasty (AD 618–907), followed by an era of five dynasties and Ten States, between AD 907 and AD 979. This clearly indicates the confused and chaotic imperial order prevailing for over seven centuries, as China was stepping into its medieval period.

The entire period ranging from 206 BC to AD 979, however, was not totally unproductive. On the contrary, the bureaucracy was firmly established and acted as an intermediary between the kings and the people, functioning as a non-hereditary system of governance, with Confucianism providing the primary guidelines. On the technological front, the production of fine glass, porcelain, gunpowder, wheelbarrow, etc., reached heights of excellence, while significant progress was also achieved in the fields of medicine, cartography and astronomy. None of the Emperors of the time, apparently, stifled the progress and pursuit of knowledge. The invention of block printing was a major achievement during the Tang dynasty.

The Third Phase (AD 960–AD 1842)

This period signified the medieval phase, starting with the Sung dynasty, followed by the Mongols, the Mings and the Qings (Manchus). The Sung dynasty was successful in re-establishing a credible political order, through the consolidation and re-unification of multiple factions, and established a firmer basis for the centralisation of authority over a unified China. Centrally-appointed officials (the bureaucrats) were given the primary responsibility of running the administration, not only in the capital but also in the other regions. Further, this dynasty took considerable interest in the development of cities as centres for industry, trade, and commerce, and facilitated the emergence of urban, non-feudal economies for the first time. It was indeed a major departure in that a new class of wealthy people—the merchant class—emerged during the reign of the dynasty. In order to be wealthy, people were no longer required to depend only on land and government jobs, as plenty of opportunities were coming up on account of trade and commerce.

On the socio-cultural side, the Sung dynasty encouraged the development of some kind of a cocktail of philosophical ideas, called 'Neo-Confucianism'—a blend of Confucian thoughts along with other ideas drawing from Buddhism, Taoism and all that. It advocated a regimented order of relationships not only between the government and the people, but also in the sphere of societal relationships, based on one-sided obligations and obedience without question⁹. Subordination became the creed of the society and governance. Given the prevalent situation at the time, this helped in restoring the socio-political order, but was, perhaps, not an entirely welcome development due to the regressive effects it had on institutional dynamics. The tradition of subordination and obligation has been continuing since then, as a distinct feature of China's social life.

With the collapse of the Sung dynasty in the mid-thirteenth century, the course of developments took a different turn, paving the way for the worst to come. Kublai Khan, the grandson of Genghiz Khan, conquered China and established the Mongolian rule (the Yuan dynasty) that lasted till 1368. The Mongols were particularly anti-Hans, who constituted the majority of the population, and

adopted policies that promoted stringent discriminations against them. The Hans, for instance, were not only denied important government jobs but were also subjected to all sorts of economic and social exploitation, causing extreme sufferings to the Chinese at the hands of an alien power in their own homeland. It was during the rule of the Mongolians that deep-seated anti-foreigner sentiments had developed among the local population. On the other hand, it was the Mongolian rulers who had exposed (or rather introduced) China to the external world, beyond Central and East/South-east Asia. It was during the Yuan era that Marco Polo arrived in China, and introduced the country to Europe on his return. This also marked the beginning of China's link with imperialist West Europe. Before this, in the perception of the Chinese Emperors, China was the Middle Kingdom, that is, it was located in the middle of the world they were familiar with, namely Asia.

The policy of discrimination against the Han Chinese led to an increasing number of revolts within the country, and finally culminated in the overthrowing of Mongolian rule by a Han peasant, leading to the foundation of the Ming dynasty (AD 1368–1644). However, the Mongolians had left enough imprints of their own, through certain constructive activities such as the construction of roads and waterways, and setting up of granaries throughout the country, as protection from possible famines or other adversities. The Ming rulers did not destroy the newly-built capital assets, but instead sought to build on them further. While the Mongolians had renovated the Grand Canal and extended it to Beijing, the Mings extended it further.

The Mings were proud of the country's history, and nurtured a sentiment of superiority over foreign countries. Their focus was on establishing a powerful China in the heart of Asia. During this period, the armies were developed with great care and several maritime expeditious were carried out, establishing China as a maritime nation. Excessive stress on building the required military power, however, put a severe strain on the economy, the impact of which was borne severely by the peasants in terms of the rising incidence of taxation on the agricultural produce.

The Mings were highly expansionist and aggressive in approach, but finally crumbled under the high economic cost of militarism, which was causing severe internal tensions. Besides, they were also

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constantly being kept on alert by the external powers. Apart from the Mongols who had been causing constant trouble along the border, the Japanese were bothering them on the southern coasts. All these events took a toll on the resilience of the Mings, virtually making the dynasty a ripe fruit to be plucked by an alien power. This time, the aliens were the Manchus. 'In 1644, the Manchus took control of Beijing' and 'became masters of north China, establishing the imperial dynasty of the Qings (1644–1911)'¹⁰, which was the third longest dynasty in the history of China. To begin with, here we shall talk of the first two hundred years of the Qing dynasty, i.e., up to the Opium War, after which the story of China takes a completely different turn, signifying an even more violent history.

China during 1664–1842

In matters of governance, the Manchu rulers were more strategic. Like the Mongols, they too unleashed discriminations against the Han Chinese, who were barred from any kind of social intercourse with the Manchus. The Hans were kept away from high official positions. To ensure that this did not foment internal law and order problems, the Qing rulers took every step to secure the total subjugation and loyalty of the Hans, mostly with the use of force. At the same time, the Qing rulers did not dismantle the legacies of the Ming rulers, and instead took effective steps to reinforce the Chinese cultural traditions, including re-invigoration of the Confucian teachings and practices. They took great care to establish identity with China's age-old imperial practices, including participation in the temple functions. There was a deliberate self-initiated process of sinicisation. They not only succeeded in earning the loyalty of the Han Chinese, but also tried, though forcibly, to get the Hans to follow the Manchu lifestyle and behavioural norms (including their hairstyle).

The Manchus had two major military successes, namely the conquest of Outer Mongolia in the late seventeenth century, and success in gaining control over Central Asia in the early eighteenth century. By all standards, it was a good beginning by the Manchus. During their reign, the Empire had grown vastly to include a much

larger area than ever before, and fears of aggression from the land borders were almost eliminated. But, as if China was destined never to be free from troubles, problems were brewing in the clandestine. To a great extent, the Manchu rulers themselves contributed to the subsequent troubles that erupted in the country. In their zeal to suppress the Hans, the Manchu kings had been confiscating the lands belonging to Han landlords, resulting in a serious decline in the land/man ratio, a development that was also caused by the rising population. Besides, extreme oppression of the Hans gave rise to frequent upstaging of revolts by the Han peasants and the formation of secret societies in several parts of the country. The secret societies were engaged in frequent disruptive activities meant to weaken the empire. The management of such internal problems was leading to high economic costs and draining the exchequer.

Apart from the rapidly deteriorating internal situation, the Qing rulers faced another headache of a more serious nature, concerning the coastal and land borders. This was due to the arrival of the Western powers. The Western missionaries (the Catholics) had already entered China during the Ming regime, and by the early eighteenth century, a few thousand Chinese had already been converted to Christianity. Initially, this was not perceived as a problem, because the missionaries, in their turn, had accepted the Chinese lifestyle and sinicised themselves in an attempt to ingrain Christianity into the Chinese framework. The problem, however, started when the Papals at the headquarters did not approve of the sinicisation of the deputed missionaries, and compelled the latter to mend their ways, generating friction with the local cultures and customs.

Besides developing a distaste for foreign goods and ideas, the Qing rulers, in their turn, had consciously nurtured the growth of a self-indulgent hedonistic attitude towards the outside world. They drove away the missionaries from the mainland. At the same time, however, the other Western interest in China, i.e., the trading interest, was already knocking on the door. This was, to a great extent, a self-invited trouble. While Marco Polo played a key role in the promotion of European interest in China, the Chinese merchants were earning substantial profits by selling silk, porcelain, tea, etc., in the European markets, at a time when the Europeans had hardly anything to offer. By the early eighteenth century, China

had substantial, primarily one-way, foreign trade with the West. Using today's trade jargon, Europe was suffering from a growing trade deficit vis-à-vis China, *which, ironically for the Europeans, is the case even today.*

It was quite natural, therefore, for the European trading interests (especially when most European nations, and particularly the British, were readying themselves for the Industrial Revolution) to explore business opportunities in China. The pioneering lead in this area was taken by the Portuguese, followed by the Spanish, the Dutch, the British and the French, all having imperialist interests. The Portuguese had already established themselves in Macao, from where they were exercising monopoly control over trade at the Chinese port of Guangzhou. Taking the lead from the pioneering Portuguese, others were also trying to establish their own footholds. But they found the policy of the Qing rulers unfavourable to their interests.

Again, going by modern-day terminology, it was a policy of discrimination and absence of the most-favoured nation (MFN) treatment. To make it clearer, China's policy with respect to Western traders was guided by a tributary system, whereby the Western traders could undertake trading activities only from and out of the tributary states, and the traders were required to comply with all the Chinese systems and practices, including the strict observance of Chinese rituals in order to enlist their total subordination to the Emperors in the capital city¹¹. This was a great source of irritation for the Western powers, who were seeking MFN treatment. Among the Western powers, it was the British who pioneered the initiatives to overcome the difficulties caused by the prevailing policy.

The British East India Company already had monopoly rights over trade at Canton, and was carrying out trade with China through the Co-hongs¹². But the problem intensified with the expiry of the rights in 1833, when the right of representation of British trading interests was shifted to British government officials, who had failed to establish a rapport with the provincial officials of the authority in Beijing. The Emperor in Beijing used to determine the level of tariffs on foreign goods, but customs officials at the coasts, who were in charge of imposition of duties and collection

of revenue, had laid out a network of corruption. For the new representatives of the British government, it was a difficult situation to operate in and justify the high cost of doing business, and hence they enjoyed little profitability, on account of rampant corruption. In addition to the unequal treatment received from the government, the high cost of carrying out trade was a cause of frustration for the British government.

Prior to 1833, the British had undertaken several unsuccessful diplomatic initiatives to persuade the government in Beijing to accord them honourable and equal treatment, and had been pleading for removal of the barriers to trade. Needless to say, apart from the Chinese domestic market, the natural resources of China were also of great significance for the rapidly industrialising British economy. The diplomatic initiatives between the two countries had, however, only intensified the obstacles in the way of trade. The Emperor in Beijing was keen to pursue a highly restrictive policy with respect to foreign trade. While the growing aversion to foreign trade in China was caused by various factors, including the fear of invasions on its territorial integrity, one important reason for it was the adverse impact of the opium trade¹³ on the economy and the socio-cultural fabric of China.

In 1729, the opium trade was banned through an official decree, but the impact of this ban was only a further proliferation of the opium trade, through illegal means and third-country trade. This caused great intrigues at the imperial court. The ban on opium trade led to the development of a triangular nexus of corruption, involving the Co-hongs, the customs officials in the coastal areas and the foreign merchants. While the foreign powers were relishing the taste and fragrance of Chinese tea, the Chinese themselves got addicted to opium. The result was proliferation of a huge domestic market for the prohibited product. At the same time, there occurred a severe shortage of silver in China, which, the Chinese government felt, was due to the outflow on account of opium. All these factors necessitated a harsh crackdown in 1939 on the bulging opium trade, which the government decided to eliminate forever¹⁴. When all foreign trading outfits were asked to hand over the stocks of opium to the Chinese officials, the British Superintendent of Trade had to hand over some 20,000 chests of

opium valued at some USD 6 million, which were then 'mixed with salt and lime and sluiced into the river'¹⁵.

This sparked off the Anglo–Chinese War of 1840–42, known as the Opium War¹⁶ in the Chinese history. The war ended with a Treaty (the Treaty of Nanking) in 1842 in favour of the British. Some of the major outcomes of this Treaty that had far-reaching consequences for China were:

1. Hong Kong was transferred to the British forever;
2. The system of carrying out trade through Co-hongs was done away with;
3. The British got the right to trade directly or with persons of their choice;
4. A huge financial compensation was made to the British towards the cost of the war and the losses incurred on account of the opium trade, thereby posing a serious burden on the government's exchequer at Beijing; and
5. Mutual consultation would now have to take place on matters relating to the fixation of duties on tradeable goods.

The Treaty of Nanking, needless to mention, was most humiliating for the Manchu government, but the latter was left with no choice. Between facing the danger of continuing foreign invasions, and ensuring its safety and integrity, it had to opt for the latter. Almost immediately after the Treaty of Nanking, another Treaty (The Treaty of Bougne) had to be signed, whereby China was forced to allow extra-territorial jurisprudence in matters relating to criminal cases. This happened at a time when the coastal areas were already highly populated by foreign nationals. The British were also given the MFN treatment.

China during 1843–1911, or The Period of Military Defeats

While loss in the battlefield at the hands of the British, and the subsequent humiliating settlements were a cause for national shame, and demoralising for the Manchu government, little did the latter realise that the war was simply like opening its door to more troubles and harassment at the hands of the foreign powers. As shall

be seen later, communist China under Mao Zedong perhaps did have its reasons for pursuing an iron curtain policy for the world outside. Resisting foreign invasions had always been a key concern of the ruling powers of China, and accordingly, constant focus on the development of military strength, both in terms of manpower and equipments/machinery, had always been a matter of priority.

The outcome of the Opium War had several snowballing effects. Encouraged by the concessions secured by Great Britain and her traders, other Western powers, having similar business interests in China, also started seeking parallel concessions for themselves. China, under the Manchu Emperor, still reeling under the shock of the war, had signed three more treaties between 1844 and 1847—with the United States (July 1844), France (October 1844), and Norway and Sweden (March 1847)—granting full right to trade with MFN treatment. The period 1842–47 was one of forced opening up of trade with the West. More importantly, it saw China's first major clash with Western imperialism.

The year 1844 was the beginning of formal Sino-US trading relations. The American interest in China trade had a very different history, and was quite unlike that of Great Britain's. First, the American merchant ship ('Empress of China') left for the Canton shore carrying furs, foodstuff and ginseng (called the dose of immorality) after Captain Cook's visit to the Pacific (1776–81). Unlike the British, the American traders were not aggressive, though they too faced the constraints of the unfavourable treatment meted out to foreigner traders by the Chinese government. They too wanted these barriers to go, but, unlike their British counterparts, they did not enjoy the patronage of or naval protection from the US Congress, which was not supportive of the British approach to China. In fact, the voyage of the 'Empress of China' was totally financed by a businessman, Robert Thomas (of Thomas Cook fame).

The demand for naval protection at the time of the trade crisis in Canton (1834–39), and the request for the appointment of an official representative were straightway rejected by the US Congress. The US government was also not supportive of any trade in opium. When the foreign traders were asked to hand over their stocks of opium, the American traders had handed over their stocks to their British counterparts. It was this and several other aspects of USA's approach to China in those days that made even Mao Zedong

acknowledge that 'the American approach to China was benign'¹⁷. However, the US Congress at that time did favour a fixed rate of duties for all in-bound and out-bound trade to, and from, China, and felt that the facility of trading in all ports was essential.

Truly speaking, the Americans did not have any definite China policy those days, mainly because they had very little idea about the country and its people. If at all they had any idea, it was not a good one. A delegation of American protestant missionaries in 1829 had described the Chinese as 'uncivilised' and 'experts of deception, merciless, risking money on results that depend on chance...'¹⁸. On the other hand, there were people who found great opportunities for several American missions for the 'wicked Chinese'¹⁹. But the USA in those days had major domestic preoccupations and trans-border relations were rather low on its list of priorities. Eventually, however, the Congress had approved the appointment of a Resident Commissioner at Canton in 1842 to 'safeguard the commercial and diplomatic interests'²⁰. The First Commissioner, Mr Caleb Cushing—a member of the then Committee on Foreign Affairs—landed in Macao in 1844 with clear instructions given to him by Mr Daniel Webster, the then Secretary of State of the United States, that the United States would find it impossible to maintain any relationship of friendship and respect with the Emperor of China if special privileges granted to any foreign country were not granted to the government of the United States.

The Americans were, however, granted MFN treatment without even asking for it. Further, a Chinese Imperial Commissioner went to Macao to sign the Treaty of Wang-hsia in 1844. On the part of the beleaguered Chinese Emperor of the time, this was not meekly capitulation, but part of a broader foreign policy objective, that is, using the (so-called) barbarians to curb the barbarians. The Chinese had signed the treaties with the British, but were not too keen to implement them. Subsequent developments thus related to difficulties pertaining to the implementation, or rather lack of implementation of these treaties, which forced the British, the Americans, and the French to collaborate with each other for applying intensified pressure on the Chinese Emperor. The latter, meanwhile, was losing his grip over the country, leading to a rapidly deteriorating internal situation, which was at its worst during the period 1851–64.

To begin with, there was an unprecedented natural crisis in China, caused by droughts, floods, and consequent famines, resulting in the loss of lives of several million people. Then there was the Taiping rebellion²¹—that had been prolonging for years—resulting in the killing of approximately 30 million people. Adding to the crisis was the imperative of raising a stronger and more powerful army, which in turn, created a serious financial crisis, compelling the government to pass on the entire burden of the crisis to the peasants by way of exorbitant taxes. This, in turn, gave rise to several revolts. When domestic problems reached a boiling point, the foreign forces, including the Americans, the British, the French and the Russians united among themselves to demand the revision of the treaties and religious toleration, thereby forcing China to sign four revised treaties, entitling them (the foreign forces) to more extensive privileges²². By 1860, Beijing, the capital city of the Manchus, had become totally vulnerable to forces of the Western countries, and was even ransacked by the British and the French forces. In an attack in 1860, the Emperor Haisen Feng was compelled to run away, leaving the capital in the charge of his half-brother and China at the mercy of the Western imperialists.

During the next four decades, China continually lost its political integrity through various concessions, secured by the foreign powers (with Russia and Japan being the more aggressive ones) under one pretext or the other. Foreign encroachments continued to increase. The French colonised Cochin China (South Vietnam) and established protectorate rights over Cambodia. Besides taking Aman (Tibet), Britain took control of Burma, and later in 1898, it gained a ninety-year lease over the new territories of Kowloon (and thus expanded Hong Kong), while the Russians penetrated into Chinese Turkistan (the Xinjiang-Uyghur autonomous region). After losing to Japan, China also had to cede Taiwan and the Penghee Islands. Japanese hegemony over Korea was also accepted by China. Everyone—the British, the French, Russia, Japan and even Belgium—gained considerably in terms of concessions and privileges. The United States, the lone exception, did not have any territorial interests in China, but wanted China to follow an ‘open door’ policy for all ports.

Towards the fag end of the nineteenth century, the Chinese Emperor, perhaps drawing lessons from the Japanese Meiji Restoration, realised

the need for modernisation by bringing in social and institutional changes. Need for reform was felt in view of the imperative of survival, which was very much at stake. However, this idea met with opposition from the conservatives within the ruling elite, and the edict of reform measures, announced in June 1898, was suspended after 100 days (known as the '100 days' Reforms'). The Boxer Rebellion of 1900 was, in fact, an anti-reform rebellion. The Boxers²³ had unleashed massive destruction in the countryside of northern China, killing missionaries and Chinese Christians, and burning Christian establishments. The Emperor managed to control the rebellion with the help of foreign forces, but only at the cost of huge payments in the form of more concessions and compensation for the damages suffered. At the end of the nineteenth century, China, under the Manchu dynasty, was virtually crippled and powerless. The dynasty was just waiting for the final blow, and it came in 1911, when the revolutionary movement under Sun Yat-sen overthrew the Manchu dynasty, ending the dynastic rule in China forever.

THE REPUBLICAN MOVEMENT AND BEYOND

China during 1911–49

As a revolutionary leader, Sun Yat-sen was popular among the overseas Chinese and the Chinese students studying abroad (especially those in Japan), who were convinced that the only solution to China's problems lay in outright revolution and in establishing a republican form of government in place of dynastic rule. Further, Sun Yat-sen also had the support of the reform-minded leaders, who had fled to Japan during the Boxer Rebellion. His republican movement received funding support from the overseas Chinese, who had fled China at various times during its history in order to escape the oppressive conditions at home, but were very keen to see the emergence of a modern and progressive China, which was their homeland!

What had caught the imagination of the overseas Chinese were the three core principles of Sun Yat-sen's movement—nationalism, democracy and peoples' livelihood. Nationalism related to

the end of foreign hegemony, democracy meant putting in place a popularly elected form of republican government, and peoples' livelihood was to be secured through regulation over ownership of means of production including land. The Republican Revolution was launched in China October 1911 by Sun Yat-sen's activists, when he himself was in USA, busy mobilising funds from the overseas Chinese. By November 1911, 15 of the 24 provinces had already declared their independence from the Manchu empire. In January 1912, Sun Yat-sen was declared the Provincial President of the New Chinese Republic²⁴ in Nanjing, but in Beijing, power had passed to Yuan Shikai, the commander-in-chief of the imperial army. This implied that there were problems somewhere. Yuan had little control over the provinces, lacked the power to appoint officials in the provinces, and could hardly collect tax revenue. At that time, some provinces even used to issue their own paper money. To make matters worse, the provincial officials started maintaining independent relations with foreign powers.

China during 1912–28

Dynastic rule was finally abolished in China, but that was not the end of lawlessness and civil strife. On the contrary, chaos continued to reign, as multiple uprisings plunged the country into utter wilderness. But the power of Yuan Shikai soon spread beyond the bicameral Parliament of the Republic of China, and he himself assumed the role of a dictator. Prompted by this development, an amalgamation of small parties joined hands to form a new party, the 'Kuomintang', under the leadership of Song Jiaoren, an associate of Sun Yat-sen. In a general election in February 1913, the Kuomintang assumed power, but soon thereafter, Song was assassinated by Yuan. As this was not taken well by the pro-Republican supporters, the country was again plunged into chaos on account of an anti-Yuan rebellion. This rebellion continued through the summer months, and was finally suppressed by Yuan himself in October 1913, when he legally established himself as President of the Republic of China. He also succeeded in securing international recognition, but only after considerable humiliation

before the foreign powers. For instance, Russia had to be given control over Outer Mongolia and Britain was allowed to retain its influence over Xizang (Burma).

THE KUOMINTANGS ARRIVE

Yuan died a natural death in 1916, but the various measures he had taken within a short span of three years or less, were enough to cause further turmoil, leading to a declaration of independence by several of the provinces and the splitting of China into multiple fragments. He had disbanded the Kuomintang, revised the Constitution to make himself President for life, and even declared his intention to re-establish monarchy in the country. Between 1917 and 1923, that is, during the period of the First World War, China was in a state of utter chaos, ruled by the warlords, on the one hand, and hamstrung by the pulls and pressures of the foreign powers, especially Japan and Russia, on the other. The government in Beijing at that time was absolutely clueless about how to handle the situation arising out of the First World War. It had also made several errors of judgement, for which it had to pay heavily during the subsequent years.

In 1915, the Japanese placed before the warlord government in Beijing twenty-one demands, the acceptance of which would have made China a Japanese protectorate. Although these demands were not accepted, Beijing had to agree to place Shandong (then under German occupation) under Japanese possession, and recognise Japan's authority over Southern Manchuria and Inner Mongolia. In 1917, China declared an unwilling war on Germany under the provocation of the British and the French, who had promised that victory over Germany would ensure the return of Shandong to China. The same powers, however, had also entered into a secret deal with Japan, instigating her to carry out a naval attack against Germany. It was only after the War that China realised that it had been betrayed. At the Paris Peace Conference, both the British and the French acknowledged Japan's authority over Shandong. Never before in its history had China experienced such a diplomatic *faux pas*. When this became public knowledge, it was again followed

by a phase of national unrest and protests. By then, that is, by the end of the First World War, the cause of the republican movement had almost faded, and China's identity as a sovereign nation was in deep crisis.

However, Sun Yat-sen, who was forced to flee to Japan during Yuan's determined repression of the republicans, had come back in 1917 as Commander-in-Chief of a military government in Guangdong, and re-established the Kuomintang in 1919 to counter the warlord government in Beijing, that still retained its legitimacy and maintained external relations with Japan, Russia, and the Western powers. By 1921, Sun Yat-sen had become President of the southern government. During the same year, Mao Zedong and a few of his associates established the Chinese Communist Party (CCP) with a handful of members, thereby inviting a bigger Russian role in the domestic politics of China. The Russians, however, were already supportive of the Koumintang even as the Kuomintangs and the Communists were at loggerheads right from the beginning. Initially, the Russians found themselves in a fix as to which one of the two they should side with. However, in all fairness to the USSR, it must be acknowledged that they tried to make the two work together for the sake of the political integrity of China. It was only due to the Soviet initiative that the two had formed an unequal and reluctant alliance in 1925, after Sun Yat-sen died of cancer.

The developments following the demise of Sun Yat-sen were a bit complex. Two main factions were involved in the ensuing power struggle—the Kuomintangs under Chiang Kai-shek and the communists under the CCP. The Soviets adopted a dual policy of supporting both, but were more active in their support to Chiang Kai-shek and other functionaries of the Kuomintangs. Soviet support was provided in terms of political and military training, including in the setting up of institutions for mass mobilisation. Chiang Kai-shek was given three months' training in Moscow for that purpose. Needless to say, the Kuomintang-CCP alliance did not last long.

Meanwhile, fissures started developing within the Kuomintang, which finally split the party into the right wing and the left wing, whereas the CCP began initiating the tactics of armed insurrection

in urban and rural areas. The communists had already made unsuccessful attempts to take over certain key cities, including Nanchang, Changsha, Shantou, and Guangzhou, among others, and the peasants in Hunan province had staged an armed uprising, called the 'Autumn Harvest Uprising'. By mid-1927, there were three capitals in China, namely the (i) warlord-led regime's capital in Beijing, which enjoyed international recognition, (ii) the capital of the communists and the left-wing faction of the Kuomintang at Wuhan, and (iii) the capital of the right-wing civilian-military regime of Chiang Kai-shek at Nanjing. But by 1928, virtually all of China was under the control of the right-wing Kuomintang under Chiang Kai-shek, with its capital at Nanjing²⁵.

In 1928, the right-wing Kuomintang under Chiang Kai-shek began the task of consolidation, development and modernisation with a view to build a strong and unified China, broadly in line with the vision of Sun Yat-sen. But two simultaneous developments eventually led to the downfall of the Kuomintang and the establishment of the People's Republic of China in 1949. First of the two was rise of the communists and second was the Japanese invasion.

In 1927, the communists were expelled from Wuhan by their left-wing Kuomintang allies. The CCP was confined to its centre in Shanghai and was operating at a low key. It was Mao Zedong and his close associate, Zhu De, a military veteran, who spearheaded the peasant-dominated movement along the border between the Hunan and Jiangxi provinces. Under this movement, the local peasants were getting mobilised into political forces. In late 1931, Mao established, under his Chairmanship, the Chinese Soviet Republic in Ruijin in the Jiangxi province. At the end of the famous Long March in October 1935²⁶, the communist headquarter was set up in Ya'nan, from where the communists continued their struggle for power, spanning over a decade.

Japan, on the other hand, had huge imperial designs on China, as it perceived the latter it as a substantially large source of supply for industrial raw materials. It had already captured Manchuria and was pushing from the south of the Great Wall into northern China and the coastal regions. The Japanese invasion was made easier by the Kuomintang government's preoccupation with programmes for the extermination of the communists, and the Japanese succeeded

in making substantial territorial gains in northern China and the coastal regions. At the same time, the communists were steadily gaining control of the areas that were not occupied by the Japanese.

Totally crippled by the internal and external attacks, the demoralised Kuomintang government became dependent on American support—both financial and military. The Americans were generous with financial, but not with military, support. The Kuomintang regime eventually collapsed in 1949 when Chiang Kai-shek and a few hundred thousand nationalist troops fled to Taiwan. Japan's defeat in the Second World War forced it to leave China in 1945, but between 1928 and 1945, the Japanese had unleashed a reign of terror and unprecedented cruelty over the Chinese people. During the period of 1945–49, China was again plunged into a civil war, this time between the communists and the Kuomintang forces, which completely shattered its economic foundation.

The state of ordinary people given this short and brief sketch of the historical process at work in the polity of China, it is reasonable to conclude that, by and large, the Chinese people have had a tumultuous history, made up of centuries of a continually oppressive socio-political order, one that had perpetrated large-scale drudgery and poverty on the people, and ended up costing millions of lives every now and then. The progress of civilisation had little impact on the economic and social lives of the average people. Economically, the country made little qualitative progress and underwent a slow transition from a proto-feudal to a feudal type, and later on, to a feudal-mercantile stage. Entrepreneurship had hardly found any opportunity to flourish, except, at a much later stage, and then too, only in areas exposed to prominent foreign influences. For the people at large, agriculture was a major economic occupation. But it was agriculture that was exploited the most by the ruling elite.

Agriculture was almost a singular source of revenue for the dynastic rulers and a source of livelihood for the people. The tax revenues collected from peasants supported not only the glittering lifestyles of the ruling elite in the royal courts and the educated elites, but were also primarily used to meet the expenses entailed by the growing military establishments. Needless to say, the peasants were subjected to oppressive taxation, and kept perennially under a situation of abject poverty. Apart from oppression at the hands

of the dynastic rulers, the peasants were also severely exploited by the warlords and their armies, who used to impose various taxes on them at exorbitantly high rates. Some taxes even used to be collected in advance. In 1912, in one region, taxes were collected up to the 56th year of the Republic, that is, up to 1968! Besides paying taxes, the peasants were also forced to render various services including menial labours without wage, direct slavery, etc. To make matters worse for the peasantry and the other lower class people, China was prone to suffer from frequent occurrences of devastating natural calamities, causing large-scale damages to crop production, and inflicting more misery on the ordinary people.

The frequency and gravity of natural disasters and famines in China is perhaps unparalleled. Between the years 1850 and 1932, which was also the worst phase of China's political history, there were 435 famines, each lasting, on an average, for 11.1 months²⁷. Out of 100 most deadly natural disasters of the world in the twentieth century, about 33 took place in China alone. Between 1900 and 1949, the major natural disasters that took millions of lives included the epidemic of 1909 (costing 1.5 million lives), the drought of 1920 (half a million lives), the drought of 1928 (3 million lives), the flood of 1931 (3.7 million lives), and the floods of 1938 and 1939 (costing 2 million lives), to mention a few (see Table 1.1).

However, hardly any relief operations were carried out at the time of the calamities. The general lack of benevolence on the part of the dynastic rulers, and subsequently, the Republicans and the Kuomintang, was also responsible for the inadequacy of support facilities that could provide cushions against natural disasters,

Table 1.1
Most Deadly Natural Disasters of the Twentieth Century in China

<i>Year</i>	<i>Disaster</i>	<i>No. of People Killed</i>
1931	Flood	3.7 million
1928	Drought	3 million
1959	Flood	2 million
1909	Epidemic	1.5 million
1920	Drought	0.5 million
1938	Flood	0.5 million
1939	Flood	0.5 million

Source: International Disaster Database, www.md.ucl.ac.be/cred.

and save the people from famines that followed in the wake of the calamities. In addition, the people had no respite from the payment of taxes under any circumstances.

As noted earlier, the rulers of several dynasties were deeply aware of the imperative of investing in agriculture, and had even provided for the creation of physical assets for the purpose of agricultural development, but such initiatives were driven essentially by the motive of collecting higher tax revenues and least of all, for the purpose of the development and modernisation of agriculture, or for the well-being of the ordinary peasants, who also had to bear the consequences of frequent civil strife perpetrated by the warlords. The repressive activities of the latter, and their impact on the lives of the people, constitute a little known aspect of China's history, but it can be fairly assumed that the people were highly vulnerable to mass killings and destruction.

The society in ancient China consisted of the ruling class (the dynastic families and their operators), the nobles (the warlords and the landed aristocracy), and the lower class of people (the slaves, the peasants, the artisans, etc.), who used to provide the requirements of the ruling elites and the nobles. The slaves were not only deployed for all kinds of tough manual jobs (including as labourers in public jobs), but were also expected to sacrifice their lives at the will of the masters. During the Shang dynasty, slaves also used to be buried alive along with their dead masters in order to be able to serve the latter in their post-death lives. They were also used as units of exchange (one horse, for instance, could be purchased for five slaves). The peasants, apart from undertaking their normal work of cultivation and harvesting of crops, also often used to be mobilised for the purpose of wars and public work projects at minimal or no wages. For most of the projects relating to the construction of social and economic assets, large populations consisting of the lower strata of the society were used extensively, and were paid only nominal wages.

The teachings of the saint-philosopher Confucius had had little impact on the quality of governance. On the contrary, they proved to be a bane for the ordinary people. One of his thoughts, 'Have leader be leader, have administrators be administrators, have fathers be fathers, have sons be sons', (Analects of Confucius, 12: II), was capitalised upon very well by the ruling elites, and used almost as a

moral sanction for their style of functioning. Right from the days of the Zhou dynasty to the Manchus, civil administration was guided by the teachings of Confucius, which were also taught as part of a regular curriculum in schools. Schools in ancient and medieval China were accessible only to children of the affluent class. It is this affluent class which generated the educated elite for employment in the royal courts and various governmental outfits. The poor, because of their financial inability, were deprived of education and, thus, of any opportunity to escape the grip of poverty.

The teachings of Confucius, and the early education system that was centred around it, helped generate a new breed of ruling elite—the bureaucrats as intermediaries between the royals and the people—signifying a powerful cog in the wheels of administration. The emergence of bureaucracy had brought in its trail an obnoxious social evil, namely corruption. The lure of easy money and the prospect of a higher social status were attracting people towards education, so much so that parents were ready to pay any price to educate the male offspring of the family (the girls were to be either married off or prepared to become the concubines of people in power). Jung Chang wrote in her memoirs²⁸:

My great-grandfather was born in 1894.... He was sent to a good school. The goal for him was to pass the examinations to become a mandarin, an official, which was the aspiration of most Chinese males at the time. Being an official brought power, and power brought money. Without power or money, no Chinese could feel safe from depredations of officialdom or random violence.... Becoming a mandarin was the only way the child of a non-noble family could escape the cycle of injustice and fear.

Changes in dynasties did not make any difference to the ordinary people's economic life, but affected their social and cultural moorings in a big way. While every change in dynasty brought about lootings and killings on a massive scale, new dynasties always imposed their own cultures and customs on the people. The process, carried out in the name of sinicisation, was utterly ruthless in its meticulousness and encompassed every aspect of the social and private lives of the people. With suppressed feelings of humiliation and ignominy, people had to live through varying modes of life brought upon them by successive rulers. From this perspective, perhaps the darkest period in China's ancient history

was a block of about 400 years after the collapse of the Han dynasty, when the process of sinicisation was accelerated beyond all limits²⁹.

Of the developments in the later period, what still lives very vividly in the memory of the present-day Chinese, and still causes intense resentment, is the humiliating process of Japanisation that the people were made to undergo during the Kuomintang regime. The process of Japanisation was started right from the schools in all the places under Japanese occupation. But the Japanese did not stop at that. The Chinese labourers in the occupied territory of Manchuria were subjected to the drudgery of hard labour. They were also deprived of proper food, and particularly, for labourers, eating rice was considered as an 'economic offence'. As Zhisui Li points out:

Labourers were worked to death in mines under Japanese guards to produce exports to Japan.... Many were deprived of salt and did not have the energy to run away....rice was reserved for the Japanese and most of the local population had to subsist on a diet of corn meal and sorghum which were difficult to digest.³⁰

What we intend to convey in the concluding section of the present chapter is that throughout its history, the people of China have suffered from injustice, fear, drudgery and poverty, resulting from both man-made and natural causes. From time to time, the people reacted by taking recourse to violent revolts, sometimes uprooting the established dynasties in the process. The Shang dynasty, for instance, was overthrown by the revolution of the slaves. Similarly, the Han dynasty, was established as a result of rebellion by the peasants. People's revolts of varying intensities were frequent occurrences throughout the country's history. And yet there was little improvement in the general economic conditions of the toiling sections of the populace, who barely managed to eke out a living.

The peasantry was a particularly unfortunate class as it had to bear almost the entire burden of the ruling class and the military, and also had to suffer the atrocities of the warlords. It was primarily because of this that socially as well as politically, China was always ready to flare up at the slightest provocation. No one understood this better than Mao Zedong, a librarian at the Beijing

University at the time of the Republican Revolution and an avid reader of China's history. He was deeply convinced of the power of the peasants, whom he had successfully mobilised, for his communist movement. Mao's communist revolution was essentially a peasants' revolution. This is evident from the fact that in 1949, more than 90 per cent of the total membership of the CCP consisted of peasants.

NOTES

1. The dynasties that ruled China till 1911 were the: (i) pre-historic Xia dynasty (21st–16th century BC), (ii) Shang Dynasty (16th–11th century BC), (iii) Zhou dynasty (11th century BC–221 BC), (iv) Qin dynasty (221 BC–206 BC), (v) Han dynasty (206 BC–AD 220), (vi) Jin dynasty (AD 265–420), (vii) Sui dynasty (AD 581–618), (viii) Tang dynasty (AD 618–907), (ix) Sung dynasty (AD 960–1279), (x) Yuan dynasty (AD 1271–1368), (xi) Ming dynasty (AD 1368–1644), and (xii) Qing dynasty (AD 1644–1911). In between, there were: (i) a period of Three Kingdoms (AD 220–280), (ii) Northern and Southern dynasties (AD 386–581 and AD 420–589, respectively), and (iii) a period of five dynasties (including the later day Liang, Tang, Jin, Han and Zhou dynasties), and Ten States between AD 907 and 979.
2. See Donald A. Mackenzie, 1985, Chapter XV.
3. See Donald A. Mackenzie, 1985, Chapter XV.
4. It is said about Chou-sin, the last Emperor of the Shang dynasty that he, himself an extravagant and intemperate tyrant, had fallen in love with a wicked woman, called Ta Ke whom he had married. For her amusement, 'there was a pond of wine; the trees were hung with flesh; men and women chased each other quite naked'. Further, for her entertainment, the queen had constructed a copper pillar that was greased all over. 'It was laid over a charcoal fire and culprits were ordered to walk on it. When they slipped and fell into the fire Ta Ke was greatly delighted.' See (2) above, page 288, Chapter XV.
5. Confucius (551–479 BC) wanted to encourage an ideal social and political order for which he prescribed relationships: 'Let the ruler be a ruler and the subject a subject.' Interested readers may also see Thomas Cleary, 1992 for a better understanding of the teachings of Confucius.
6. Qin is actually Ch'in, from which the English name China is derived. It was the Qin King who took the title of the 'First Emperor', a formulation that was earlier reserved only for the deities.
7. The Great Wall actually consists of four great walls, rather than a single continuous wall.
8. It is the Hans who constitute a majority of the ethnic Chinese, and currently they account for over 90 per cent of the country's total population.
9. Zhu Xi, the most influential Neo-Confucian philosopher, had synthesised the thoughts of Confucius, the Buddhists, and the Taoists, as also other ideas that

had become imperial ideology from the time of the Sung to the late nineteenth century.

10. See M.L. Gupta, 1994.
11. For instance, the foreign ambassadors were expected to kowtow nine times before the emperor in the capital in exchange for a minor commercial concession.
12. Meaning the local Chinese merchants.
13. Opium was first introduced in China by Arab traders as a medicine some time in the eighth century AD. By 1620, the Portuguese traders had introduced it as a luxury habit. Since it was expensive, its consumption was confined to the well-to-do families, who perceived a status value in its consumption.
14. Emperor Dao Juang ordered the closure of the Canton Port to all opium traffic and the confiscation of opium stocks with the foreign traders.
15. See M.L. Gupta, 1994.
16. There was another opium war from 1856 to 1858, following which all restraints on drug trafficking were removed.
17. See Zhisui Li, 1996.
18. See M.L. Gupta, 1994.
19. See M.L. Gupta, 1994.
20. See M.L. Gupta, 1994.
21. The Taiping Rebellion was led by a village teacher, Hong Xinquan, who had formulated an eclectic ideology combining the ideas of pre-Confucian utopianism with Protestant beliefs. He had a large number of followers who were heavily anti-Manchu and anti-establishment. Taiping means the 'Heavenly Kingdom of Great Peace'.
22. This was when the second opium war took place.
23. It was a movement of an anti-Christian Secret Society—the Society of Righteousness and Harmony. In 1900, the Boxers had spread all over the countryside in north China.
24. Sun Yat-sen had agreed to Yuan's demand that China be united under a government in Beijing under Yuan, and on February 12, 1912, Yuan was sworn in as President of the Republic of China.
25. The communists were driven out of Wuhan by the left-wing Koumingtang ally, while the latter were annihilated by the military of the right wing.
26. The 'Long March' was a strategic retreat of Mao's Red Army and its supporters that began in October 1934. It involved 1,00,000 functionaries, trudging 12,500 km through 11 provinces, 18 mountain ranges and 24 rivers in south-west and north-west China.
27. See Jung Chang, 1992.
28. This was the Era of Disunity, also known as period of Three Kingdoms, when politically China was the most fragmented.
29. See Jung Chang, 1992.
30. See Zhisui Li, 1996.

Two

China under Mao Zedong

Rise and Fall of Socialist Paradise

When Mao Zedong announced the establishment of the People's Republic of China (PRC) on 1 October 1949, the entire country experienced excitement, anticipation and hope. Tears swelled up in many eyes, when they heard his soft but powerful voice claiming, '*The people of China have stood up*' (emphasis added). For the first time, perhaps, they felt proud that at long last, they had arrived as a nation. For the first time, they were proud to be Chinese. They shouted over and over again, 'Long live the Peoples' Republic of China,' 'Long live the Chinese Communist Party'.

On the death of Mao Zedong on 9 September 1976, however, there was little mourning. On the contrary, there was a suppressed euphoria in the minds of the people, and the mood was distinctly against the continuation of Mao's policy. A month later, when the Gang of Four¹ was arrested, there was a mood of celebration. The people said that the last tyrants were finally gone. There were official celebrations as well. On hearing the news of the arrest of the Gang of Four, many had rushed to nearby liquor shops only to find that the shops had already run out of stocks. What had gone wrong in China between 1949 and 1976? What did Mao do to China, his own nation, as Chairman of the PRC that prevented him from getting heartfelt mourning and genuine tears from his people? In order to understand all these, we need to look at the state of China under his rule and the catastrophe he had inflicted on his nation.

As Chairman of the PRC, Mao Zedong faced the onerous task of building a New China—a united China under a centralised government that was to be the Central Peoples' Government. The PRC had inherited a devastated structure of governance and a collapsed

economy. Four years (1945–49) of civil war had concluded with the victory of the CCP, but there were still simmering fires within the surviving opponents. Peace was yet to be restored. More importantly, in the post-War geo-political re-alignments of the time, China was literally a stand-alone nation. Given this backdrop, Mao and his closest colleagues in the CCP began their innings fairly well.

The immediate challenge was that of the unification of China (from the scattered remnants of the Manchu dynasty) and the establishment of a centralised government. Towards this end, a beginning was made by moving the capital from Nanjing to Beijing, and by adopting a national flag and a statement of national purpose. The centralised government was to exercise all executive, legislative and judicial powers. Under the system that was established, people elected local assemblies, which, in turn, elected their representatives for higher (provincial) assemblies, but local assemblies were supposed to show total obedience to the higher assemblies. In other words, democracy was to be practiced largely at the local levels. The provincial assemblies elected the National People's Congress, that is, the cabinet. The new Constitution was adopted on 28 September 1954, five years after declaration of the PRC.

SOCIALIST MAN AND FIVE LOVES

The establishment of a new socio-political order, encompassing the entire country, with a view to establish a socialist society, was a rigorous and tortuous process, and kept the government of Mao Zedong heavily preoccupied, along with his other plans. In this, Mao was no different from the ancestral dynasties of China in the sense that like the dynastic rulers², he too wanted to transform every citizen of China into his idea of a socialist man. On assuming power, the CCP got bogged down by its objective to convert the entire populace (then about 550 million) into a body of communists. Every citizen was to be a communist first. Between 1949 and 1954, it is learnt, over 8,00,000 individuals (branded as class enemies) were executed all around the country, and the party cadres, mostly drawn from illiterate peasant families,

were authorised to undertake large-scale 're-education' and 'self-criticism' campaigns in order to weed out counter-revolutionary political and other ideas, so as to convert the entire country into a nation of socialist people³. People who were not perceived to be easily mouldable through 're-education' and 'self-criticism' were sent to forced labour camps. Every single individual was to be a socialist in thoughts and deeds, and in total ignorance of his/her private self.

The rigours of the state were so deep and intense, that they interfered even in the private lives of the young people. A socialist man was supposed to have only five loves: love of country, love of people, love of labour, love of science and love of common property. All other forms of love, including a pregnant mother's love for a particular food, were treated as selfishness and considered reactionary. A regularly orchestrated mass movement, a central aspect of Mao's communism, was organised to convert the entire nation into a huge mass of organised socialist people, ignited with a sense of common purpose of 'nation-building'. Fine! But, flag-bearers of the mass movements were the poor and illiterate peasants who mostly determined what a socialist man should be, with the common denominator being the lifestyle that they were accustomed to. Several semi-government type mass organisations, spearheading the task of mass indoctrination, were given the task of ensuring the complete subordination of the people to the ideology of a communist state. This task was often carried out with excessive zeal, spreading fears and suspicion of each other among the people, and making them live programmed lives⁴.

INITIAL ECONOMIC MEASURES

The task of nation-building could not be complete without a matching action on the economic front. By 1949, the economy was badly, if not totally, damaged. It was suffering from the crippling effects of decades of political turmoil, in general, and of eight years of fighting with the Japanese, in particular. And add to it four years of civil war (1945-49) on top of that. As a huge number of mines and factories were damaged, industrial output had declined by three-fourths from the 1937 level. After the end of the War with Japan

in 1945, Soviet troops had dismantled several pieces of machinery, and shipped the same back to their country. As a consequence, the basic infrastructure, that is, transport, communication and power systems were either destroyed or irreparably damaged. Agricultural production was 30 per cent lower than the pre-War peak, ushering in severe scarcity and starvation for the bulk of the population. To make matters worse, virulent inflation had rendered the currency useless⁵. Given the prevalent chaos, the immediate task before the CCP was to restore order and stability in the economic system, and save the people from a state of mass hunger, malnutrition and beggary⁶. Life expectancy at birth was only 43 years in 1949.

The situation prevailing in China during the period between the fall of the Manchu dynasty in 1911 and the final victory of the Communists in 1949 justified Mao's strategy for economic re-construction. Some of his ideas already existed, particularly, his idea of 'land reform' was in secret circulation among the peasants and the youth during the 1930s, as also his idea of 'New Democracy'. These ideas were obviously circulated with a view to mobilise mass support and alienate the counter-revolutionaries, but land reform was a major plank of Mao's communism and socialist economy.

In order to restore economic stability and lay the foundation for growth, two steps were immediately undertaken. The first step included the introduction of a new currency (the yuan) and measures to stabilise prices, while the second step was the enactment of the Agrarian Reform Law. Immediately after the introduction of the new currency, steps were taken to control wages by linking them to the prices of five essential items⁷, which were strictly monitored. The idea was to keep real wages unchanged. Money wages could increase or decrease in keeping with movements in the prices of those essential commodities. This guaranteed income stability to the working class, by acting as a cushion against inflation.

At the same time, the government of Mao Zedong ensured tight monetary and fiscal control, with a view to restrict the money supply and impose controls over the fiscal profligacy indulged in by the Kuomintang. The banking system was nationalised. State Trading Corporations (STCs) were established both to stimulate as well as regulate commercial activities, even though private trading was not altogether abolished. As part of yet another strategy to keep prices under control, STCs were meant to procure goods

from the producers in competition with the private traders and to sell the same to consumers and enterprises. Within a matter of one year, however, an extensive strategy was put in place to restore the dignity of the currency, to establish a firm official grip over the erratic market forces and the private players.

All these were prudent initial economic steps, though at the same time, they were like a curtain-raiser, signifying the shape of things to come under the communist regime. The various measures undertaken during the period 1949–52 were primarily intended to restore normalcy in the economy, and yet gave indications of the future direction for the economy. As part of a strategy to make the inherited assets operational, and keeping in view the limitations of the exchequer, the government's immediate priority was the reinstatement of the damaged infrastructure, mainly in the area of transportation and communication. It had carefully avoided any disruption in the sphere of industrial production. About one-third of all the enterprises had already been brought under state control by the Kuomintang⁸. To begin with, only such enterprises were converted into state-owned enterprises. But with the peasant revolution being the quintessence of Mao's communism, agricultural reform could not be made to wait.

The mass mobilisation of the poor peasants was the starting point of the formation of the Peoples' Liberation Army (PLA) and of the cadres for communist movement. The 'Long March of 1934–35', though a strategic retreat, was actually a long march undertaken by the peasants. The uprising of the peasants was not a new phenomenon in China. There had been several instances of revolution by the poor peasants throughout the history of China⁹. For Mao, the task of mobilisation of the peasants was easier in this sense. The poor peasants were always ready to undertake anything that had the potential of a regime change. While the peasants had reposed complete faith in him, Mao himself was confident about his ideas on agrarian reform, which, as already mentioned, along with his idea of the New Democracy, had already been in circulation through clandestine pamphlets for about two decades prior to the declaration of the PRC in 1949. The victory over the Kuomintang therefore, in a way, signified the mandate for the launch of agricultural reform.

The Agrarian Reform Law was intended to ensure an even distribution of land and other assets, including agricultural tools, among landlords, and the rich and poor peasants. In effect, it amounted to taking away the surplus land from the big landlords and rich peasants, and distributing the same to the poor peasants. The key concept of the programme that was launched under the Law was called '*land returning home*'. Under this programme, not only land but draft animals and houses were also to be re-distributed. Needless to say, the implementation of the Law was tough, and not without opposition from the landlords, who had suffered the loss of most of their lands and houses. There were several instances of two-way excesses being committed through extreme cruelty, in the process of implementation of the Law, which took more than a year. During that period, entire rural China was in a state of bloody turmoil.

A relatively peaceful transition had taken place only in those areas where hostile landlords had already been killed or executed, during the fight with the Kuomintang. However, land reform, being concerned with the re-distribution of land and assets in favour of poor peasants, had salutary effects on the agricultural economy. The poor peasants, who had always toiled hard only to hand over the bulk of their produce to the ruling class by way of high taxes¹⁰, suddenly felt unshackled and found an opportunity to lead better lives through hard work. Many among them, for instance, could now think of buying a wooden chair to sit on after full day's hard work, a luxury they had never enjoyed in the past. They now got not only land but also capital assets to till that land. By 1952, agricultural production had shot back to the level of the pre-War peak, while many poor peasants already had wooden chairs to sit on¹¹.

This luxury was, however, shortlived, and ended with the launch of the second phase of reform in 1953, when agricultural operations were undergoing the process of collectivisation. During the first stage, farmers were asked to help one another, purportedly to encourage bonds of fellow feeling. During the second stage, they were asked to pull their resources (tools, labour and land) while retaining ownership of land, and during the third stage, farms were collectivised under co-operative communities, resulting in the formation

of about 8,00,000 co-operative farms comprising 600–700 persons each. The process finally ended in 1958 with the formation of communes that signalled the end of individual ownership and choice of production. In effect, this resulted in the total subjugation of individual and private lives to the highly intrusive larger social lives of multiple communes that began dotting all of rural China¹².

The process of collectivisation of agricultural operations, completed over the five-year period of 1953–57, that is, during the course of the First Five Year Plan, was a sequential process, compelling the peasants to gradually give up everything and finally bequeathing individual entity in the hands of the state. In the process, all the peasants were converted into wage farmers, deriving wages according to individual contribution, measured by the number of hours worked to the total number of labour hours spent. No difference was maintained in terms of the quality of labour put in. Labour was considered skill-neutral, and every farmer was expected to be able to perform any kind of activity. Specialisation was thus sacrificed on the altar of collectivisation. The entire process was meticulously thought out, and rigorously implemented through a system of de-centralised arms of governance at the provincial, and subsequently the commune, levels.

The same was true of the re-organisation of the industrial economy, where state ownership was extended gradually. In 1952, about 17 per cent of industrial enterprises were still outside the state system. Mao was more concerned about the conversion of factory workers into communists but not into a class of proletariats *a la* Marx. Mao did not call upon the workers to unite. Instead he called upon them to become 'socialist men'. The party workers were sent to factories to spread communist ideals among the workers, and to influence the latter to become members of the party. The factory workers were already living in miserable conditions, earning wages that only allowed bare subsistence. Tuberculosis resulting from malnutrition and lack of hygiene was rampant among the factory workers. When preached about the lofty ideals and goals of communism, the hapless factory workers became happy converts. The CCP thus did not have to labour much to achieve its goal of smoothly converting factory workers to communism even as the enterprises were being slowly brought under state ownership. By 1953, both the processes were complete.

With the twin initiatives aimed at ensuring price control, stability of the currency and effective monetary-cum-fiscal controls, on the one hand, and the re-organisation of agriculture, industry and commerce, on the other, the economy was soon restored to order, and by 1952, it was doing reasonably well. The ground was then prepared for long-term growth and stability, for which Mao and his associates had in mind a socialist model of centralised planning along the lines of the Soviet model. In passing, it may be mentioned that Mao Zedong, the person, had no love for the Russians. On the contrary, he held them in contempt. The same can be said about the Russian leaders' attitude towards Mao, the individual. As his personal physician, he had chosen an America-trained doctor (Dr Zhisui Li), in whom he had confided that the American attitude to China had always been benign. The problem, however, was that the USA did not extend its recognition to the PRC.

The Russians were the first to recognise and establish diplomatic relations with China. Besides, the Korean War had also resulted in a conflict with the USA. The Russian view of Mao was, however, that he was a turnip: white on the inner side, and red on the outer side. During his two-month long visit to Moscow, which happened to take place in the immediate aftermath of the proclamation of the Republic, Mao did not receive a warm welcome. It was only towards the end of his, generally speaking futile, visit that Stalin agreed (rather reluctantly) to sign the Friendship Treaty. On his part, Mao always considered the USSR as 'a threat to China, determined eventually to gobble it up'¹³.

When the USSR finally decided to enter into the Friendship Treaty¹⁴, it was primarily because of the emerging Cold War divide leading to a bi-polar world order. China, the most populous nation of around 550 million people at that time, was on the left side of the divide, but was a stand-alone nation. If Mao was keen on the Friendship Treaty, it was because: (i) he did not want China to be seen as a 'stand-alone' communist nation, and (ii) he needed huge technical assistance, which was not available from elsewhere. Given the state of the national economy and the challenges of restoring internal socio-political order in the aftermath of the war with the Kuomintang, total isolation was not desirable for China. On the economic front, Mao's vision was to raise China to the level of the advanced Western world in fifteen years, which he wanted

to fulfil through a unique China-style communism. He looked at the USSR model only for the basic structure of planning, not for a total transplant. His way of re-organising what were China's primitive agrarian relations offers ample evidence of this. It was mainly in the case of industry and the development of industrial structure that Mao borrowed the Soviet model to a great extent. But China's own history, where military priorities always dictated the purpose and structure of industrial operations, had also left its imprint. Mao knew it well that as a nascent communist state, China was perhaps not very secure in the prevailing geopolitics of the time. In fact, Mao Zedong always felt that there was an impending Third World War, and he wanted China to be prepared for that.

THE FIRST FIVE YEAR PLAN AND THEREAFTER

The First Five Year Plan (1953–57) was a plan for rapid industrialisation under state ownership. Both in formulation and implementation of the Plan, the Soviets had offered generous assistance by way of technical and other supports. The Soviet experts helped in the construction and erection of several plants based on Soviet technology and capital goods. The Treaty of Friendship was at work. A wide array of large enterprises came up to produce basic industrial goods—iron and steel, coal, cement, electricity, capital goods, etc.—and thus facilitated the creation of a large industrial base. By the end of the Plan, no privately-owned firms were left in China. About 68 per cent of all industrial enterprises (with the number increasing substantially by 1957) were state-owned, while the rest were jointly (public-private) owned.

The small unorganised enterprises (in villages and smaller towns) were made to form co-operatives. The motivation was to build a strong economy of communist China and, as if in a prelude to self-imposed isolation later, a self-sufficient economy. As has been already mentioned, the re-organisation of the agricultural production system was, more or less, complete by the end of 1957. The concern for re-organisation was overwhelming. In the process, the government had practically overlooked the need to invest in this

primary sector. The increase in agricultural production was achieved entirely through re-organisation of the means of production.

On the whole, the First Plan, under Soviet financial and technical assistance, was reasonably successful. Agriculture did not get an investment boost, but re-organisation had positive effects on both productivity and efficiency. The poor peasants, benefiting from the policy of land distribution in their favour, were enormously enthusiastic. Also, the transition to a commune-based system was gradual from loosely structured tiny mutual aid units to the lower stage of producers' co-operatives (in which the farmers received incomes on the basis of the land that they contributed) and then to advanced co-operatives, wherein farmers not only got a share of income on the basis of the land that they contributed but were also allowed to retain small private plots (the size of a kitchen garden) to grow vegetables, fruits and livestock for their own use only. The farmers were still a few steps away from being converted into socialist people. During this period, agricultural production increased at an annual average rate of 4 per cent, while the incremental grain production in the five-year period, 1952–57 was 64 million tons. Massive investment in capital-intensive industries, resulting in the establishment of thousands of enterprises (including 156 very large facilities), facilitated a growth in industrial production by over 19 per cent a year between 1952 and 1957. Gross material production, the socialist nomenclature for Gross Domestic product (GDP), increased by 9 per cent a year, a highly substantial achievement in those days of the world economy.

GREAT LEAP FORWARD AND THE GREAT FAMINE

Mao and his radical associates (Lin Biao and others such as members of the Gang of Four) were, however, not happy¹⁵. They felt that more could have been achieved. Mao was particularly in a hurry and could not wait to see the fulfilment of his vision of socialism with Chinese characteristics, that is, a socialist China inhabited by rich and wealthy people. For this, the economy needed to grow at a rate much higher than what had been achieved. At the same time, by the end of 1957, the Treaty of Friendship with

the then USSR was also on shaky ground on account of growing mutual suspicions between the two countries that had gone beyond repair¹⁶. Driven by the desire for a quantum progress, Mao was convinced that centralised planning based on the Soviet style was not worth pursuing. His ambition, for instance, was to surpass British industrial output by 1972.

The Second Five Year Plan (1958–62) was abandoned in favour of a programme for a Great Leap Forward (GLF). The primary reason for abandoning the Second Plan was, of course, lack of faith in the Soviet-type model, but there was also uncertainty about the availability of financial, technical and other supports required to pursue a highly industry-intensive development strategy. The GLF was also to be a costly affair, but Mao had different ideas. He wanted to achieve a quantum leap in production in all sectors of the economy, especially agriculture and steel, through full harnessing of the potential of the human capital stock, that is, the extensive use of each and every individual by way of total ideological orientation along the party line. Mao thought that nothing was impossible if the people's power could be harnessed to the optimum, and this was to be achieved in a meticulously planned manner¹⁷.

The initial first step towards harnessing of people's power was de-centralisation, whereby a great deal of measures were taken to delegate the authority for taking economic decisions to the provincial, county and local levels of administration, in what might be called a 'bottoms-up' approach to planning. The idea was to maximise production in every corner of the country. While collectivisation of agriculture was completed by 1957, in 1958, the advanced agricultural co-operatives were re-organised into communes called 'people's communes', having three organisational levels: a central commune administration, a production brigade (of a traditional village), and a production team (of 20–30 families). By the end of 1958, about 7,50,000 agricultural producers' co-operatives were merged into about 23,500 communes, each averaging about 5000 households.

The communes were supposed to be in total control of all means of production and to act as a self-supporting community in charge of agriculture, small-scale local industry, schooling, marketing, administration, local security, etc. Since the communes had kitchens, dormitories, mess halls and nurseries, the system had the effect of

denting the institution of families. While the ideological motive behind the establishment of communes was to convert every individual into a socialist human being and to kindle a strong sense of commitment to the ideals of communism and a spirit of nationalism, the economic logic was to: (i) ensure extensive agricultural operations to maximise production, and (ii) generate surplus labour for deployment in areas like irrigation projects, electricity generation, and other infrastructural projects. At the same time, a free food supply system was introduced, thereby eliminating private families and private kitchens. Salaries were replaced by food coupons and private kitchens were banned.

Alongside the commune system, the leadership under Mao had initiated its own brand of a more responsive political system quite unlike a normal one. It was essentially aimed at the indoctrination of people, especially the technical experts, and was accomplished through a 'down-to-the-countryside' movement (*Xiafang*). People, both inside and outside the party, were sent to communes, factories, mines, public work projects, etc., to undertake manual labour and gather first-hand experience of the realities of nation-building. In reality, by its very nature of implementation, this was similar to sending people to concentration camps as was the practice in the USSR. Neither age nor the health conditions were considered in the choice of the people. If any logic had to be found for the *Xiafang*, it was perhaps to achieve mass mobilisation of people's power, which was a core aspect of the GLF strategy, and was partly a means of overcoming financial constraints in the achievement of the objectives of GLF. The ideological orientation of people, it was believed, could generate the motivation to fulfil the ambition of high and fast growth for a country of over 700 million people.

Mao Zedong was highly conscious of the large-sized population of his country, and often considered it as an advantage. He believed in the extensive utilisation of this renewable capital, and did not even mind losing a great deal of it if occasions to do so arose. In 1957, in a speech in Moscow, Mao said that he did not mind losing 300 million people—half of China's population. 'Even if China lost half its population,' he said, 'the country would suffer no great loss. We could produce more people'¹⁸.

Indeed, it was the people who were expected to undergo extreme hardships in the pursuit of Mao's utopian dream of a Great Leap.

Two things were perceived to be very critical for the success of the grandiose idea of the GLF—increased food production and large-scale steel production. To Mao, the people's commune was a great idea for lifting the people out of poverty into abundance, which explains why overnight, the whole country was converted into people's communes, functioning under directives coming from the central leadership and percolating down through the provincial party bosses. The communes were to act as primary instruments to fulfil the targets and goals of the GLF. Huge excitement was generated through the propaganda machinery with slogans, posters, paintings on the walls, etc., figuring everywhere. Even loudspeakers blurring music, proclaiming 'Long Live the Great Leap Forward' and 'Everyone Make Steel' were brought into action¹⁹.

EVERYONE INTO STEEL MAKING

What followed was a frenzied irrationality, fanned by the party leaders at all levels. In 1957, China's steel production was 5.35 million tonnes, which, by the order of Mao, had to be doubled to 10.7 million tonnes in 1958. Instead of setting up additional steel plants with skilled labour, he wanted every citizen to get involved in the production of steel in, what came to be called, backyard furnaces. The entire country—including schools and hospitals, peasants and even doctors—was asked to produce steel. Every commune was given a steel quota to produce.

Family cooking was banned, and everyone had to eat at the common canteens, so that all the family utensils of steel could be melted in the backyard furnaces to produce steel, ironically perhaps only to make the same utensils. What the end-product was did not matter, as long as people were producing steel. At any cost, steel production had to be doubled, even if the means used for doing so were irrational. Even schoolchildren, on their way to and from schools, were supposed to collect unused materials of iron, including nails, from the roadsides for use in the school furnaces. The teachers were more concerned about keeping the furnaces burning twenty-four hours and teaching, their main job, could be ignored.

An estimated 100 million peasants were dragged into the production of steel. At the same time, there were instructions to ensure that agricultural production should also not suffer, even though there was likely to be a serious shortage of labour in this sector. The situation that prevailed in China was thus one of total dictatorship sans rationality. The local leaders did what was safest for them to do: made tall claims and promised the impossible in a mindless competition amongst themselves. They had no other option, as talk of impossibility was to invite punishment. Given this, the farmers took to fantasies and even started believing them. For instance, they fancied that they could produce 'more than a million pounds of potatoes in a *mu* (one-third of an acre), 1,30,000 pounds of wheat in a *mu*, cabbages weighing 500 pounds each', and so on²⁰.

The fantasies that the people indulged in were, however, not always out of fear of punishment. To some extent, this was also due to the fervour of irrational nationalism stoked by their great leader. The capitalist world, Mao had told them, had humiliated China by not establishing diplomatic relations with it. The Soviets were revisionists, he had told them. But the Communist Party of China was capable of achieving miracles and establish Chinese hegemony in the world economy. China, they were told, could do anything and everything on her own. Thus, inspired by Mao, the people had begun to believe in fantasies, even if it meant indulging in utter stupidity (as was the case in steel production).

Birds were destroyers of corns, and Mao had a dislike for these creatures. So the peasants, particularly the elderly and the children among them, were assigned the major preoccupation of beating metal objects all day long in order to create unbearable noises, so that the birds would be frightened and would drop dead from the exhaustion of non-stop flying. Many peasants were quite unscrupulous and took to the deceptive practice of transplanting crops from other fields into one single plot in order to show that their fields had yielded bumper crops, primarily to showcase the ostensibly successful yield of Chinese peasants before foreign visitors. In general, the frenzy of the GLF had turned the entire country into a nation wherein, people defied reason and took to deceptive practices.

HEADING TOWARDS THE GREAT FAMINE

Going back to the issue of increasing agricultural production, Mao had divided agricultural operations into eight characters: soil, fertiliser, water, seeds, dense planting, protection, tending and technology. He prepared guidelines relating to each of these elements for the farmers to strictly follow, and no deviations were allowed. As for fertiliser, since the country was hardly producing any chemical fertilisers, large human and cattle population had the capacity to produce enough night soil daily to fertilise the available arable lands. There was thus no need for chemical fertiliser, as the competing bio-fertiliser was both plenty and cost-free²¹. But agriculture suffered from a shortage of labour, during both the sowing and harvesting seasons. In a way, agricultural operations were allowed to be neglected, with the priority shifting to the production of steel. While the menfolk were engaged in the procurement of materials required for the production of steel and were busy attending to the melting furnaces, agricultural operations were left to be undertaken largely by the women and the children. Even animals were drawn into the maddening task of steel production, and were used for the transport of raw materials from forests and other places to the burning furnaces. Agricultural operations were thus virtually undertaken manually by the women and children.

There was yet another absurdity that had impacted agricultural production in the country, particularly the productivity in agriculture. Mao was obsessed with his idea of 'public canteens with free meals', and had effectively banned eating at home, presumably for the purpose of saving household kitchen utensils, which could be melted to make steel. Under the system, everybody was supposed to eat from the canteens at the communes, effectively meaning that the people's needs would be looked after by the communes. One positive aspect of this policy was that the peasants were able to eat to their hearts' content for the first time in their lives. Food entitlement was not related to the contribution to production. So the peasants ate as much as they could, thereby soon emptying the food reserves in the process. On the negative side, as soon as the peasants realised that their produce now belonged to the state and that they were not producing anything for themselves, they lost

the motivation to work. With little motivation to work and sufficient food to eat, they went to the fields to while away their time. Consequently, productivity suffered, paving the way for a serious shortage in the production of food. When the harvesting season arrived, the local leaders produced fabricated reports of increased production, and kept the top leaders in darkness about the ground reality. The latter were rather euphoric about the fabricated reports, and were not ready to see signals of the approaching crisis.

The Great Leap Forward had fumbled even before the 'leap' could take off the ground, reasons being the pursuit of unrealistic ambitions that were well beyond the means of domestically available resources, implementation of faulty policies by the inept and corrupt officials and party leaders, lack of motivation and incentives, and mismanagement and inefficiency fostered by the oppressive diktats of the communist regime, among others. But more importantly, Mao himself was faltering in his leadership and was driven by paranoia. Within the party, he could see emerging signs of challenges to his authority. He was intolerant of even honest, though contrary, viewpoints and ideas, which sometimes he had to counter while giving shape to his version of socialism. External relations, especially with the USSR, had touched a nadir²². To make matters worse, the country, already engulfed in madness about the GLF, and the utopian ideas being incorporated in various strategies and state policies, was visited by terrible natural calamities, leading to the worst famine in its history.

The combined impact of all these events on the economy was disastrous (see Table 2.1). At current prices, the GDP that rose from 82.4 billion yuan in 1953 to nearly 146 billion yuan in 1960, had dropped sharply to 114.9 billion yuan in 1962, leading the economy to incur a loss of over 31 billion yuan in two years. Between 1958 and 1962, the per capita output had declined from 200 yuan to 173 yuan. Within the three year-period, 1959-61, the population of the country declined by 13.5 million. Starvation deaths were rampant during this period. The number of actual deaths during the period of the famine is estimated to be around 30 million. The gravity of the crisis arising out of the famine can be understood from the severe decline in its population during this period. Between 1953 and 1959, the average annual addition to

Table 2.1
Impact of the Great Leap Forward and Famine (1959–62)

	1953	1957	1958	1959	1960	1961	1962
GDP (billion yuan)	82.4	106.8	130.7	143.9	145.7	122	114.9
GDP per capita (yuan)	142	168	200	216	218	185	173
Population (million)	587.9	646.5	659.9	672.1	662.1	658.6	672.3
Agri-output value (billion yuan)	51	53.7	56.6	49.7	45.7	55.9	58
Production (million tonnes)							
Rice	71.3	86.8	80.8	69.3	59.7	53.6	62.9
Wheat	18.3	23.6	22.6	22.3	13.6	14.2	16.7
Grain	163.5	190.7	193.4	165.2	139.4	143.1	155.3

Source: United States Department of Agriculture (USDA) database.

population size was roughly 14.3 million. At this rate, the population of China should have been about 701 million in 1961, but it was only 658.6 million. In two years, China had thus lost around 43 million potential lives.

While grain production declined from over 193 million tonnes in 1958 to 139.4 million tonnes in 1960 (and in 1962, it was still below the 1953 level), the value of agricultural output had fallen from 56.6 billion yuan to less than 46 billion yuan. It may be noted that even as the population size declined between 1959 and 1961, in 1961, the population (658.6 million) was significantly larger than what it was in 1953 (587.9 million), but the production of grain in 1961 (143.1 million tonnes) was significantly lower than in 1953 (163.5 million tonnes). This should also help us understand the gravity of the food crisis prevailing during the years of the GLF.

The industrial sector too suffered from a serious shortage of raw materials, general mismanagement, over-production of poor quality goods and the deterioration of plants and machinery. The shortage of raw materials had severely hit the textile industry, and the production of cloth declined by about two-thirds from 7.6 billion metres in 1959 to 2.8 billion metres in 1961. A similar loss was also seen in the production of edible oils, which declined by more than 50 per cent in two years. The production of electricity, a vital requirement for facilitating higher industrial production,

had been increasing steadily since the launch of the First Plan and had crossed 59 billion kwh in 1960, but had dropped to 48 billion kwh in 1961, due partly to the shortage of coal and partly to mismanagement.

In the absence of data, the exact production of steel in 1958 is not known. We also have no idea about the extent of increase in the production of steel, or about the quality of steel being produced during this period. What we do know is that the targeted production of 10 million tonnes for 1958 was achieved only in the late 1960s. In 1962, it was 6.5 million tonnes. Both quantitatively as well as qualitatively, the Chinese economy had gone backward by several years during the years of the GLF. The consequences of the mistakes were severely compounded by the Great Famine of 1959–61. The system of free supply of food was badly affected, but the influences of hierarchy, privileges and corruption in the operation of the system had greatly added to the miseries of the people. There was also a difference of opinion within the party about the cause of the famine. While Mao claimed it was 70 per cent due to natural disaster and 30 per cent man-made, Deng Xiaoping thought it was just the other way round.

If the hapless people did not revolt, it was due to the fear of the party cadres operating at every level of the administration. But there were signs of brewing restiveness everywhere. Within the higher echelons of the party, there was some acknowledgement of the adverse consequences of policies adopted in support of the GLF, and finally there was some re-organisation within the party in favour of policy re-adjustments and relaxations²³. Thereafter there had followed a short period of recovery (1961-65). In the meantime, however, the Soviets had suspended all economic and technical supports, and withdrawn all the Soviet experts from the country.

CULTURAL REVOLUTION: IF THIS IS PARADISE, WHAT THEN IS HELL?

From the point of view of the economy, 1958–61 was the darkest period in the Mao era, compelling Mao Zedong to move to the sidelines of party politics²⁴ and temporarily paving the way for

moderates within the party such as Liu Shaoqi, Deng Xiaoping, Peng Zhen and others to take control of the situation. It was this group, headed by Liu Shaoqi, that took some quick corrective measures to restore normalcy and stability in the economy, though without deviating at all from the ideological rectitude. They simply re-organised the commune system, encouraged populist-type leadership at all levels, vested production authority in factory managers and laid emphasis on realistic planning.

The Chinese economy was always like a fertile soil, and responded immediately to the softening of the rigorous economic policy being followed by the Communist Party. Foodgrain production, for instance, increased from 143 million tonnes to 194.5 million tonnes, on account of increased consumption of chemical fertilisers (from an average of 4.3 kg/hectare in 1961 to 18 kg/hectares in 1965), and an increase in the mechanical/electrically operated irrigated area (from 5.3 m.ha to 8.1 m.ha). The production of both cloth and edible oils doubled and the overall GDP (at the prevailing exchange rate) increased from less than USD50 billion to nearly USD70 billion (growing at the rate of 8.9 per cent a year). After 1965 and till the end of the Mao era, there were no significant economic disruptions, except in 1972, when the economy grew at a much slower rate.

Mao, as mentioned before, had gone into self-imposed semi-exclusion after owning responsibility for the fiasco of the GLF and the famine, but he had retained the Chairmanship of the CCP and continued to be at the helm of party affairs. He did not interfere much with the economy, but was watching the developments and hatching a coup of a different type. He did not stop Liu Shaoqi, Deng Xiaoping and others, the so-called rightists within the party, from doing what they did to put the economy back on to the rails, but was viewing them as creeping capitalists and their works as 'anti-socialist tendencies' in the country. He was growing increasingly uneasy, and in 1962, had launched a campaign to 'purify' the party through the Socialist Education Movement (SEM) (1962–65), before finally launching the infamous Cultural Revolution in 1966, which continued till his death in 1976.

While the objective of the SEM was to restore ideological purity, re-infuse revolutionary fervour and intensify the 'class struggle,'

the Cultural Revolution was essentially intended to get rid of those who were by then perceived as capitalists, and those he (Mao) had identified as, 'bourgeois obstructionists'. By then, there were three prominent factions within the CCP: the Mao-Lin Biao group, the Liu Shaoqi-Deng Xiaoping group and a moderate conciliatory group comprising Premier Zhou Enlai and others. Finally, it was the Mao-Lin Biao group that prevailed to launch the Cultural Revolution. Liu Shaoqi, Deng Xiaoping and their fellow 'capitalist roaders' were purged from public life in 1967, while Lin Biao was promoted to the post of Party Vice Chairman and even named as Mao's successor. Mao got himself confirmed as the supreme leader. It was at this time that the Gang of Four also rose to prominence and a position of higher influence.

This time, however, Mao, was careful that the economy did not collapse. Accordingly, he did not tamper much with the working of the economy. Instead, he focused on damaging the very basis of a civil society by creating a system where everyone lived under an unprecedented state of fears and uncertainties. Initially, the Cultural Revolution was launched by ushering in a reign of terror by the young (mostly teenaged) Red Guards that Mao had encouraged. Deep-rooted fears were instilled in the minds of the people by 'bloodcurdling diatribes' through the 'blurring loudspeakers'²⁵. Very soon, the reign of terror and fear, which was unleashed by the immature illiterate young people in the garb of Red Guards, started making people wonder whether socialist China was really a 'paradise on earth' as they were told and made to believe. *If this is paradise, what then is hell?* was the question in their minds but that they never dared to ask openly. Some of the social evils that the Cultural Revolution, in its very initial stage, generated were stealing, gangsterism, street-fighting and black marketeering. The young Red Guards, as mentioned, were primarily uneducated young people from poor families, volunteering themselves into the new-found occupation of Red Guardism.

One of the machinations of the Cultural Revolution was 'Thought Reform Through Labour'. Schools, colleges and universities were closed. Then, it was the turn of the intellectuals, professionals and others to go to villages and remote places to do manual labour. No one was spared. It was not meant to increase production, nor to

take another attempt at a great leap on economic front, but simply to ensure that his (Mao's) country's people, men and women alike, and irrespective of physical abilities, were toiling and suffering like beasts of burden. It was as if being a beast was a necessary first step to becoming a socially educated man. It is doubtful that Mao's communism was really about any material improvement in the lives of the people and putting China on a solid economic foundation. The core intention behind the Cultural Revolution, as has been mentioned, was to project his adversaries, such as Liu Shaoqi and Deng Xiaoping, as revisionists. When they were purged of their positions in 1967, the rigours of the Cultural Revolution had been considerably lessened.

As has been mentioned, Mao did not undertake any major experimentation with the economy, but the tense political situation did not allow anyone to do much on the economic front. Liu Shaoqi and Deng Xiaoping were already out of action. Deng Xiaoping, of course, was brought back in 1973, but mainly as a reserve force, whose administrative capability could be used in case the economy needed his expertise. Mao secretly admired this quality in Deng Xiaoping. Premier Zhou Enlai, of course, had talked of Four Modernisations²⁶, but that was when he was only a few months away from his last day.

During the decade beginning 1965, the economy was deprived of any significant policy encouragements, and left to itself to roll on with the momentum that was imparted to it by the Shaoqi–Xiaoping combine prior to 1965. During 1965–76, the GDP grew only at the rate of 2.1 per cent annually but purely on the strength of better organisational structure. During this period (see Table 2.2), the land area under cultivation declined by four million hectares, yet grain production increased from 194.5 million tonnes to over 286 million tonnes. This was possible due to increased cropping intensity, besides an increase in the area under irrigation, the growing use of chemical fertilisers, and the ability of the farmers to spend more time on farming activities. Much of the increase in grain production (an annual average of 3.5 per cent) was due to a very high growth rate in the production of wheat (6.5 per cent) as compared to rice. However, the production of commercial crops such as sugarcane, cotton, etc., remained stagnant during the period 1970–76.

Table 2.2
Performance of Agriculture in China (1965–76)

	1965	1970	1971	1972	1973	1974	1975	1976
Cultivated								
Land Area (m. ha)	103.6	101.1	100.7	100.6	100.2	99.9	99.7	99.4
Irrigated Area (m. ha) ^(a)	8.1	15.0	16.6	17.5	19.8	21.7	22.9	24.2
Grain Production (m. t.)	194.5	239.9	250.1	240.5	264.9	275.3	284.5	286.3
Rice (m. t.)	87.7	109.9	107.7	113.3	121.7	123.9	125.6	125.8
Wheat (m. t.)	25.2	29.2	32.6	36.0	35.2	40.8	45.3	50.4
Oil Crops (m. t.)	3.6	3.7	4.1	4.1	4.2	4.4	4.5	4.0
Cotton (m. t.)	2.1	2.3	2.1	1.9	2.6	2.4	2.4	2.1
Sugarcane (m. t.)	13.4	13.5	13.1	16.4	17.0	16.4	16.7	16.6
Total Sown Area (m. ha)	143.3	143.5	145.7	147.9	148.5	148.6	149.5	149.7
Fertiliser Con- sumption (kg/hr)	18.4	34.6	35.7	41.7	51.0	48.6	53.8	58.6

Source: United States Department of Agriculture (USDA) database.

Note: (a) Mechanical/Electric operated irrigation only.

m. ha = million hectares, m. t.= million tonnes.

MAO'S ECONOMIC IDEAS: MARRED BY ADVENTURISM

What has been narrated so far is a broad overview of the state of the economy during Mao Zedong's regime. In all fairness, it has to be admitted, however, that the state of the economy did not in any way reflect his economic ideas. One lesson that we learn from the story of China under the Mao era is that faulty implementation can make a mockery of ideas, however great these may be. We need to evaluate Mao's economic ideas in the context of the state of the world economy during his time. As mentioned earlier, Mao had begun well. His First Five Year Plan (1953–57) was reasonably successful. During this period, Mao followed the Soviet style of centralised planning, resulting in a higher concentration of authority with the Central government. For instance, the number of enterprises subordinated to the Central government had increased

from 2800 in 1953 to 9300 in 1957. During the said period, the Central government accounted for as much as 75 per cent of the total budget.

However, Mao Zedong was not really in favour of over-centralisation; nor was he an admirer of Soviet-style centralised planning. On the contrary, he was in favour of de-centralisation and the decentralised planning model. He believed that for a vast country with a vast territory (comprising a diverse geography) and a large population, initiatives for development had to be taken by both the Central and local governments (Lien, 1999). 'The Central authorities should take care to give scope to the initiative of provinces and municipalities, and the latter in their turn should do the same for the prefectures, counties, districts and the townships; in neither case should the lower levels be put in a straight jacket' (Mao, 1956).

The Third Plenum of the Eighth Party Congress, was focused on the Centre-province relationship, and decided to delegate the supervisory power of all except large state enterprises to local governments. The latter were also granted greater autonomy in fiscal matters, allocation of resources, planning, pricing of non-important products, personal management, etc. Similarly, if we ignore the effect of the GLF and instead just examine its ideological aspect, we will observe that the idea of the GLF was about further de-centralisation. The idea of village communes, as independent economic units, was a manifestation of de-centralisation at its extreme. The communes were supposed to oversee every economic activity, including agriculture and manufacturing. It was Mao's idea of socialism with Chinese characteristics, quite unlike the Soviet model. This apart, it was also decided to de-centralise the planning system itself, by segregating the country into seven co-operative regions. Each such region was to be responsible for developing a complete industrial structure and for achieving faster growth. By December 1958, most SOEs were again delegated to local governments, reducing the number of enterprises under Central authority from 9,300 in 1957 to 1,200 in 1958, and the share in the industrial output of SOEs under Central authority declined from 40 per cent to a mere 14 per cent within a year. These two, namely the commune system, on the one hand,

and de-centralisation of the planning system, on the other, were the two basic planks of the GLF. The latter strategy, we believe, had immediate positive effects. The communes had established a large number of commune and brigade enterprises, later known as township and village enterprises (TVEs), accounting for a total industrial output of 10 billion yuan in 1959, and employing about 18 million people (Qian, 1999; Byrd and Lin, 1990).

Conceptually, the strategy for the GLF was, perhaps, not faulty. Why then did the GLF prove to be an utter disaster? And why did it result in The Great Famine? There are several reasons for this, but here we shall cite the two main reasons. First, the less important one was the natural factor, that is, the drought of 1960–61. Second, the famine was largely caused by the failure of the administration. It was a social catastrophe, perpetrated by total abuse of the authority vested with the corrupt and inefficient local authorities. ‘The famine showed clear marks of omission, commission and provision’ (Vaclav Smil, 1999). The greatest act of omission was the failure of the Chinese rulers to acknowledge the famine, as also the fact that it took the governments nearly three years to act. The blame for the famine cannot be passed on entirely to Mao, but the entire body of leadership was culpable. The questions that however, remain unanswered are: Were Mao’s colleagues in the Central CCP and in the provinces not under his control? How did he allow himself to be misled by fabricated reports?

The disaster led to some reversal of Mao’s de-centralisation process, and caused re-centralisation of the planning system. Even the importance of the communes was diluted to a significant extent. Re-centralisation and limited liberalisation measures introduced during the period 1961–65 were not to Mao’s liking, even as he was forced to undergo self-criticism of his GLF policy in 1962, and own responsibility for the disaster. During his second incarnation as Premier, he initiated the Cultural Revolution to create an altogether new order, in which the bureaucracy had little role to play. The Central Planning Commission did not make any annual plan for the years 1967 and 1968. While this subsequently caused another economic setback, it spoke of Mao’s intolerance of centralisation, and how the bureaucracy needed to support it. In 1970, (see Qian, 1999), nine ministries in charge of various aspects

of planning were merged to create a new state Planning Committee with a staff strength of only 619 (11.9 per cent of the total, before the Cultural Revolution).

What took place in 1970 was the second wave of re-centralisation, which was much deeper than that in 1958. Again, a high growth rate was targeted in the Fourth Five Year Plan (1971–75), and again steel production was slated to double in five years. This again brings us to the question as to why Mao was so fixed on high growth. Alternatively, why was achieving high growth so important to him? The answer lies beyond economics, and in the realm of Mao's paranoia about the Soviet Union, in particular, and the capitalist world, in general. For some reason, he was expecting a Third World War to take place soon, and wanted to prepare China for that. In his view, only de-centralised multiple strongholds of local economies could make China a strong economy. Accordingly, he practically undid what Deng Xiaoping and Chen Yun had done.

The number of Centrally-supervised SOEs was brought down from 10,533 in 1965 to 142 in 1971, and the share of such enterprises in the national industrial output came down to mere 8 per cent. Once again, local governments were made responsible for both material allocation as also fixed investment decisions. Under a new fiscal contracting system, provinces were allowed to contract remittance of a fixed sum from revenues collected by them and receive a fixed amount from the Central government. But all these stipulations created confusion and chaos in the economy in the mid-1970s.

END OF THE MAO ERA

In 1976, China was not only in the midst of utter chaos and political instability, but was almost as clueless about its future direction like a ship without a radar. Chairman Mao was practically in bed all the time during the months leading to his demise in September. The Gang of Four under Mao's third wife Jiang Qing, was desperate to grab power, even though she had no popular support within and outside the Party. She had all along attacked Zhou Enlai,

the Premier. But after his death on January 8, 1976, which passed without proper official mourning, and after Hua Guofeng was chosen to succeed him by Chairman Mao himself, Jiang directed her attack against Deng Xiaoping, who was virtually nowhere in the picture in the power circuit at that time.

During the first week of 1976, a significant incident occurred at the Tienanmen Square. In a spontaneous popular move, the people decided to pay their respects Zhou Enlai and began placing mourning wreaths for him at the Monument to the Revolutionary Heroes in Tienanmen Square. April 4 was the day of the Qing Ming festival for honouring the dead. On that day, the Square 'was filled with tens of thousands of people singing, making speeches and reading poems' (Jung Chang, 1992). The day after, the crowd returned again, but this time it was an angry crowd.

Actually, they were demonstrators criticising Jiang Qing and her associates. Ten thousand militiamen, three thousand policemen and five battalions of security men were deployed to seal off the Square and beat up the demonstrators. Following the incident, Deng Xiaoping, who Mao thought was behind the incident, was, for the second time purged of all his positions in the Party as well as the government. Hua Guofeng was made permanent Premier and Vice Chairman of the Party.

After the incident and encouraged by the purging that followed, Jiang Qing re-doubled her attack on Deng Xiaoping. In July 1976, there was a devastating earthquake in the city of Tangshan, a coal-mining city near Beijing, that, according to an official broadcast, killed nearly 2,50,000 people and left over 1,60,000 injured. The victims needed quick and effective relief operations. Jiang was so vehement in her tirade against Deng Xiaoping that at that moment, she issued a strong message for the people through the official media. 'There were merely several hundred thousand deaths, so what? Denouncing Deng Xiaoping concerns eight hundred million people' (Jung Chang, 1992). To Jiang and her associates, Deng was the only real opposition, in view of the latter's growing popularity in the minds of the people, which was clearly evident in the act of mass protest at the Tienanmen Square. The CCP was, however, getting increasingly suspicious of the motives of the Gang of Four, and were looking for an opportune moment

to denounce the Gang members, or perhaps it was merely awaiting the death of Mao. Within a month after his death, the Gang of Four was arrested and removed from the scene forever.

The Cultural Revolution was formally ended by a pronouncement at the Eleventh National Party Congress (12–18 August 1977). The Gang of Four was held responsible for the developments during the period of the Cultural Revolution. The year 1976, in the minds of the people at large, was the year when the 'Mandate of Heaven' was withdrawn. Politically, it was a year of great vacuum for the first time since 1949, with three top leaders expiring within a year—Zhou Enlai (in January), Zhu De (in July) and Mao Zedong (in September). It took a couple of months for the party to re-organise itself and re-assess the situation before it.

The party had been in the midst of internal upheavals ever since the failure of the GLF. The rigorous implementation of the Cultural Revolution had only helped to create visible chasms within it between the radicals and the moderates. By 1975, the party was manifestly divided into two factions. After the death of Mao, the moderates who came to dominate the political scene, while the radicals became vulnerable in the face of the changes that were in the offing. It was not so much a power struggle, but an intense ideological strife. Mao had already announced Hua Guofeng as his successor, and his Chairmanship of the Party was confirmed. The question, however, was about the road ahead for the communist China. Should China continue to follow Mao's policies and wills or not, was the issue. Actually, the central issue within the party pertaining to this question related to the need for, and the direction of, reforms. It was on this vital issue that Hua Guofeng failed to rise to the occasion. His leadership was shortlived, and usurped by Deng Xiaoping, who was twice purged of and twice restored to power.

NOTES

1. The members of the Gang of Four were Madame Jiang Qing (Mao's wife), Wang Hongwen, Yao Wenyuan and Zhang Chinqiao.

2. Every dynastic ruler had sought to change the lifestyles of the Chinese people according to the lifestyles of the respective dynasties, and, accordingly, interfered into the minutest details such as the type of haircuts, hair length, manners, etc.
3. Meaning leading a life, including a lifestyle, set by the party cadres, who often interfered in such trivial matters as to whether one should maintain physical cleanliness through regular baths or washing clothes. Both the activities, and many such other daily chores, were considered as a revisionist mentality.
4. Meaning daily routine as set out by the local party leaders and a routine that allowed little scope for a private life.
5. When the Kuomintang first arrived, they issued a new currency called Law Money. After a while, when this failed to control inflation, they issued a new currency called the 'Golden Yuan'. Jung Chang writes that it 'soon became worth so little that when my mother wanted to pay her school fees she had to hire a rickshaw to carry the huge pile of notes'.
6. Much of the crisis during this time was a man-made crisis. Spiralling inflation had resulted in the large-scale hoarding of foodgrains by the traders. People used to sell daughters for 10 kilos of rice. Also, there was large-scale prevalence of prostitution during this time.
7. The five essential commodities were: rice, wheat, edible oil, steel and coal.
8. The Kuomintang basically believed in capitalism, but were acting under the Soviet influence so as to obtain assistance.
9. In ancient times, for instance, a peasant leader established the Han dynasty. During the medieval period, the Ming dynasty was established by a peasant named Zhu Yuanzhang, who had overthrown the Mongols in 1368. In later years, the Taiping Civil War was also initiated by the peasant community.
10. During the dynastic rule, the expenses of the ruling elite as also the entire burden of the military and all developmental expenses were borne by the peasants, who, besides paying taxes, were also required to provide physical labour either free or for a minimum wage.
11. Historically, Chinese peasants lived in utter poverty. After doing back-breaking work throughout the day, they needed something to relax on, and yearned for a wooden chair on which they could sit and straighten the backs.
12. A communist in China under Mao was supposed to give himself or herself completely to the Revolution and the people, so much so that any demonstration of affection for children was frowned upon as a sign of divided loyalties. Anything that was regarded as having nothing to do with revolutions, like carrying one's own children in one's arms, washing clothes daily, etc., could be regarded as counter-revolutionary and had to be stopped as speedily as possible.
13. See Zhisui Li, 1996, pp.116-18.
14. Called the 'Sino-Soviet Treaty of Friendship, Alliance and Mutual Assistance'.
15. In the late 1950s, Mao's ideas were very daring and risky. His plan for China was grandiose. According to Dr Li, 'in insisting on rapid transformation of China into a socialist state, he was defying the more deliberate and cautious central leadership' (Zhisui Li, p. 166).
16. Mao and Stalin never got along well together. Mao had even accused Stalin of trying to further divide China and create a third communist party in Manchuria. The last meeting between the two leaders had taken place by the side of Mao's

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swimming pool, and that was the start of an open split between the two nations.

17. Writer Andrew J. Nathan, in his foreword to Dr Li's *The Private Life of Chairman Mao*, says, 'In a vast, continental country with huge and poor population, Mao sought economic growth through mass mobilisation, trying to substitute ideological fervour for material rewards.'
18. See Dr Zhisui Li, p. 125.
19. See Jung Chang, 1993, pp. 296–300.
20. Same as (19) above.
21. This had been wrongly touted by many as China's revolutionary success in the use of bio-fertilisers.
22. By 1958, the Soviets had withdrawn all economic and technical support.
23. For a short while, the responsibility was given to Liu Shaoqui–Deng Xiaoping to pull the economy out of the mess.
24. Mao resigned only from the chairmanship of the Republic, but remained the chairman of the party.
25. See Jung Chang's *Wild Swans*, pp. 374–93.
26. In January 1975, Zhou Enlai had outlined a programme at the Fourth NPC that came to be known as 'Four Modernisations for the Four Sectors', that is, agriculture, industry, national defence, and science and technology.

Three

Struggling to Stand Straight

Initial Decade of Reform: 1978–88

At a session of the Central Committee of the Party in July 1977, Deng Xiaoping was restored to power, and was re-instated in all the posts from which he had been removed in 1976. In a way, this was a great setback for the Mao loyalists, and, to some extent, even for the legitimacy of Hua Guofeng. The Eleventh Party Congress that confirmed Hua Guofeng as Party Chairman, had also appointed Deng Xiaoping and three others¹ as Vice-Chairmen.

For Deng, this was the beginning of his, if we may say so, new political life as a statesman. He had joined the party in 1924 and was one of the closest associates of Mao, almost throughout the communist movement, leading to the foundation of the PRC. However, when it came to choosing the strategy of leading the country and the economy into becoming a great socialist power, he always adopted a bold-but-cautious approach. His differences with Mao on the GLF strategy and the implementation of the Cultural Revolution had led to his removal from all positions in 1967, though his usefulness as an able administrator and his understanding of the functioning of the economy had saved him from total isolation. He was re-instated in 1973. It was purely on account of the political vendetta, unleashed by Jiang Qing, that he was purged again in 1976. But by then, he had developed enough clout within the party, which was itself keen for a change and ready to move along the reformist path. More importantly, the people were supportive of his ideas².

UNDERSTANDING DENG XIAOPING

On being restored to power in 1977, with full dignity and privileges, Deng had promptly got down to the implementation of his

ideas. At the same time, considering the sensitivities of the Chinese people and the risk of the turmoil and consequent instability that China was prone to at that time, he chose an experimental approach to change. To begin with, he had to get the party on his side, but the party was headed by Hua, a Mao protégé, who was in favour of the status quo³ and wanted to continue the policies of Mao⁴. Accordingly, he had to begin with attempts to reform the Party. The Eleventh National Party Congress (NPC) was committed to building China into a modern powerful socialist country by the end of twentieth century, and was supportive of the 'Four Modernisations'⁵. But Deng found the power structure, that had been put into place by the Eleventh NPC, unsuitable to his objectives. He was rather apprehensive of the Mao loyalists and the possible derailment of the political process that was necessary for undertaking economic reforms.

The power balance between the two competing factions⁶—one led by Hua Guofeng and other Mao loyalists, and the other under himself and his fellow moderates—had to be restored in his favour. Acting quickly to capitalise on the prevailing sentiments against the Cultural Revolution, and in a bid to initiate a broad range of reforms, he undertook the re-organisation of the bureaucracy and reform of the educational system that had been crippled during the period of the Cultural Revolution. Further, he got the party to denounce the mistakes of the past and the 'two whatevers' policy⁷. It was at the Third Plenum of the Eleventh NPC (in December 1978) that the historical party line of the protracted class struggle was abandoned in favour of Four Modernisations, signalling the party's commitment to building a modern China and paving the way for its rapid economic growth.

It was this Third Plenum of December 1978 that proved to be the real turning point for post-Mao China. For the first time, economics got priority over politics, and policies were made responsible for successes and failures on the economic front. In the same Plenum, the party also approved the New Agricultural Policy curbing political restrictions on the peasants, and allowing them to produce more on their own initiatives. The other initiatives of Deng Xiaoping that were approved by the party, included the establishment of diplomatic relations with the United States, and termination of the Treaty of Friendship with the USSR that was to expire in 1981.

Even though these were minor preliminary steps towards the modernisation of China, they had earned Deng Xiaoping considerable criticism from the extreme leftists within the party, and forced him to halt the process from rolling forward for a short period. The indomitable Deng, however, undertook some cleaning up operations to silence his critics. It was a political warfare directed against Hua Guofeng and the leftist elements in the party, a movement that was aimed at helping the Communist Party get rid of the extreme leftists. He focused his energies on the preparation of a document for presentation at the Fourth Plenum of the Eleventh NPC held in September 1979. The document⁸ contained an assessment of the achievements of the Party since its establishment in 1921.

The document not only listed all the achievements of the party, but also pointed out the mistakes committed by the leadership (in an oblique reference to Mao) that affected the lives of the people. The Cultural Revolution was seen as an ‘appalling catastrophe’ and held responsible for the ‘severe setback’ to the socialist cause⁹. The Fourth Plenum further vindicated Deng’s ideas, besides adopting a new ideology in favour of ‘seeking truth from facts’¹⁰. The elementary agricultural reform, in the meantime, had encouraged great initiatives by the farmers, the results of which were already visible. In a further setback to Hua Guofeng and a vindication of the reformist measures, the Plenum accepted the resignations of the leftists from the party as well as from the state posts. The latter had sought to resign in protest against the initiatives of Deng Xiaoping. In the subsequent political developments, Deng gained considerable mileage, with his chosen people being awarded several key positions, and in 1980, Deng himself became the Premier, following the resignation of Hua Guofeng.

It was then that Deng and his associates could get down to the business of modernising China with full vigour, placing economic progress above all other objectives. However, for a country that was soaked in ideological fervour, reform measures needed to be imparted an ideological basis that could not be totally alien and disconnected. Deng and his associates did not falter in this. Reform, it was articulated, was not being undertaken in view of any failure or weakness of socialism, but was needed only to strengthen the socialist cause. At the forefront was always the interest of China and the Chinese people. Two of Deng’s many phrases were useful in

this context: 'seeking truth from facts' and 'socialism with Chinese Characteristics'¹¹. The second phrase was reminiscent of several attempts at reforms undertaken earlier by some of the dynastic rulers, and greatly appealed to the Chinese sentiment.

Articulation of the cause for reform was an on-going process, and was felt necessary not only to sustain the party support but also as a check against the possible backlash (read revolution), which the country could ill-afford at a time when the world's economic and political climate was changing rapidly in technological as well as in geo-political terms. It was also not Deng's intention to dismantle socialism. On the contrary, he was an ardent socialist himself, and would not accept anything that posed even the slightest risk to China's socialist credentials; Mao had wrongly implicated him for the Tienanmen incident of April 1976. It was Deng who had suppressed the democracy movement in Tienanmen Square in 1989. The fact that he had been able to pursue reforms, packaged in the form of socialist ideals, spoke of his ability as an effective communicator.

Deng used to argue that for its success, socialism must establish a harmony and convergence between theory and practice, and that the two must not be divorced from each other, as had been the case earlier. The mistakes of the past, in his view, lay in the lack of harmony between the two. He also did not counter the Marxist–Leninist creed, and was instead of the view that the same was also adaptable to China's situation, but he maintained that China was still in the initial stage of socialism. The progress of socialism, he argued, was hampered by the mistakes committed by the leftists at the time of the GLF and the Cultural Revolution.

What had endeared Deng most to the hapless and exploited masses, however, were some of his approaches to socialism. He ardently believed that socialism was not about sustained poverty, nor poverty a socialism. 'To get rich is glorious' was the new *mantra* that became a soothing ring tone to the people's ears, like a monsoon bringing relief after a prolonged drought. His management ethos, spelt out in a speech in 1975, was equally endearing: 'Leaders should say to the professionals, "I follow, you lead"'. On another occasion, he had outlined his plans for improving the living standards of the people, allowing them more freedom and ending their political victimisation, and made him a sort of

folk hero¹². One of his famous oft-quoted statements, it may be mentioned here, was: ‘It does not matter whether a cat is black or white, so long as it catches mice’. Many people understood this statement, rather unfairly to Deng’s thoughts, as a reflection of his economic philosophy. He had apparently made the statement in a fit of frustration in the aftermath of the Great Famine and its terrible consequences¹³. If at all, it reflected his feelings for the suffering millions in those days.

INITIAL REFORMS (1978–83)

Deng had an unenviable task before him. Modernising a backward economy into a powerful one involved enormous risks. As has been mentioned, he had secured the party’s mandate, but many people were waiting to see him fail. At the same time, China faced financial and technological constraints, coming from her years of isolation from the rest of the world. In 1978, China was virtually on its own. More importantly, Deng had to show a quick turnaround of the economy and visible signs of improvement in the living standards of the people. Nobody was ready to wait any longer. He needed luck on his side.

Further, Hua Guofeng had added to the challenge by announcing in early 1978 his own plans for the modernisation of China, which was a kind of another version of the GLF. Notable among Hua’s plans were three targets to be achieved by 1985, including the production of: 60 million tonnes of steel (as against 24 million in 1977), 400 million tonnes of grain (as against 278 million tonnes in 1977), and 1,000 million tonnes of coal (as against 500 million tonnes in 1977). Besides, 122 major projects were outlined that were to be implemented with the extensive use of domestic resources, mainly manpower and raw materials.

Fortunately for Deng, Hua Guofeng was getting sidelined by the Party. In its wisdom, the Party had decided that the year 1978 would be a year of exploration and assessment, and that 1979 would be a year of decision-making based on detailed assessments. They wanted to assess a wide range of things, including the response of the Western investors and banks to China’s decision to modernise along the market way and the capabilities of the

Chinese to handle the challenges of modernisation. It was a kind of 'look, before you leap' sentiment. Delegations of the party were sent to various Western countries to study the possibility of getting foreign assistance, including investment.

The reports from the delegations were highly encouraging. The Western enterprises were, in a way, thrilled that China wanted to open up. The establishment of diplomatic relations with the USA and non-renewal of the Treaty of Friendship with the USSR had already been hailed. Besides, faced with an extremely difficult world economic recession in the aftermath of the oil crisis of 1978–79, the Western enterprises were already looking for new avenues for growth. When the Chinese delegations told them about China's intention to open up, they could immediately visualise a picture of one billion markets. In fact, there was a great deal of euphoria, '...almost daily came reports of one huge deal after another—the millions became billions and billions were doubled and re-doubled. Press statements were issued by excited Western business executives announcing the consumption of vast deals ranging from power stations and steel mills to Coca-Cola plants and breweries'¹⁴.

All these developments took place in the context of Hua's plan for modernisation. The party took due note of the responses of the Western investors, but refused to be swept away by the euphoria. Instead, they evaluated the Western response as a litmus test of several hard realities prevailing in China at the time. After the debacle of the GLF, the CCP was extremely cautious. They decided in favour of realism as the touchstone—'no romancing, no building castles in the air, no carving out of economic empire'¹⁵. You don't serve a hungry and starving man with plenty of five-star food, for he will instantly die of indigestion. The CCP was right in deciding against Hua's plan, and in instead favouring a gradualist approach. There was consensus on the implementation of economic reforms and opening the door to the outside world, but the course and the pace of reform had to be different—realistic, achievable and sustainable.

Chen Yun, the main architect of economic reform and a close associate of Deng Xiaoping, had articulated an ideological basis for reform that was politically safe and economically viable in the given

politico-economic circumstances of the time. It was an ideology favouring planning as the principal element and the market as the supplementary element. According to Chen's ideology, there should be two types of economies throughout the socialist period—planned economy and market-regulated economy. Economic reform was to be primarily about facilitating the latter, while planned economy was also to undergo managerial and other changes in order to retain its relevance and usefulness. Ultimately, of course, both would complement each other in developing a strong economy. In this perspective, the reform measures that were to be initiated, would usher in the era of a regulated market economy.

ASPECTS OF INITIAL REFORMS

Several aspects of what may be called the 'initial phase of reform' (1978–88), can be observed, namely, de-centralisation, marketisation, financial, internationalisation, etc. Some of these aspects are briefly discussed here.

De-centralisation was not really a new initiative. The structure of governance, which was introduced in 1949, was virtually a de-centralised model within a centralised system. It is a different matter that the de-centralised elements had been functioning at the dictates of the centralised authority of the CCP and Mao, at the helm of the dictatorial regime, was running the affairs of the country in the style of a dynastic ruler, but the Constitution had provided for a de-centralised structure. However, as has been mentioned in Chapter 2, Mao had preferred de-centralisation as opposed to Soviet-style centralisation. But it was a limited de-centralisation that did not penetrate much beyond the layers of provincial administrations. The system of agricultural-cum-rural communes, it may be mentioned, was also a kind of de-centralisation. During the Mao regime, de-centralisation did not work because of two reasons. First, de-centralisation was kept limited and was not allowed to percolate much down to the lower levels due to the strangulating control over the provincial and local authorities by the CCP. Second, not only did de-centralisation not percolate down to the people, but the CCP

under the Chairmanship of Mao had completely robbed the people of any kind of freedom and incentives. There was little, except biological, difference between the 'socialist' Chinese and the draught animals.

The de-centralisation initiated by Deng Xiaoping, on the contrary, was aimed at converting the socialists into human beings, by allowing the restoration of their human instincts. The introduction of the Household Responsibility System (HRS) in agricultural production, in a phased manner¹⁶ was a significant first step in this direction. For the first time, de-centralisation was directed towards people at the grassroots, with a view to incentivise them for translating their latent capabilities and initiatives into hard work. Under the HRS, the households were given contracts to farm a piece of land each, along with the right of management of the land. The households were allowed to retain all the surplus products, after paying what they should be paying to the government and the community. The fruits of their labour were no longer to be entirely appropriated by the state. This single action helped legitimise the efficiency of the people, and spark the entrepreneurial spirit among them. The farmers had immediately responded by way of judicious allocation of family resources (especially labour), diversion of surplus labour into new avenues, the advent of specialisation (giving rise to the emergence of specialised households), and putting in hard and longer hours of work. China's agriculture began to undergo interesting structural changes,¹⁷ as a result.

De-centralisation was also used as the first tool for reforming the State Owned Enterprises (SOEs), though to a limited extent. As in the case of the HRS, the SOE reform was also implemented in phases and was meant to incentivise the SOE managers to carry out profitable operations. The initial reform directed at the SOEs was about the autonomy of enterprises and the retention of profit. The enterprises were given limited autonomy with respect to production and sale, in the sense that they (the SOEs) could produce for, and sell to, the market after completing the planned quota of production. They were, however, required to retain the profits under three separate funds, namely welfare (for example, housing), bonuses, and product development. By 1980, about 60 per cent of the SOEs were operating under the profit retention scheme (PRS) introduced in 1979. Apart from the SOEs, relaxations were

granted to a large number of commune and brigade enterprises (so-called township and village enterprises or TVEs), by way of allowing them to enter into the production of items other than agriculture-related ones, namely fertilisers, pesticides, farm implements, etc.¹⁸. Besides, they were also allowed to sell their produce beyond their local markets.

Incentivisation was an integral aspect of the de-centralisation strategy. Both HRS and PRS were essentially meant to motivate people to produce more and beyond the quotas for personal gains. Allowing people to earn profits was an incentive that the government provided without any financial cost to itself. However, to the commune and brigade enterprises, the government had also extended a facility of a tax holiday of 2–3 years, in order to allow such enterprises to diversify their operations through the re-deployment of profits. The measures aimed at incentivisation were broad-based, and intended to cover every level of the government.

Fiscal de-centralisation was a very significant step in this direction. So was financial de-centralisation. The fiscal system was highly centralised during Mao era, when the centralised Planning Commission under the Central Government used to determine the local revenue and expenditure plans every year, under a system of unified revenue and unified expenditure (*tongshou tongzhi*). This had changed with the introduction of the fiscal contracting system (FCS), implying eating from separate kitchens (*fenzao chifan*). It was intended to work in the following way. The provincial government's revenue income was to be divided into two parts: the Central fixed revenue and the states' own revenue, that is, a part of the total revenue income would go to Central Government and a part would be the local revenue, which the provinces were to share with the local governments. Along with this, the provincial governments were given the autonomy to structure their expenditure plans, in consultation with the local governments, in consonance with their developmental needs and priorities. The revenue income that the provinces were allowed to retain was, thus linked to the level of their economic prosperity. A similar arrangement was followed for the revenue sharing relationship between the local and provincial governments.

The fiscal contract system acted as a great incentive for the local governments, who were encouraged to increase their revenue

collections for two reasons. First, they realised that revenue was linked to expenditure. Hence they had the incentive to boost expenditure. Second, revenue collection depended on development. At the level of the local governments, therefore, the focus of expenditure was on development—enhancing expenditures such as the expenditure on infrastructure. The FCS, in this sense, had greatly influenced developments right from the early days of reform. The rapid growth of infrastructure (mainly economic infrastructure) since 1978 can, to a large extent, be attributed to this factor.

Fiscal reform was subsequently supplemented by the actions the financial sector. During the era of water-tight centralisation of the economy, only the Peoples' Bank of China (PBOC) was the sole in-charge of central banking and commercial banking operations. In 1983, for the first time, four specialised banks were created to carry out commercial banking operations: Agricultural Bank of China (ABOC) for rural areas, Industrial and Commercial Bank of China (ICBOC) for the industrial sector, Peoples' Construction Bank of China (PCBOC) for long-term finance, and the Bank of China (BOC) for foreign exchange business. At the same time, the enterprises were allowed to open accounts with more than one bank. The immediate effect of all these measures was to usher in a competitive financial market, though in a limited way.

Another aspect of the early reform measures, marketisation, was a direct fallout of the HRS, PRS, and financial reform. Peasants as well as the enterprises were encouraged to produce for the market and make profits. The direct and immediate result of this was the advent of a dual pricing system. The Government too wanted to use price as an incentive to make people produce and earn more, and to ensure higher growth in the process. For instance, in 1978, when the grain procurement price was increased by 20 per cent, the input prices were also reduced. At the same time, market prices were not allowed to be determined completely by supply and demand; limits were fixed in relation to the procurement price. For instance, in most cases, market prices were not allowed to exceed more than 20 per cent of the government price. Under this practice, those who could afford to do so could buy more and eat more by paying higher prices. In this way, the government had encouraged a reasonable degree of

inequality. However, in order to be unequal among the equals, the households had to work more in order to earn more.

Finally, another aspect of reform had attracted the attention of China observers the most. Known as internationalisation, this was brought about through an ‘open door’ policy. For China, it was not really a new idea. During the historical period of the Ming and the Qing dynasties, the rulers had experimented with the ‘open door’ policy in a limited way. However, much of it was implemented through a tributary system and meant to contain the imperialist designs of the foreign, especially the Western, powers. Trade liberalisation was not the objective of this policy in those days. On the contrary, higher import duties used to be levied to stop foreign goods from penetrating the hinterland markets. As seen earlier, China was under circumstantial compulsion to adopt an ‘open door’ policy, and did not have a good experience with it. During Mao era, the economy was a virtually closed economy, even as China’s two-way (export and import) trade had moved from around USD 3 billion in 1950 to USD 13 billion in 1976. The increase in trade was due primarily to food imports.

The ‘open door’ policy, introduced by Deng Xiaoping, was experimental and gradual, aimed primarily at attracting foreign investment. Export promotion was the concomitant objective, to be achieved from the inflow of foreign investment in the special economic zones (SEZs). In other words, exports were to ride on the back of the foreign investors. Liberalisation of trade, especially of imports, did not take place during the initial five-year phase of economic reform. In 1979, the Guangdong and Fujian provinces were chosen to experiment with openness, when they were allowed to adopt special policies suited to their development. In 1980, when China joined the World Bank, four SEZs were established at Shenzhen, Zhuhai, Shantou, and Xianan, with the attraction of lower tax rates and extra authority over their economic development. The authorities in these places, for instance, could approve of foreign investments worth up to USD 30 million (higher than in the other regions) without clearance from Beijing. The SEZs were allowed to become market economies, outside the purview of Central planning that was still the dominant feature of the Chinese economy. During the next phase, fourteen coastal cities were opened up to the outside world in a similar manner.

These measures facilitated not only the inflow of foreign capital (in the form of investments from abroad) but also the internationalisation of the economy, by way of rising exports and imports. The chosen areas also began to emerge as showcases of rapid transition in China's otherwise controlled economy. The selective approach to opening up of the economy, of course, had the risk of creating both regional as well as income disparities, but the CCP under Deng Xiaoping did not mind some creeping inequalities. It had no problem if some regions/provinces went ahead of others, nor if some people became richer faster than the others. Incidentally, Mao Zedong also had a similar mindset and believed that a certain amount of impurities in the water was necessary for the growth of fish. Accordingly, he had often overlooked some corrupt practices that the party functionaries indulged in¹⁹. Post-Mao, the CCP had, however, apparently used this thought process in a positive manner in order to propel economic growth.

As has been already mentioned in passing earlier in this chapter, Deng's initiatives were sweeping and encompassed not only political and economic reforms but also bureaucratic and cultural reforms. It goes to his credit, and speaks of his grasp of the deep-rooted realities prevailing in his country, that he could visualise the need for an all-out and comprehensive set of reform measures. Among other things, the overhauling of the bureaucracy and transforming it by changing its mindset, was a major challenge. Here again, the strategy followed was that of de-centralisation and empowerment with regard to decision-taking. But a lot had to be done to ensure greening of the bureaucracy. Many of the older retiring (or about-to-retire) people were replaced by younger bureaucrats, with greater responsibility and accountability. It was not just liberal economic policies, but motivation and incentives, among other things, all aimed at unleashing the latent energies of the people, that were brought into play in order to fulfil the goal of making China a powerful socialist economy by the end of the twentieth century²⁰. Another essential requirement for the modernisation of China, and it did not escape the attention of the authorities, was educational reform. Deng was encouraging young people to go abroad to renew their skills and knowledge, and to pursue advanced degrees in various scientific and technical fields.

A NEW WAVE OF REFORM: 1984–88

The response to initial reforms was encouraging, especially in the rural economy that could break away from stagnation to catalyse the entire economy. In rural areas, there was an unprecedented spurt of entrepreneurial initiatives in every household. It was like a revolution of another type, a revolution of the peasant households wanting to get out of the clutches of poverty and catch the flavour of prosperity. For the first time, they had found the way to prosperity, and would grab every opportunity and every means to achieve it. They were impatient for a better life. Two things happened promptly. One was increased agricultural production along with its diversification, and the other was the proliferation of township and village enterprises (TVEs), producing all sorts of goods but primarily light consumer goods. This, in our view, was the beginning of the manufacturing revolution in China that we see today. More specifically, the highly visible and much talked about manufacturing revolution in China was led by the peasants. Unlike the revolt against the warlords in the past, in the early 1980s, the peasant revolt was against another tyrant called poverty. This time, the peasants had the support of an instigator, in the name of Deng Xiaoping.

However, the SOEs, especially the larger ones, were still structurally weak and lacking in energy. Their problems were huge and complex. The factory managers were given certain incentives, similar to those given to the peasant households, but they were not expected to do what the peasants could do. The production responsibility system was operative within the overall framework of controls, regulations, and manuals that provided detailed guidelines on the procurement of materials, production, pricing, distribution, and marketing. Even as the successes of initial reform measures were becoming increasingly visible on all fronts, the industrial sector definitely needed a big push. Industrial reforms were also needed to encourage the growth of urban areas, which were being overshadowed by the proliferation of entrepreneurship in the rural areas. More importantly, the rapid growth of TVEs was creating supply-side problems for urban-based industrial operations.

Before going any further, here it is necessary to mention that the process of political reform, needed for smooth implementation of the measures to be followed for economic modernisation, was far from complete. On the contrary, many people in the Party were still trying to pull the plug on economic reform. There was a pervasive confrontation over the reform measures. Within the Party, there were both conservative opponents to reform, and conservative reformists. What is more, Chen Yun, the principal architect of reform, was himself 'opposed to bourgeois liberalisation of the modernisation process that came with infusions of foreign, especially Western, cultures'²¹. If the implementation of the open door policy was staggered, it was, to some extent, due to the opposition and debate within the Party, and not entirely due to cautious experimentation, that has been pointed out earlier. Many of the conservative (pro-Mao) opponents to reform had earlier been sent into retirement, but the conservative reformists were still exerting their influence through the Standing Committee.

While the difficulty in arriving at a consensus within the party was a serious problem, another problem was brewing on the social front, involving a section of the population comprising mostly the intellectuals and the youth. They wanted faster improvements in social and individual lives, and basic human rights, and were proponents of democracy in China. Throughout the 1980s, sporadic pro-democracy movements were taking place, finally culminating into a massive pro-democracy demonstration in 1989 at the Tienanmen Square²². Throughout the 1980s, economic reforms were moving along amidst rough political weather, which had kept the CCP busy with continued overhauling and refinements, that were needed to sustain the initiatives for economic modernisation. In one such overhauling of the party machinery, Deng himself had stepped down from the premiership, handing over the reins to Zhao Ziyang to steer the reform process.

Beginning from 1984, the focus of reform was directed at the industry and urban sector, but only after putting into place a codified judicial system, so as to provide legitimacy to the reform measures and to create a favourable investment climate. At the Third Plenum of the Twelfth Party Congress in October 1984, a decision on the reform of the economic system was adopted, ushering, what was, a high wave of economic reform. The document

adopted at the Plenum involved a further ideological shift from what was earlier the ‘plan as a principal part and market as a supplementary part’ to the ‘planned market economy’, putting the plan and the market on an equal footing for the first time. With this, China launched a dual track market liberalisation—market track and planned track—for the industrial sector, with the market mechanism becoming a more important part than the planned track. The government concentrated on the rationalisation of prices, revamping the wage structure and reform of the financial and taxation system.

Under the new system, called the contract responsibility system (CRS), the practice of quota delivery and planned prices was retained, but above-the-quota production of the SOEs was allowed to be sold in the market at prices that were allowed to be determined freely on a supply-demand basis, and without any cap on the market price. The result was that every product had two prices—planned price and market price. Since the planned quota was fixed, enterprises had the incentive to expand production well beyond the quota and earn market-dictated profits. Besides, the system encouraged the marketisation of the economy, and enabled managers to understand the market behaviour. However, the retention of profit had to be negotiated annually. The practice of annual bargaining was later changed to once every three years. By the end of the 1980s, practically all the SOEs had adopted the CRS.

The result of the CRS was, however, still slow for various reasons, the primary reason for which was that, unlike the peasants and the rural households, the managers in the SOEs could not acquire personal assets of their own. The SOEs needed total re-orientation in the culture that the CRS had sought to develop. Most managers were quite comfortable with the earlier practice of eating from the rice bowl, and were loathe to adopt the new work ethos. Accordingly, the spurt in industrial production during the 1980s came largely from the TVEs. Several factors worked in favour of such enterprises, some of which are mentioned below.

First, the withdrawal of limitations imposed on the enterprises, employing eight or more people, and the legalisation of such enterprises encouraged the proliferation of individual and collective enterprises. Further, such enterprises were allowed to manufacture all items. The second favourable factor was fiscal de-centralisation.

Since the local governments were not required to share the tax revenue collected from such enterprises, they enjoyed incentives for encouraging the development of smaller enterprises by way of tax concessions and subsidies. Third, the financial sector reform, which had led to the establishment of four specialised competing banks, resulted in the opening of several bank branches in cities and small towns. This ensured not only the easy availability of credit, but also the mobilisation of rural savings.

Fourth, the dual track pricing system had the effect of legalising black market operations and the growth of open markets, the advantages of which were thoroughly exploited by the TVEs. Finally, there was a huge pent-up demand that had found an outlet as a result of the reform. In addition to all these, through a policy change in 1984, the government had encouraged the peasants, individually as well as collectively, to buy, and invest in, shares of all types of enterprises. The enterprises were allowed to issue shares in the early 1980s. The outcome of all these factors was a phenomenal increase in the number of TVEs. While the number of TVEs had doubled between 1978 and 1983, there was a five-fold increase between 1983 and 1988. As mentioned earlier, this had laid the ground for the rapid growth of manufacturing activities throughout the country, and brought about a significant structural change in the economy in favour of manufacturing.

THE HOT ECONOMY AND AUSTERITY MEASURES

The decade of the 1980s, however, did not end well for China. Perhaps, things that begin well do not necessarily end well. What happened and how did things go wrong? There was nothing wrong with the policies, nor was liberalisation premature. If something did go wrong, it was perhaps market behaviour, which essentially was about peoples' behaviour in the newly created market economy. For long, there was no market economy in the country (except the black market in some sectors) and for long, people were denied a decent lifestyle. But amidst deprivation and poverty, they were secretly nurturing in their private minds (wherein the communists in the Mao era had no entry) a dream for a better life. Communism, in spite of its numerous and vigorous education

and rectification programmes, it appears, could not erase many of the evils of pre-revolution China's feudalist mindset, profiteering mentality, corruption and all that; nor did it succeed in planting socialist ideals into the minds and hearts of the toiling people.

Propelled by the multi-pronged initiatives of people, the economy responded very well to the reform measures. What followed instantly was the working of a labour-intensive growth, which was backed by financial investment coming from household savings and supplemented by newly facilitated institutional savings. The quantitative performance of the economy, and especially the performance of agriculture, was miraculous. Let us examine the performance of agriculture first.

China, as we know, suffers from a severe shortage of arable land, as compared to the size of its population, (which already exceeded one billion in 1982) and the size of the country. For instance, land per capita in the country at about 0.8 hectare is less than one-third of the world average. Only 14 per cent of the land area is arable land, but the best arable land²³ comprises only 40 per cent of the total arable land, and 3 per cent of this is not suitable for cultivation. In fact, the land under cultivation (taking the cropping intensity into account) has declined significantly since 1978. With the increasing use of land for non-cultivation purposes, a serious loss of crop land has taken place in the coastal areas. In the early 1980s, the conversion of arable land to non-agricultural purposes was taking place at the rate of 1 m.ha/year. Yet grain production increased significantly in the decade beginning 1978 from about 305 million tonnes to over 400 million tonnes in 1987 before falling to 394 million tonnes the next year (the fall being due to unfavourable weather conditions).

The increase in production was largely due to an increase in productivity resulting from intensive mechanised farming (see Table 3.1). The cultivated land area declined from 99.4 m.ha in 1978 to 95.7 m.ha in 1988, but the consumption of machine power and of fertiliser per hectare increased during the same period, from 117.5 million kwh to 265.7 million kwh, and from 88 kg to 224 kg, respectively. The gross output value of agriculture (in current prices) increased from 140 billion yuan (USD 83 billion) to nearly 587 billion yuan (USD 158 billion) during the corresponding period. A significant aspect of development in agriculture during

Table 3.1
Performance of Agriculture in China (1978–88)

	1978	1988
Cultivated Land Area (m. ha)	99.4	95.7
Total Sown Area (m. ha)	150.1	144.9
Agri-machinery Power (m. kwh)	117.5	265.7
Fertiliser Consumption (m. t.)	8.8	21.4
Grain Production (m. t.)	304.7	394.1
Sugarcane (m. t.)	21.1	49.1
Fruits (m. t.)	6.6	16.6
Agricultural Employment (million)	283.2	322.5
Non-agricultural Rural Employment (million)	23.2	78.2

Source: USDA: Economic Research Service, China Agricultural and Economic Data for the relevant years.

this period was the diversification of the production basket in favour of more remunerative crops, mainly horticulture and non-cropping agricultural operations such as dairying, piggery, fishing, poultry, etc. There was an over three-fold increase in the area under fruit and vegetable cultivation, as the demand for these increased significantly following an increase in household incomes.

While detailed data on industrial production during this period is not available, we can, however, get some idea of progress in the industrial sector from the available data (see Table 3.2). Apart from substantial increase in the production of basic industries such as steel, cement, fertiliser, etc., industrial production witnessed significant diversification in favour of several light and consumer goods industries such as processed foods, garments, colour televisions, household refrigerators, etc. Between 1978 and 1988, for instance, the production of household refrigerators increased from 28,000 to nearly 7.6 million. By the end of the 1980s, China was producing about 3,00,000 varieties of light products ranging from textiles, plastics, textile products, etc., to various light engineering goods. But several technology-intensive products such as information technology (IT) products, office automation items, automobiles, etc., had also reached the commercial scales of production. Significantly, the initial spurt behind this development was provided by the TVEs.

Table 3.2
Industrial Output of Select Products (1978 and 1988)

	1978	1988	CARG(%)
Beer ('000 tonnes)	400.0	6590.0	32.2
Canned Food ('000 tonnes)	488.0	2209.0	16.3
Chemical – Fertiliser (million tonnes)	8.7	17.4	7.2
Chemical – Fibres ('000 tonnes)	284.6	1301.2	16.4
Chemical – Pesticides ('000 tonnes)	33.0	179.0	18.4
Cloth (billion meters)	11.3	18.8	5.2
Cotton Cloth	8.15	11.87	3.8
Edible Vegetable Oils (m. t.)	1.8	4.8	10.3
Electricity (billion kwh)	256.6	545.2	7.8
Household Refrigerators ('000 nos.)	28.0	7576.3	75.1
Sugar (m. t.)	2.3	4.6	7.2
Yarn (m. t.)	2.38	4.66	6.9

Source: USDA: Economic Research Service, China Agricultural and Economic Data for the relevant years.

The macro-picture shows that the GDP (converted into US dollars by the exchange rate of the relevant years) increased from USD 215 billion in 1978 to USD 402 billion in 1988, and grew at an annual average rate of 6.5 per cent which did not signify a substantial improvement, when compared with the achievements of the East Asian countries in their early growth phases, but has to be understood and appreciated in the context of China's own situation. As has been mentioned earlier, the decade of 1978–88 was a difficult period in view of the internal turmoil and intra-CCP problems. In between, the population of the country had exceeded one billion, and yet the per capita income had grown by around 4.5 per cent per annum. As the incomes grew, the people saved more, but they also spent more on account of their living expenses. Between 1978 and 1988, the living expenses increased substantially in both the rural and urban areas. In 1988, while people in the rural areas spent over 87 per cent of their disposable incomes, those in urban areas spent over 40 per cent of the latter.

The disposable income had increased significantly in both rural as well as urban areas, but the rural–urban income disparity had

Table 3.3
Income–Expenditure Pattern (in Yuan) in Rural and Urban China (1978–88)

	1988		1978	
	Urban	Rural	Urban	Rural
(1) Per Capita Disposable Income	1181.4	544.9	N.A	133.6
(2) Per Capita Living Expenditure	1104.0	476.7	N.A	116.1
(3) Per Capita Food Expenditure	567.0	254.6	N.A	78.6
	(51.3)	(53.4)		(67.7)
(4) Per Capita Savings	77.4	68.2		17.5

Source: USDA: Economic Research Service, China Agricultural and Economic Data for the relevant years.

Note: Figures in brackets are percentages of 3 in 2.

also widened (see Table 3.3). In 1988, the per capita disposable income in urban areas was more than double that in rural areas. Naturally, there was a disparity in the purchasing power. However, in rural areas, there was a distinct shift in the allocation of expenditure in favour of non-food items of consumption, with its share in the total living expenditure increasing from nearly 32 per cent in 1978 to about 47 per cent in 1988. As far as savings were concerned, rural areas showed better propensity for savings, as compared to their urban counterparts, and contributed largely to the growing household savings during that period.

China's open door policy also got an encouraging response, in terms of both foreign direct investment (FDI) and trade. Within a year of the open door policy, China was able to attract an FDI of over USD 6 billion and the cumulative FDI was around USD 25 billion by 1990. The country's share in the global FDI jumped from 0.8 per cent in 1980 to 1.1 per cent in 1985, and further to 1.3 per cent in 1990. Among other things, FDI had acted as a catalyst in promoting external trade and building foreign exchange reserves. By 1990, China's foreign exchange reserves at USD 28.6 billion were already the second highest in Asia after Japan. Similarly, exports increased from USD 9.7 billion in 1978 to USD 47.5 billion in 1988, and further to USD 62 billion in 1990, when the country achieved its first trade surplus. To some extent, the growth of exports was supported by the depreciated currency, adding to price competitiveness.

While quantitative performances were remarkable, the macro-economy, however, was unable to digest the manner in which some of the policy measures were working. The economy was heating up. In the late 1980s, inflation ranged between 19–20 per cent, giving rise to widespread concern within the CCP. More importantly, there was growing criticism against liberal economic policies in the country. And the critics of liberalisation got a boost, when the pro-democracy protestors were meted out harsh and brutal treatment at a gathering at the Tienanmen Square in 1989. In the face of overwhelming criticism, the process of economic reforms had to be given a temporary break.

Undoubtedly, the economic growth of the country was spectacular and a section of the Chinese people were waking up to new-found opportunities. For the first time, people were enjoying the comforts of rising income. The quality of life was also improving, largely the result of improved consumption. Between 1979 and 1985, the per capita consumption rose at an average annual rate of 12.5 per cent. The problem lay with the macro-economy, which suffered partly from corruption and partly from systemic deficiencies that arose due to the lack of market-oriented institutions. The near run-away inflation of 1988–89, that had nearly derailed the economy, was the result of both these factors. Certain features of the initial decade of economic transition may be mentioned in this context.

The economic reforms of 1978–88 were primarily incentive-oriented, with subsidies being their main plank. In terms of their sweep, the reform measures, though limited, were indeed very significant and irreversible. Another feature of the reforms during this period was that they were meant to encourage the production side of the economy and usher in high growth quickly. The issues pertaining to inputs were not appropriately addressed. Similarly, while the market was encouraged to grow, the need for the creation of market-supportive institutions was not adequately recognised. For instance, while fiscal reforms were introduced, the potential risk of budgetary constraints was overlooked. Several other deficiencies had surfaced with the reform measures, but could not be visualised. Let us explain.

First, the reform measures undertaken during the decade 1978–88 were experimental, on the one hand, and piecemeal, on

the other. Uncertainties about the stability of policies remained. The policy changes were not part of any comprehensive development vision of the new power set-up. The Party machinery itself was passing through volatilities of prolonged re-structuring, the impact of which was manifested in the piecemeal, and somewhat disjointed, actions on the policy front. Second, as leadership had ushered in market operations, there was no market infrastructure and/or institutions to guide and regulate the market forces. What was unleashed subsequent to marketisation and liberalisation was a situation wherein only the privileged few could prosper. 'Getting rich is glorious' was fine as a liberal thought, but there was not much introspection on the possible impact of such a thought on a society that always suffered deprivations and inequality. This, and several other thoughts championed by the Party, had acted as the tacit approval of corrupt practices at all levels.

Third, since the reform measures were piecemeal, many of the policy changes were also incomplete. Take the case of marketisation, for instance. The government had encouraged the marketisation of surplus products in agriculture and SOEs on the output side, but this was done in almost total negligence of the input side. Given this, the output growth was bound to meet with shortages of inputs and carried the risk of cost-push inflation. Some of the basic measures of reform, such as HRS, PRS, etc., had inherent inflationary impacts, besides encouraging a shortage economy syndrome. This was especially so, as there were hardly any markets for factor inputs such as land, labour, capital, technology, etc. The near run-away inflation by the end of 1980s was, to a great extent, due to the absence of marketisation of the factor inputs.

However, rampant and almost open corruption was no less responsible for the inflation. The operation of the fiscal contract system—HRS, PRS, financial de-centralisation, etc.—encouraged numerous corrupt practices, alongside a rush for prosperity at the fastest. The under-reporting of land, productions, etc. was common and widespread. Besides, these schemes had created an unholy government–business nexus, mostly at the local levels of government. The latter had not only generated large-scale corruption at the grassroot level, but was also responsible for allocative inefficiency and income inequality. For instance, following the de-centralisation of financial and fiscal controls,

the local governments always favoured the flow of bank credit (at lower rates) in the activities that were exempted from tax-revenue sharing. The operation of the fiscal contract system, on the other hand, created a situation of budgetary constraints for the Central government in Beijing.

The last two years of the decade of the 1980s were years of alarming inflation, and the consequent concern about the effect of liberalisation. The retail price index (1978 = 100) shot up by 18.5 per cent in 1988 and again by 17.8 per cent in 1989. The impact of it was felt equally in both rural and urban areas.

The GDP growth in 1988 and 1989 had declined to 4.4 per cent and 3.9 per cent respectively, following a contraction in the output of several agricultural and industrial products. For a country that was aspiring for consistently high growth, the experiences of 1988 and 1989 were simply nightmarish. Needless to say, the circumstances necessitated severe austerity measures, aimed at cooling down the over-heated economy, with immediate effects.

The high inflation, low growth, and the brutal suppression of the pro-democracy demonstration at Tienanmen Square culminated in a considerable backlash at home. The Western reaction was negative, with potential investors casting doubts over not only the prospect of China's transition to the market economy but also the political stability of the country. There were serious debates in the Western world about the latter's possible business and political relations with China. Inside the country, the CCP was debating the possibility of the reversal of reforms. Suggestions were made for the re-collectivisation of agriculture and the re-centralisation of financial and fiscal powers. However, it was realised that reform measures had gone too far to be reversed, and the reformists within the party argued successfully that the only way to improve the situation was to go in for further and faster reforms.

Indeed, lot had changed within the economy, including a change in its basic structure. The share of agriculture in the GDP had fallen in favour of manufacturing and the open door policy had resulted in a significant increase in economic, technological and trading relations with several countries. But more importantly, people were no longer interested in sharing poverty. They were demanding faster implementation of the publicised economic goals of the party. The demonstrators at Tienanmen Square, it may

be mentioned, also included poor people wanting to see improvements in their living standards.

What followed after the austerity measures was accelerated reform, with the full backing of the party, and with Zhao Ziyang in the driver's seat. Between 1992 and 1993, a slew of measures were introduced to put the reform boat back on stream. These measures were:

1. Phasing out of planned prices, with the narrowing of the gap between planned and market prices (an outcome of the tight money policy introduced as an austerity measure).
2. Further extension of the open door policy, by way of granting special privileges to more coastal cities, and facilitating the establishment of more development zones attracting more foreign investment and the flow of foreign technologies. The development zones had come up in inland cities that did not qualify as SEZs or coastal cities.
3. Removal of all price caps on stocks in the Shanghai Stock Exchange.
4. Granting of more autonomy to SOE managers, by way of rights of decisions on matters relating to labour, wages, foreign trade, investments, etc.

As a result of all these and several other measures, the economy bounced back in no time. Due to the austerity measures, inflation was brought under control in 1990 itself (see Table 3.4). Foreign investment had shot up from USD 4.4 billion in 1991 to USD 11 billion in 1992 and USD 28 billion in 1993. The austerity measures

Table 3.4
Inflation—Sudden Flaring Up Caught the Nation Unawares

	<i>(in per cent)</i>			
	1978	1988	1989	1990
Increase in Urban CPI	8.8	20.7	16.3	1.3
Increase in Rural CPI	6.2	17.5	19.3	4.5
Increase in RPI	7.3	18.5	17.8	2.1

Source: USDA Price Data for relevant years.

had brought severe hardships to private enterprises, leading to the bankruptcy of an estimated three million TVEs and a huge loss of employment. Such enterprises, however, grew rapidly to lead the economic recovery and facilitate an increase in industrial output. The exchange rate was adjusted from yuan 4.7832 to a dollar in 1990 to yuan 5.3234 in 1991, and then further to yuan 5.762 in 1993, and finally to yuan 8.6187 in 1994. Exports shot up from USD 62 billion in 1990 to USD 91.7 billion in 1993, and USD 120 billion in 1994. On an exchange rate basis, the GDP had increased from USD 388 billion in 1990 to USD 600 billion in 1993.

It may be mentioned, however, that the fear of heating up of the economy remained, as after going down to 2.1 per cent in 1990, the CPI inflation rate (1985 = 100) kept inching up once again and was about 11.5 per cent in 1993. But this time, the authorities had left the issue to be debated by others, and instead focused more on liberalisation. Apart from their strengthened conviction on the benefits of reform and liberalisation, the government also had some compulsions about the continuation of liberalisation.

China had sought re-entry into GATT, when the Uruguay Round of Negotiations for Multilateral Trade Liberalisation began in 1986. The accession negotiations on bilateral levels had begun and were in full swing by the end of the 1980s. China was under continued pressure for opening up its market. In 1994, China entered the next phase of reforms, trying to align the domestic economy with the broad trends in the fast-moving and rapidly globalising world economy in terms of systems, policies, and practices. The economic reforms undertaken during 1978–93 did help in putting the economy into some kind of an order and in changing some aspects of the old order, but was far from sufficient if China had to establish itself as a responsible member of the global economy. For this, its economic policy needed total realignment. Membership of GATT/WTO was rightly felt as a necessity, but this necessitated that China's economy undergo a paradigm shift towards a market economy. In the mid-1990s, the challenges before China were huge. Managing the challenges of internal transitions on the one hand and the external pressure for liberalisation on the other, required deft handling. Deng Xiaoping had indeed handed over a difficult legacy and a challenging task to Zhao Ziyang.

NOTES

1. The three included Ye Jianing, Li Xianorian and Wong Dongxing.
2. Deng Xiaoping's ideas were in circulation through his speeches, particularly the ones he made in 1975. In one of his speeches, that had made him a sort of folk hero, he had admitted that the peasants in Yan'an were worse off than when the Communists first arrived there forty years ago. In another speech, he had outlined his plans for improving the living standards of the people, allowing them more freedom, and ending political victimisation.
3. There were two 'whatever' policies that the Mao loyalists were advocating: Follow whatever policy decisions that Mao made, and follow whatever instructions that Mao gave.
4. As Chairman of the Party, one of Hua's first acts was to announce the construction of a huge mausoleum for Mao at Tiananmen Square, even as the victims of the earthquake in Tangshan were waiting for rehabilitation works.
5. The 'Four Modernisations', suggested by Zhou Enlai and articulated by Deng Xiaoping in 1975, included modernisation of agriculture, industry, science and technology and national defence. The Gang of Four had termed this measure as a revisionist and capitalist tendency.
6. The year 1978 was a crucial one for China. There were open differences over the disproportionate development of the national economy. The Mao loyalists had called for counter-attacks and strict adherence to Mao's thoughts and the class struggle.
7. The document was presented by another party Vice Chairman, Ye Jiyanning, and not by Deng Xiaoping. It was decided that in the future, the attainment of economic goals would be a measure of the success or failure of policies and industrial leadership.
8. See historical setting in <http://www-chaos.umd.edu/history/setting.html>. It was in this document that the Cultural Revolution was declared as an appalling catastrophe and the most severe setback to the socialist cause.
9. China and The Four Modernizations, 1979–82. Source: The Library of Congress Country Studies, <http://www.workmall.com>
10. It was a new party line adopted at the Third Plenum.
11. It was primarily an ideological phrase to ensure the support of the party for reform. Deng and his supporters had articulated a position that China was still in the initial stage of socialism—a viewpoint that was re-affirmed at the Thirteenth National Party Congress in October–November 1987.
12. See Jung Chang, 1992.
13. When asked by a fellow party leader, Bo Yibo, as to what he meant by it, Deng provided two separate explanations. One was that he could not recall exactly what he meant; the other was that it did not matter since it was a statement that was suited to the prevalent conditions at that time and was not infinitely transferable. See <http://www.sacu.org/dingciasping.html> for Deng Xiaoping, 1904–97.
14. See <http://www.sacu.org/industry/70s.html>: *Twenty Years Leap—From Feudalism to Technology*.
15. Same as 14 above.

16. The HRS, applicable to peasant households, was tantamount to being a limited liberalisation in agriculture, but had the effect of freeing them from the drudgeries of communes.
17. For instance, for the first time, the people were free to cultivate remunerative crops and divert land from the cultivation of foodgrains to more profitable agricultural operations.
18. Earlier, the TVEs were allowed only in agriculture-related manufacturing operations.
19. See Zhisui Li, 1996.
20. The Eleventh National Party Congress, August 12–18, 1977, had reiterated that a fundamental task of the party was to build China into a modern powerful socialist country by the end of the twentieth century.
21. <http://www-chaos.umd.edu/history/prc.html>. Leaders such as the Standing Committee Member Chen Yun objected to the bourgeois liberalisation of the modernisation process that came with the infusion of foreign, especially Western, culture.
22. In the 1980s, China's intellectuals and students accelerated their protests and criticism of the party that reached its peak in 1986 when thousands of students throughout the country took to the streets, leading to a brutal crackdown on them in Tienanmen Square. Following this incident, the General Secretary, Hu Yaobang was demoted for failure to deal with public activism, and Zhao Ziyang was given control of the party.
23. The 'best arable land' implies land that is free from any problems.

Four

Preparing for a Socialist Market Economy

Towards the end of 1980s, leadership in the CCP was grossly preoccupied. The preoccupation involved management of the decade-old economic transition, as well as the internal re-organisation of the party. The latter was intended to make the party more relevant for the ongoing economic transition, and enable it to provide the necessary political supports. What had begun was an exercise in political reform. Acceleration of the pace of economic reform was not possible without a favourable political environment, that was lacking at that time, especially in the aftermath of the Tienanmen Square incident. More importantly, faster reform was considered necessary for the faster well-being of the people and balanced development of the economy, as also for facilitating the country's entry into the WTO.

The Thirteenth National Party Congress (NPC) (25 October–1 November 1987) sought to speed up economic reform, through a major reshuffling of the key party functionaries, along with some administrative changes. The Congress, it may be mentioned, provided a much broader ideological basis for Deng's reform programme in the late 1980s and early 1990s, and emphasised quite categorically that since the end of the period of socialist transition in the late 1950s, there were numerous leftist errors in the party's ideological lines. Accordingly, while the opponents of reform were forced into retirement, the conservative reformers (which included many Members of the Standing Committee and intellectuals) were either demoted or expelled from the party. It was in late 1987 that Deng Xiaoping stepped down to make way for Zhao Ziyang. Deng, however, remained a *de facto* leader as Chairman of the Party. The Party constitution was amended to make the Party Secretariat a staff arm of the Political Bureau and its Standing Committee. Numerous leadership changes also

took place below the national level, bringing younger and better-educated leaders at the provincial levels. New governments were elected in the provinces, autonomous regions and municipalities. The re-organisation exercise had one principal objective, namely, as mentioned earlier, the induction of *younger educated cadres* (emphasis that of the author) into leadership positions.

All these were significant milestones in the context of the uninterrupted pursuit of a full-fledged market economy. Besides addressing several other economic and social issues, the Thirteenth NPC was aimed primarily at political preparations for a stable and fast-moving economy, with its own space in the globalising world economy. The changes were comprehensive and sweeping. It was a new look party in which vigorous dynamism had been brought in by more than 600 younger and better-educated leaders at the provincial level congresses and governments. The purpose of this exercise was to revitalise the administrative machinery at all levels. The Party had, thus, undergone a significant ideological shift, away from that of the struggle against class enemies and social revolution to that of a market-based economic revolution. Economic growth had replaced political revolution as the religion and faith for new China. What it meant was greater economic freedom for the people, a shift from the traditional rural society to a modern industrial society with accelerated urbanisation, social mobility on a larger scale and integration with the global economy.

The ideological shift, the Party leadership had realised, was not tenable without matching reform in governance. Significant Government Organisation Reforms (GORs) were carried out between 1988 and 1992, with a view to achieve higher governmental efficiency. During the Seventh NPC (25 March–13 April 1988) and the Seventh Chinese People's Political Consultative Conference (CPPCC) (24 March–10 April 1988), the Party had conceded considerable openness and transparency, by such measures as allowing the direct telecast of the meetings and panel discussions, publication of dissenting statements in the media, etc. The State Council was restructured and some administrative reforms¹ were also carried out. The role of the government itself underwent a change from an omnipotent one to a function-limited government, wherein the focus shifted to supporting functions like providing infrastructure, public goods and services, social security, economic

stabilisation, etc. The civil service system was also reformed in favour of an expertise-oriented civil service. With the necessary political overhauling and some bureaucratic reforms in place, the stage was ready for fast-paced reform, even though minor irritants still remained². Three Es—efficiency, effectiveness and economy—were adopted as part of the new value system.

At the Fourteenth Party Congress in September 1992, the Party endorsed the 'Socialist Market Economy' as the goal of economic reform. The significance of this phrase lay in understanding the implied role of the market economy in a socialist state. According to Yingqi Qian (1999), 'in socialist market economy, market economy is the goal and socialist is an adjective.' The establishment of a market economy was, thus, no longer a contentions issue, except that it was to have a socialist framework. The Party would be pushing for, and determining the pace of, transition to a market economy, according to its own judgement. This step was viewed as 'emancipation of the mind'³. Following this, a strategy for transition to a market economy was designed in 1993⁴. The output called 'Decision on Issues Concerning Establishment of a Socialist Market Economic Structure' was adopted at the Third Plenum of the Fourteenth NPC in November 1993 (henceforth referred to as the 1993 Decision). It is this Decision that was to be the guiding light for the future direction of the economy. The major thrust areas that were identified included: a rule-based system, building of market-supporting institutions, and property rights and ownership, that is, all the key elements of a market economy structure. These vital aspects did not exist during the initial years of reform.

The focus on a rule-based system was meant to serve two basic objectives, namely, to (i) establish a transparent market economy and (ii) provide a non-discriminating business environment, that is, to usher in a level-playing field. With this, the government also sought to achieve two fundamental principles of the GATT/WTO system, that is, the principle of national treatment and transparency, both being important for the transition to a market economy. Broadly speaking, as the first step towards a socialist market economy, with the process planned to be completed by 2010, attempts were undertaken to re-align domestic policies with international standards, which was a requirement for the Country's accession to the WTO. The economy was to be seen to be

aligning itself with the policies and practices of an internationally compatible system. However, the switchover to a rule-based system of economic governance meant a more complicated task of overhauling an autarkic system of management.

The good thing was that the party's commitment to a market economy was unflinching, and was clearly stated by Premier Jiang Zemin during his address to the Sixteenth NPC in these words:

We should give a fuller play to the basic role of the market in the allocation of resources, and build up a unified, open, competitive and orderly modern market system. We must get rid of trade monopolies and regional blockades to allow free movement of goods and production factors on markets around the country.

In fact, in that speech, the Premier also gave an outline of what he proposed to do. Being solely at the discretion of the Party, amendment to the Constitution was one of the easiest things to do in China, and, as we all know, this is one of the primary pre-requisites in any transition process. China had no problem in amending its Constitution as and when required. Since 1978, the Constitution had been amended several times, and, as we shall see, it has always been in the amendment mode. But a significant amendment to the Constitution took place in 1999, whereby the non-public sector, including individual and private, businesses were recognised as being a very important component of the socialist market economy. The Constitutional amendment also included the principle of governing the country according to the rule of law, indicating the establishment of a market-friendly judicial order in the years to come.

Beginning with 1994, we can see continuity in the reform process, except for a brief while during 1997–98, on account of the Asian financial crisis that had called for caution and prudence. It is not within the scope of this book to provide a chronology of the reform measures introduced in China since 1994, but we shall briefly touch upon some of the broad policy measures in certain areas, which, apart from the objective of facilitating the transition to a socialist market economy, were also aimed at preparations for the country's entry into the WTO. In the true sense, the year 1994 marks the beginning of the second phase of economic reform in modern China. Since then, there has been no looking back on this transition.

As has been mentioned in Chapter 3, the first phase of reforms had suffered from several inadequacies, which usually accompany a gradualist and incremental approach. The objectives of reforms during the earlier phase were rather limited and primarily incentive-based. Accordingly, the reforms during the earlier phase had certain implied costs for the government, primarily by way of subsidies that meant both lost revenue as well as revenue transfer. During the second phase of reform, the focus on soundness, or long-term sustainability of policies, was very much at the forefront. Planning, sequencing and sustainability of reform measures were the main planks of the smooth transition (in the sense of achieving transition without pitfalls) to a market economy. We can presume that pitfalls accompanying economic transition in some of the East European economies, and also of Glasnost in the erstwhile USSR, may have pre-warned the leadership in China about the risks involved in the transition process. In fact, the leadership in the Party did study the experiences of the East European countries relating to economic transition in great detail.

Let us now look at some of the broad aspects of the country's economic reforms aimed at the transition to a market economy. We begin with reform or restructuring of State Owned enterprises (SOEs). The transition to a market economy required significant market orientation of the enterprises that formed the foundation of the socialist economy. An efficient market economy, on the other hand, required efficiency in the allocation of resources, which were not possible in the old-style state enterprises. More importantly, most of the SOEs in China were incurring huge losses. In 1994, for instance, nearly half of about 100,000 SOEs were earning losses, and were primary contributors to a huge macro-economic deficit.

REFORM OF THE SOEs

During the initial phase of reform, when the task of industrial restructuring was undertaken, the idea was to urge the SOEs to improve efficiency and achieve higher production. This could not be achieved without some incentivisation. Among the basic incentives for increasing production by effecting improvements in

productivity were the profit-sharing scheme, dual pricing scheme and provision of autonomy, to a limited extent, to managers. Of course, the creation of a market for the SOE products was a corollary objective, and, to some extent, it was achieved. However, there was no talk of transfer of ownership, or outright sale into private hands, for a long time since 1978. During the late 1980s, there was some dilution of control by way of de-centralisation. The bulk of the SOEs (around 99 per cent) were small and medium enterprises (SMEs)⁵.

By way of de-centralisation, the ownership and management of such enterprises were left to the local governments. Space for the private enterprises was created by way of encouraging the growth of individual/collective enterprises, jointly-owned enterprises and foreign-owned enterprises. In the process, the share of the public sector in industrial output, employment, etc., was beginning to come down. For instance, the share of SOEs in the national industrial output had come down from 77.6 per cent in 1978 to less than 55 per cent in 1990, while that of collective-owned and private enterprises had gone up from 22.4 per cent to 45.4 per cent. This change, it may be noted, was due to the growth of the latter category of enterprises, and not due to privatisation of the SOEs. When the profit-retention scheme was introduced, it was the SMEs among the SOEs that were quick to respond and adopt the scheme. Understandably, the reform process needed a further impetus.

The 1993 decision had addressed the issue of SOE reform in a more fundamental way in the sense that it addressed the issues of property rights and ownership. Further, the decision had emphasised the need for transforming the SOEs into modern enterprises in terms of management practices (stressing the need for scientific internal management). With respect to small and medium SOEs, it was decided that the management of some of these enterprises could be contracted or leased out, while others could be shifted to a partnership system or sold to individuals and collectives. However, the issue of the future of large SOEs was not adequately addressed, even as it was here that the bulk of the state capital was locked in and the losses incurred by such enterprises were costing the exchequer in Beijing.

At the level of the small and medium SOEs, the privatisation process had begun following the 1993 decision, mostly at the

initiatives of the local governments, some of which were eager to speed up the pace of transition at any cost. On its part, the Central government was virtually pursuing the practice of *grasping the large and letting the small go* (Yingi Qian, 1999). By the end of 1996, about 70 per cent of small SOEs had been privatised in most provinces, giving rise to a massive unemployment problem. About 10 million workers were laid off by the end of 1996, and an additional 11.5 million were laid off in 1997.

The issue of the reform of the SOEs was again discussed seriously at the Third Plenum of the Fourteenth NPC, where it was decided that the reform of the SOEs should not mean mere de-regulation, but institutional innovations as well. Subsequently, a modern corporate system was introduced in select large SOEs. A series of theoretical innovations and policy resolutions coming out of the Fifteenth NPC (1997) provided a clear direction on SOE reforms in the future. For instance, it was clarified that:

1. The quality of a socialist state had nothing to do with the size of the state sector.
2. Adjustment and perfection of the ownership structure of the SOEs needed to be undertaken.
3. The domain of the state sector should be narrowed and state capital should withdraw from areas that were not relevant to the economic lifeline of the nation.
4. Multiple form of public ownership should be developed in order to encourage productivity.
5. Development of non-public sector (private sector) enterprises needed to be encouraged so as to make such enterprises the key to a socialist market economy.
6. Four categories of enterprises (that is, industries important for the purpose of national security, important public goods and services, natural monopoly and high technology) were to remain under state control, but others were to diversify the state ownership.
7. Revitalisation of the small and medium SOEs needed to be undertaken.
8. All SOEs would put in place better corporate governance norms in alignment with market economies.

For the Fifteenth NPC, the above directions signified a major breakthrough, by way of a very significant ideological shift. It was at this Congress that state ownership was recognised as a 'pillar of the economy'—a downgradation from the earlier 'principal component of the economy'. The difference lay in understanding the concept of 'pillar'. Pillars are things on which structures are built. Pillars are important, but by themselves they are of little use. To put it more clearly, the market economy was to be built on the pillars provided by the state enterprises. At the same time, the above points also made it clear that the emphasis would be on restructuring the large SOEs and not privatisation in the sense of the Western concept of reform.

In tune with the directions enumerated above, about 10,000 SOEs were selected for adopting the new accounting standards, while 1,000 large SOEs were to adopt new asset management regulations and about 100 were selected for incorporation as shareholding companies under their own board of directors. Further, 18 cities were chosen to experiment with comprehensive reform programmes.

The government policy with regard to the reform of SOEs, it has been pointed out by several critics of SOE reform in China, has not succeeded in fulfilling the conventional stated objectives of PSU reform. We shall revert to this issue later, but it needs to be reiterated here that the focus of reform had been restructuring of the SOEs so as to enable them to meet the requirements of an efficient market economy, besides letting the SOEs, especially 1,000 large ones, operate as corporates in a market economy. Although several small and medium SMEs were sold off, privatisation was not the thrust of SOE reform. On the contrary, autonomy of management, corporatisation and the induction of modern management practices, etc., were the primary focus of the reform process. Further, the SOEs and their operations were to be compatible with a competitive market economy, as was envisaged by the leadership.

As the restructuring exercise was giving rise to the large-scale retrenchment of employees, the issue of providing a social safety network had, accordingly, assumed significance, but during the entire decade of the 1990s, no adequate solution could be

evolved. The problem in this context had two broad dimensions. For the first time, the workers were exposed to the risk of losing jobs, irrespective of age. On one hand, there were old and retired workers, who had to be compensated. On the other hand, the remaining members of the workforce faced the prospect of job loss. The question that arose for the latter category was one of rehabilitation, while for the former, it was primarily that of providing sufficient retirement benefits. The question of compensation was broadly applicable across all the categories, but also involved payment of pension. To make matters worse, China did not have any unified national social safety network, which was primarily a responsibility of the local governments. The latter had their own programmes that covered pensions, healthcare, unemployment insurance, etc., but these were not adequate to compensate for loss of jobs. To cap it all, there was the issue of budgetary costs on account of the social safety net.

An attempt was made to address this issue in 1993, when a combined system of *social responsibility* (pay-as-you-go) and *individual accounts* (a programme funded by the employees as well as the state) was introduced. The enterprise-based pension system was abolished. In 1997, the State Council introduced a system whereby: (i) a mandatory amount 11 per cent of the pay roll of an employee was to go to individual accounts (including 8 per cent by the employee and 3 per cent by the enterprise), and (ii) local governments had to decide on the social responsibility amount (of around 17 per cent). Thus, under the framework that was provided for, the employees (the individuals) contributed 8 per cent, the enterprises provided for 20 per cent and the combined effect was 28 per cent. In 1998, the government adopted the 'two guarantees' policy, that is the guarantee of providing basic livelihood and re-employment service to the laid-off people.

THE LABOUR MARKET AND EMPLOYMENT

However, earlier in July 1994, the government had promulgated a new Labour Law, that became effective from 1 January 1995. The Law, applicable to all types of enterprises, was aimed at

protecting the legitimate rights of the workers, including the right to participate and organise trade unions. According to Article 5 of the Law, 'the state shall take various measures to promote employment, develop vocational education, formulate labour standards, regulate social incomes, perfect social insurance, coordinate labour relations and gradually raise the living levels of labourers'. The Law, by virtue of Chapter 3 (Labour Contracts and Collection Contracts) and Chapter 4 (Working Hours, Leaves, etc.), had the effect of creating a formal labour market, where wages were to be fixed on the principles of supply and demand, and employment was subjected to a legal contract between the employers and the workers. Further, the Law sought to achieve a balance of rights and obligations for the employers as well as the workers. The labour contract system clarified the rights and obligations of the employers and the employees. It safeguarded the employees' right to select jobs and the employers' right to select employees⁶. The law also provided for a group contract system through equal consultation, whereby employees of an enterprise could participate via a trade union representative or a representative of their own choice.

Although the government relied largely on economic growth to promote employment, it also initiated several measures that were meant to facilitate absorption of the new as well as the retrenched workforce. Here mention can be made of the institution of the labour market information network for promoting the exchange of information on labour supply and demand, besides the promotion of academic and vocational qualifications, including a system of nine-year compulsory education. The employment service system including employment agencies, training, guidance, consultancy, etc., was strengthened. In order to promote re-employment of the laid-off workers, the government promoted re-employment service centres in all the SOEs that had laid off workers and staff members. 'Under 10 Million in 3 years' training programme, launched in 1998, re-employment training was provided to 13 million laid-off and unemployed persons, resulting in a 60 per cent rate of re-employment. In addition, the 'starting a business' training programme was launched in several cities, so that the laid off workers could start small businesses.

FINANCIAL SECTOR REFORM

Closely related to reform of the SOEs was the issue of financial and banking sector reform, as both were linked to each other. Till 1990, China did not have a proper financial market except for a weak banking sector. There was no capital market and no financial intermediaries. During the initial phase of reform, some amount of de-centralisation had taken place in the banking sector, when four commercial banks were established and the PBOC had set up its own provincial branches. These PBOC branches were, however, suffering from the frequent influences exercised by the local governments, and were unable to adequately discharge their functions, that is, control over the operations of the commercial banks and the exercise of monetary policy instruments.

This problem was addressed in 1993, when the central banking operations were centralised, and the PBOC headquarters in Beijing brought all the local branches under its direct supervision. The immediate effect of this was the end of interference by the local governments. In 1995, the Central Bank Law was enacted, giving the Central Bank the authority to determine the monetary policy. This law not only ended the influence of local governments, but also had a significant disciplinary effect on the flow of credit. As a result, the principle of allocative efficiency with regard to credit disbursement was established.

Moving ahead, in 1998, the provincial branches of the PBOC were replaced with nine regional branches, which further curtailed the scope for influence by the local governments and paved the way for the effective operation of the monetary and credit policy. In yet another significant step during the same year, the Central Bank abolished the credit allocation limit and replaced it with measures such as standard reserve requirements, asset management regulations, interest rate regulations, etc. Earlier in 1995, the Commercial Banking Law was introduced, requiring commercial banks to follow standard international practices with respect to risk management, profitability of operations, quality of loans, etc.

With these measures in place, more modern banking practices were introduced in the banking sector, with the emphasis on the

profitability of operations and norms of capital adequacy. Four commercial banks, that is, Industrial and Commercial Bank of China (ICBOC), Agricultural Bank of China (ABOC), Bank of China (BOC) and People's Construction Bank of China (PCBOC), were able to restructure their operations and compete with each other in a constructive manner, wherever there was an overlapping of operations. However, the competitive pressures were still little, in view of the absence of competition from any other sources. Although foreign banks were allowed to set up branches, they were not allowed to carry out local currency businesses, and their operations were restricted mainly to SEZs and some major cities. The government did not think it prudent to expose its still inexperienced commercial banks to competition from foreign banks.

While the banking sector was very fragile, in view of its large volume of non-performing assets, growing out of its lending to equally vulnerable SOEs and also its lack of experience, the non-banking financial sector was in its early evolutionary phase. It was only in 1994 that the status of four commercial banks was transformed into that of national commercial banks. For the first time, these banks were divested of policy operations, so that they could concentrate purely on commercial operations. Separate policy banks—China Agricultural Development Bank, National Development Bank and China Import and Export Bank—were established in the same year to deal with policy operations. Commercial banks were not allowed to invest in company stocks, but separate banks were established for that purpose. However, while protecting its banking sector against competition from foreign banks, the government was also giving greater access to foreign banks in most cities. By end-1999, the number of agencies of foreign banks operating in China had gone up to 248. On the other hand, domestic commercial banks were allowed to open branches abroad for the limited purpose of international credit business, mainly with a view to facilitate exposure to international operations and practices.

In the context of the totality of the financial sector, the growth of non-banking financial operations in China was highly limited during the 1980s. There was a large informal credit market run by moneylenders and unregistered private banks that had remained

outside the purview of the official actions. The interest rates charged by the moneylenders were not considered usury, as long as they did not exceed four times the interest rates charged by the organised banking sector. Further, after the creation of commercial banks, households began to channelise their savings through the banking sector. As of 1995, households were generating 70 per cent of the domestic savings (accounting for 25 per cent of the GDP), but mostly through banking channels. There were hardly any other formal channels to route the savings.

The Government had started issuing bonds (mostly treasury bonds) from 1981 onwards, and a government bond market was created. But access to this market was highly limited. Stock markets were established in Shanghai (1990) and Shenzhen (1991). However, very little was done to encourage active trading in government bonds, and the growth of bonds markets was, accordingly, limited. Even as the stock exchanges were created, there were several restrictions in the way of their operations. The ownership of stocks was largely in the hands of the government, including government-controlled legal entities. The shares owned by the latter were not allowed to circulate, while those owned by the individuals were not many. In 1995, the ownership of stocks on the Shanghai Stock Exchange included 45.7 per cent government and 20.8 per cent government-owned legal entities, while the rest were owned by overseas funds and individuals.

Further, even as the capital market was limited, the operations were not trouble-free. Both the stock markets were suffering from high volatility due to large-scale manipulations by the market players, who happened to be the government-owned institutional players. For instance, in 1995, the turnover happened to be more than 300 per cent of the market value of tradable shares; government bonds were showing a much higher turnover, as compared to the turnover of the enterprise shares (Naughton, 1998). There was a large amount of money flowing in and out of the market, much of which was coming from the banking system.

It was because of this experience that the government had to crack down on manipulative tendencies, by imposing more regulations in market operations in place of further liberalisation. The Trust and Investment Company (TIC) and other agencies responsible for the use of public money were prohibited from direct participation in

the stock market. Several securities companies that had come up, following the creation of a securities market, were closed down, and banks were ordered to withdraw from secondary debt market operations.

FISCAL REFORM

As mentioned in Chapter 3, during the initial phase of reform in 1980, the government had introduced the fiscal contracting system (FCS), so that local governments could take increasing interest in the collection of tax revenues under the contract system and finance their own developmental needs. In the process, the local governments, it was assumed, would become more accountable, besides being motivated to develop their respective local economies. The system had gradually evolved into six categories of contracting, namely, (i) incremental contracting, (ii) basic proportional sharing, (iii) proportional as well as incremental sharing, (iv) remittance incremental contracts, (v) fixed remittance, and (vi) fixed subsidy. The system had served the purpose of giving more space and opportunities to the local governments, to plan and finance their own developments. However, the system had put the Central Government in a tight spot. It had increased the outgo on account of revenue transfer to the local governments, and reduced the share of the Central government's revenue as a percentage of the total revenue (from about 35 per cent in 1985 to about 22 per cent in 1992). In other words, the impact of the FCS had imposed growing stress on the Central Government's finances.

Further, the system had a serious drawback in that it favoured the more prosperous provinces having greater bargaining positions vis-à-vis the Central government, and was accordingly generating regional inequalities, which were emerging due to the differing fiscal gaps among the regions. The prosperous provinces were getting a greater share of the revenue transfer and could bargain for more in view of their larger contributions to the central kitty. The Central Government had, of course, taken measures by way of periodic changes in the system, but without much success. The difficulties came mainly in terms of responses from the local governments. Faced with the problem of differing fiscal gaps among

the regions, the government re-designed the revenue-sharing arrangements in 1985, by way of differentiating schedules based on the local governments' budgetary balances during the previous years. Further, the weaker regions were allowed to retain more revenues, and the grip over revenue-sharing with the better-off provinces was tightened.

The latter, however, responded by showing lack of enthusiasm over revenue collection through expansion of the tax base. The impact of this was felt on the tax revenue buoyancy. Also, while under the system, the tax rates were fixed by the Centre, the local governments could offer tax concessions to developmental programmes and thus reduce the effectiveness of the tax rates. Besides, the latter (mainly the better-off ones) often concealed revenue collection in order to show lower growth in revenue collection. The system offered enormous scope for the concealment of revenue collection. The overall result was a weakening of the fiscal power of the Central government (see Table 4.1). As can be seen from this table, for the Central government, the situation was quite precarious by 1993.

Fiscal de-centralisation under the FCS was, thus, not helpful for the Central government, as it had begun to suffer from a growing

Table 4.1
Central-Local Governments Fiscal Allocation: 1979-93

<i>Year</i>	<i>Revenue (%)</i>		<i>Expenditure (%)</i>	
	<i>Central</i>	<i>Local</i>	<i>Central</i>	<i>Local</i>
1979	20.2	79.8	51.1	48.9
1980	24.5	75.5	54.3	45.7
1984	40.5	59.5	52.5	47.5
1986	36.7	63.3	37.9	60.3
1988	32.9	67.1	33.9	66.1
1991	29.8	70.2	32.6	67.4
1993	22.0	78.0	32.2	67.8

Source: China's Fiscal De-centralisation by Jun Ma and John Norreggaard, October 1998.

Notes: Revenue does not include/exclude revenue transfer from/to the Centre.
Expenditure = (Revenue plus fiscal transfers from the Centre)—(fiscal transfer from the provinces to the Centre).

fiscal gap, which was 2.5 per cent of the GDP in 1993. The system had to be changed. Accordingly, in 1994, the FCS was replaced by a system of revenue-expenditure assignment. The primary goal of the assignment system was to simplify the taxation system in a transparent manner. As per its name, the system was related to the assignment of revenue as well as expenditure between the Central and local governments, and was based on a clear demarcation of responsibilities with regard to revenue and expenditure (see Boxes 4.1 and 4.2 for the assignment of responsibilities of revenue and expenditures). What is notable is that the expenses on account of subsidies were largely passed on to the local governments⁷. On the revenue side, Box 4.2 gives an idea of the plethora of taxes imposed by the local governments. The system of tax rebate from the Central to the provincial governments was retained as

Box 4.1

Expenditure Assignment between the Central and Sub-national Governments

The Central Government	National Defence, Armed Police Troops, Diplomacy and External Assistance, The Central Government's Administration, Capital Construction, Innovation Funds and Science and Technology Promotion Funds of Centrally-controlled SOEs, Geological Prospecting Expenses, Expenditure for Supporting Agricultural Production and Agriculture Operating Expenses, Principle and Interest Payment for the Domestic and Foreign Debts, Expenditure for Public Security Agency, Procuratorial Agency and Court of Justice, Operating Expenses for Culture, Education, Science and Healthcare, Other Expenditures.
The Sub-national Governments	Sub-national Government Administration, Expenditure for Public Security Agency, Procuratorial Agency and Court of Justice, Local Capital Construction, Innovation Funds and Science and Technology Promotion Funds of Local SOEs, Expenditure for Supporting Agricultural Production and Agriculture Operating Expenses, Urban Maintenance and Construction Expenditure, Operating Expenses for Local Culture, Education, Science and Healthcare, Price Subsidies, Others.

Box 4.2

The Revenue Assignment between the Central and Sub-national Governments in 1994

The Central Revenues	Tariffs, Consumption Taxes, Income Taxes of SOEs under the Jurisdiction of the Central Government, Import-related Consumption Taxes and VATs, Taxes Imposed on Banks, Non-bank Financial Institutions and Insurance Companies (including Business Taxes, Income Taxes, and Urban Maintenance and Development Tax), Taxes on Railroads, Profits from the SOEs under the Jurisdiction of the Central Government.
Sub-national Revenues	Business Tax (Not including Banks, Non-bank Financial Institutions and Insurance Companies and Railroads), Company Income Tax (Not including Local Banks, Foreign Banks, and Non-bank Financial Companies), Local Company Profits, Personal Income Tax, Urban Land Using Tax, Urban Maintenance and Development Tax (Not including Banks, Non-bank Financial Institutions and Insurance Companies and Railroads), Fixed Assets Investment Adjustment Tax, House Property Taxes Agriculture and Related Taxes, Tax on Contracts, Tax on the Use of Arable Land, Stamp Taxes, Animal Slaughter Taxes, Land Value Increment Taxes.
Sharing Revenues	Value Added Taxes (the Central Government 75 per cent, Sub-national Governments 25 per cent), Stamp Taxes on Security Exchange (50 per cent each), Resource Taxes (Ocean Petroleum Resource Taxes Belong to the Central Government).

a lump sum transfer payment. The new system clearly defined a new revenue-sharing arrangement, introduced a single unified income tax for all enterprises and broad-based value-added tax (VAT), covering almost all goods and services, excise duty on a few selected commodities and a business tax on services not covered by VAT. National and provincial tax bureau were also established to segregate the collection of revenue and to minimise the scope for concealment of revenues.

The immediate impact of the tax assignment arrangement was quite visible in the shift in the sharing of tax revenue between the Central and local governments. The system had fundamentally changed the way the revenues were shared. With VAT⁸ as a component of the shared tax (with the Central government retaining 75 per cent of the collection), the balance of revenue had tilted in favour of the Central government. The share of the Central government in the total revenue, for instance, suddenly jumped from 22 per cent in 1993 to 55.7 per cent in 1994, though subsequently it began to decline again. The basic point was that VAT, as a major indirect tax shared between the Centre and the local governments, had brought about a significant change in the fiscal relationship between the Centre and the local governments. Also, as a result of removal of the responsibility of collection of Central taxes and VAT from local governments, the new system succeeded in eliminating the scope for diversion of Central revenues to the local exchequers.

In a way, the new system, as opposed to the earlier one, had the effect of removing some implied incentives for the local governments. In this sense, the new system ran the risk of curbing revenue growth and creating more budgetary constraints in the future. It was, perhaps, in anticipation of this that the Budget Law was passed (by the Ministry of Finance) in 1995, which: (i) prohibited the Central government from borrowing from the central bank and having a deficit in the current account, and (ii) imposed stringent restrictions on local governments, besides restricting their borrowings from the financial markets. The Law was intended to impose fiscal disciplines at all levels of the government. The establishment of an independent auditing system was also introduced in order to ensure the effective enforcement of the Law.

The Budget Law, however, gave rise to an important issue, namely, the issue of financing the expenditures in a situation of declining revenue collection/GDP ratio. The issue was particularly relevant for local governments since they were responsible for most of the expenditures. What emerged subsequently was a steady rise in extra-budgetary revenue (EBR) mobilisation by the local governments. It had risen from 186.2 billion yuan in 1994 to 382.6 billion yuan in 2000, when it was about 10 per cent of the

GDP. By the end of the 1990s, the task of fiscal reform had made much progress, but it still remained unfinished. The system, which was introduced in 1993, had left much room for improvement, and fiscal reform remained a priority area for reform during the subsequent years. Yet, the taxation policy went a long way in the direction of creating a market economy, while seeking greater alignment with international standards.

EXTERNAL LIBERALISATION AND OPEN DOOR POLICY

The open door policy was perhaps the central aspect of China's economic reform, and was the starting point of the deviation from Mao's economic ideology. Before 1978, the economy was almost closed, with the trade/GDP ratio being less than 10 per cent. China, in those days, did not borrow money from international sources; nor did it allow foreign enterprises to come in. It was not a member of General Agreement of Tariff and Trade (GATT), nor of the World Bank/International Monetary Fund (IMF). It did not seek foreign technology either. The Party-controlled media had kept the people in isolation. The open door policy was obviously the first priority for Deng Xiaoping, as China had to send out signals about its desire for transition and modernisation. The process of modernisation required external support, by way of capital, technology, soft loans, trade, etc., amongst other things. However, the policy of external liberalisation had to pass through an evolutionary, rather than revolutionary, process, meaning that the door was being opened up in stages.

To begin with, the open door policy was strictly experimental. Truly speaking, as in the case of the reform measures relating to agriculture, industry, etc., China did not have any well-designed strategy for opening up the economy, at least not during the initial phase. The need for the open door policy was more than a conviction about its relevance in China's context, but it had to be tested and tried. Even in the formulation of its strategy for economic transition, it may be mentioned, China did not borrow any ideas from foreign experts who could have instantly provided a package, along with a roadmap and a timetable for the same. China's new economic policies were not import-oriented, but

were derived from internal debates and the experiences gained. The growth model of China, in this sense, is an isolated, purely indigenous, model. The open door policy did not have any external influence on it.

The first phase of the open door policy was the period 1979–86, when besides opening the door, China joined World Bank and the IMF, and applied for re-entry into GATT. As mentioned earlier in Chapter 3, in 1980, Special Economic Zones (SEZs) were established in four coastal cities in the Guangdong and Fujian provinces. These cities were the homelands of many overseas Chinese. These zones were given the authority to offer special advantages to foreign investors, namely exemptions from profit tax and import tariffs, licenses to conduct foreign trade in specified products, etc. In 1984, the open door policy was extended to 14 coastal cities, and to the deltas of Yangtze, Pearls and Minoan Rivers in 1985. Subsequently, foreign banks were allowed to open offices in the SEZs and later in the coastal cities, though they were prohibited from doing business in domestic currency (Renminbi).

On the trade front, before 1980, only 14 Foreign Trade Corporations (FTCs) were conducting foreign trade operations. They were in sole charge of export-import operations. Liberalisation began with the breaking of the state monopolies, and allowing more enterprises to get into foreign trade operations, though in specified products. Initially, this facility was restricted to those located in the Guangdong and Fujian provinces. Subsequently, all provinces were included. Enterprises were granted licences to carry out trade in specified products, but later in 1984, a negative list was prepared. The import of products not included in the negative list was allowed freely. Further, the number of approved FTCs in the country also increased to 1,000 in 1984.

During the 1980s, external liberalisation was basically controlled liberalisation with respect to both foreign trade and investment. The Government wanted foreign direct investment (FDI) to come in, but only in selected provinces. Also, FDI was not supposed to create disruptions by way of crisis in the balance of payments. Accordingly, the requirement of foreign exchange balancing⁹ was imposed. Foreign banks were not allowed to do business in domestic currency, and their operations were confined

to the SEZs and open cities only. There was no convertibility of the currency either. All foreign currencies coming into the country had to be converted into domestic currency. The result was that increasing exports and foreign investments were rapidly building up foreign exchange reserves, which were further supplemented by the government's borrowing from abroad on soft terms. The exchange rate and trade control mechanisms, which will be covered later, were also judiciously exercised to serve the dual purpose of promoting exports and protecting the reserves.

The scope of a liberal FDI regime was further expanded towards the late 1980s, when an additional 140 coastal cities and Hainan Island were allowed to exercise similar authorities, as had been extended to the SEZs and the coastal cities earlier. Trade policy liberalisation went ahead with the creation of more FTCs, whose number reached 4,000 in 1988. During the same year, the Ministry of Foreign Trade and Economic Co-operation (MOFTEC) introduced the export contract system, whereby each FTC was responsible for achieving targets of export volume, cost and profit set by the MOFTEC. The idea was to make the FTCs focused and profit-oriented. Further, in a move towards de-centralisation, the MOFTEC also allowed the provincial authorities to approve FTCs.

There was a period of about two years of a standstill on external liberalisation during 1989–90, on account of over-heating of the domestic economy, to which the external sector had also made some contributions. Competition among growing number of FTCs was giving rise to the worsening of terms of trade and an adverse current account balance. The austerity measures that were introduced to facilitate cooling off of the economy were not extended to cover the external sector, but in 1989, all FTCs were required to be registered with Ministry of Foreign Economic Relations and Trade (MOFERT), and the FTCs that were found to be unqualified were closed down, in addition to a tightening of exchange controls to curb import growth. As a result, import growth was significantly curbed, the trade balance turned into a surplus, and foreign exchange reserves at about USD 22 billion were sufficient for an equivalent of more than nine months of imports.

Beginning with 1992, when Deng Xiaoping undertook his famous 'tour of the south' and reported on the successes of the

coastal cities, we see a new wave of external liberalisation taking place. The authority to approve FDI was delegated to local governments, more regions were opened up to foreign investment and ownership requirement for FDI was also relaxed. In addition, the government had begun to allow FDI on a trial basis in certain services sector such as distribution, retail trade, insurance and securities. Foreign banks were allowed to open businesses in more cities. Apart from FDI, the government was also exploring the possibilities for more channels to attract foreign capital, and in 1992 itself, the B-share market was launched in Shenzhen and Shanghai. With this, the domestic companies were allowed to issue foreign currency-denominated shares in the stock markets that could be purchased by the non-residents. Next year, non-banking financial institutions (NBFIs), that is, financial leasing corporations, finance companies, securities firms, trust and investment companies, were all allowed to do business in foreign currencies, and, later on in 1996, they were allowed to issue bonds in international markets. In yet another significant step towards liberalisation of FDI, in 1995, the Foreign Fund Enterprises (FFE) were allowed to invest in the SOEs by way of equity purchase or capital injection.

The most important step in the FDI policy during the 1990s was, however, the amendment of the Constitution in 1993. This amendment was intended to improve the overall climate for economic growth and to re-affirm the commitment to a socialist market economy. It also sought to create confidence in the minds of the foreign investors. Earlier, laws were enacted to ensure investment protection, namely, (i) Law on Sino-Foreign Joint Venture Enterprises (JVEs), stipulating non-nationalisation, (ii) Constitutional provision of December, 1982 stipulating protection of legitimate rights and interests of the FFEs, and (iii) the 1986 Law on FFEs stipulating the protection of investment, profits etc. The amendment in 1993 incorporated all these, and many more, to lay the ground for predictability, transparency and non-discrimination. Subsequent developments towards the liberalisation of the external sector related mainly to liberalisation of the exchange control regime. In what follows, we shall give an outline of major policy initiatives in this area.

EXCHANGE RATE AND EXCHANGE REGULATIONS

When the process of opening up was started in 1978, foreign exchange transactions were in the hands of the Bank of China, a specialised bank that was set up for the purpose. There was only an official exchange rate. All foreign currency earnings had to be deposited with the Bank of China at the officially determined exchange rate. The system of foreign exchange management that did exist was typical of a closed economy, which China was. The opening of the economy required a careful management of foreign exchange regulations. The policy that began to evolve, beginning with 1979, had to take care of several objectives, namely:

1. Promotion and encouragement of foreign investment.
2. Promotion of exports and regulation of imports.
3. Management of balance of payments.
4. Harmony between domestic and external economy.
5. Safeguarding against turbulences in the global economy.
6. Stability of exchange rate, etc. among others.

The new system of foreign exchange management, adopted in various phases since 1979, was geared towards liberalisation in a gradual manner. The first step was de-centralisation of the business of foreign exchange transactions, when foreign banks were allowed to set up branches in the SEZs to do business in foreign currency transactions, but not in Renminbi. This step was extended further when all the domestic banks were also allowed to conduct business in foreign currencies. This helped the banking sector build up foreign exchange assets, by way of taking foreign currency deposits from companies and individuals.

De-centralisation was accompanied by a system of dual exchange rate, namely, the official rate and the swap rate. The dual exchange rate had come to exist in view of a retention quota system, under which, while the domestic enterprises had to surrender all the foreign exchanges earned by them, the local governments were allowed to retain a part of the deposit. The domestic firms were then given a quota, according to their shares

in foreign exchange surrendered. The quota could be sold in the swap market. The system provided domestic firms a motivation to earn foreign exchange.

In order to contain the unnecessary outgo of foreign exchange, it was made mandatory for the FFEs to maintain foreign exchange balancing. The domestic enterprises were, similarly, required to submit foreign exchange plans. As a result of the balancing requirement, each FFE was expected to earn sufficient foreign exchange not only to pay for imports but also to expatriate profits, salaries, etc. This balancing requirement was somewhat liberalised later when it was applied to sectors in which the FFEs had invested, rather than to individual FFEs. The FFEs with a shortage of foreign exchange were allowed to borrow from the cash-rich FFEs. The foreign exchange plans of domestic enterprises were supplemented by the trade plan of the State Development and Planning Commission (SDPC) and the foreign capital utilisation plan of the Ministry of Finance (MOF).

Following the crisis of 1988–89, the Government had resorted to somewhat stricter monitoring of foreign exchange outgo, while still maintaining the liberalisation process. For instance, a 1989 Regulation required all the FFEs to deposit all receipts of foreign exchange in domestic banks. But if the FFEs products substituted imports or were sold to SEZs or other FFEs, they could settle the trade in foreign exchange with the approval of the State Administration of Foreign Exchange (SAFE). Similarly, through another regulation, domestic enterprises were allowed to invest overseas with their own foreign exchange earnings, after clearance by the SAFE as to the sources of their earnings. But they were required to deposit 5 per cent of the investment amount, in a special account of a bank to be designated by the SAFE.

By way of control and to ensure the larger inflow of foreign exchange, all firms engaged in exports had to undergo the verification of export receipts, by submitting copies of export contracts and customs declarations to SAFE. Beginning with 1992 and continuing up to the end of the 1990s, there was a spate of liberalisation of foreign exchange control measures, some of which are mentioned below (interested readers can see Annexures XVII and XVIII for details).

1. Firms allowed to retain part of foreign exchange earnings from non-trade transactions.
2. Unification of official and swap market exchange rate (on 1 January 1994) at the swap rate of 8.7 yuan/dollar, unified rate being market-based managed floating rate with +/- 0.3% band.
3. Phasing out of swap centres.
4. Operationalisation of China Foreign Exchange Trade System (CFETS).
5. Repeal of foreign exchange retention and quota system.
6. Ceilings on an individual's purchase of foreign exchange raised.
7. Abolition of foreign exchange balancing requirement and foreign exchange plans.
8. Acceptance of Article VIII of the IMF (that is, undertaking to refrain from imposing restrictions on payments and transfers or from discriminatory currency arrangements without approval of the IMF).

At the time of the Asian financial crisis, the Government had used exchange control regulations in a manner that could check outflow but encouraged the inflow of foreign exchange, so as to reduce the pressure on balance of payments and prevent the currency from devaluating. It had allowed foreign banks in a total of 18 cities to conduct business in Rmb. Also, except for the purpose of doing business in Rmb, geographical restrictions on foreign banks were removed. Further, foreign banks were also allowed to invest in domestic banks.

ACCESSION TO WTO

As mentioned earlier, one of the objectives of the accelerated reform programmes of the 1990s was to allow China to gear up for accession to the World Trade Organization (WTO), for which bilateral negotiations under the Working Party arrangements were already on in full steam. The Working Party partners were trying to extract maximum concessions as a pre-condition for entry into the WTO. Internally, China was debating the impact

of its entry into the WTO, but was also keen about accession at the same time. There were several reasons for this. Membership of the WTO would allow it to reap the advantages that come with multilateralism, especially of a permanent trading relationship with all WTO member countries.

Remaining outside the WTO entailed a significant cost, namely, that of the annual renewal of bilateral agreements. In this context, mention can be made of the annual renewal of the trading relationship (known as permanent normal trading relations) with the USA and an atmosphere of uncertainty that used to surround this negotiation. The accession negotiation with the USA, incidentally, was the toughest challenge for China, in view of several stringent demands coming from the former.

Accession to WTO was also important for ensuring automatic access to most-favoured nation (MFN) treatment with all the member countries. Further, accession would ensure access to all the markets on the basis of national treatment and transparency, implying great export opportunities. No doubt, accession meant subordination to multilateral rules and disciplines, but in the ultimate analysis, it was a to be 'win some, lose some' accommodation arrangement. But more importantly, membership of WTO was considered necessary, as it would earn China the image of a responsible global player, besides establishing its firm commitment to a market economy. Actually, China, in the words of the then Premier Jiang Zemin, wanted to do a better job in opening up by 'bringing in and going out' in the context of 'the new economic situation of globalisation'.

It had taken China fifteen long years of hard bargaining with about 50 Working Party members, before it could finally secure accession to the WTO on 11 December 2001. It was a high-drama scene at Doha, where the General Council had finally approved the Draft Protocol on China's accession on 11 November 2001. Accession amounted to China undertaking several multilateral commitments to fully open its economy, in a phased manner, by 2011. Following were some of the broad commitments implied in the accession:

1. Full respect of all laws, regulations and administrative requirements with the principle of non-discrimination between domestically produced and imported products

- would be ensured and enforced immediately upon accession.
2. China would repeal and cease to apply all such existing laws, regulations and other measures, whose effect was inconsistent with WTO rules on national treatment.
 3. Measures would be taken at the national and sub-national levels, including repeal or modification of legislation, to provide full GATT national treatment in respect of laws, regulations and other measures applying to internal sale.
 4. The Government of China would further improve its taxation system and would continue to improve the efficiency of fiscal expenditure through implementing reform measures such as sectoral budget, centralised payment by the national treasury and zero base budget, as well as improving management of fiscal expenditure.
 5. With respect to future monetary policy, the Central Bank would continue to pursue a prudent policy, maintain the stability of Renminbi (RMB), promote interest rate liberalisation and establish a modern commercial banking system.
 6. China would implement its obligations with respect to foreign exchange matters in accordance with the provisions of the WTO Agreement and related declarations and decisions of the WTO that concerned the IMF.
 7. China would fully comply with the provisions of the GATT 1994 and the Balance of Payments (BOPs) Understanding.
 8. Those measures taken for BOPs reasons would only be applied to control the general level of imports and not to protect specific sectors, industries or products.
 9. China had promulgated investment guidelines and the Government of China was in the process of revising and completing these guidelines. These investment guidelines and their implementation would be in full conformity with the WTO Agreement.
 10. China would only impose, apply or enforce laws, regulations or measures relating to the transfer of technology, production processes, or other proprietary knowledge to an individual or enterprise in its territory

that were not inconsistent with the WTO Agreement on Trade-Related Aspects of Intellectual Property Rights (TRIPs Agreement) and the Agreement on Trade-Related Investment Measures (TRIMs Agreement).

11. Price controls would not be used for purposes of affording protection to domestic industries or services providers. China would apply its current price controls and any other price controls upon accession in a WTO-consistent fashion, and would take account of the interests of exporting WTO Members as provided for in Article III: 9 of the GATT 1994.
12. Administrative regulation, departmental rules and other Central Government measures would be promulgated in a timely manner so that China's commitments would be fully implemented within the relevant time frames. If administrative regulations, departmental rules or other measures were not in place within such time frames, authorities would still honour China's obligations under the WTO Agreement.
13. The Central Government would ensure that China's laws, regulations and other measures, including those of local governments at the sub-national level, conformed to China's obligations undertaken in the WTO Agreement.
14. During the three years of transition, China would progressively liberalise the scope and availability of trading rights.
15. China would apply and administer in a uniform, impartial and reasonable manner all its laws regulations and other measures of the Central Government as well as local regulations, rules and other measures issued or applied at the sub-national level pertaining to or affecting trade in goods, services, trade-related aspects of intellectual property rights (TRIPs) or the control of foreign exchange.
16. China's local regulations, rules and other measures of local governments at the sub-national level would conform to the obligations undertaken in the WTO Agreement.
17. China would apply to imported products, including physically incorporated components, introduced into the

other parts of China's customs territory from the special economic areas, all taxes, charges and measures affecting imports, including import restrictions and customs and tariff charges, that are normally applied to imports into the other parts of China's customs territory.

18. Without prejudice to China's right to regulate trade in a manner consistent with the WTO Agreement, China would progressively liberalise the availability and scope of the right to trade, so that, within three years after accession, all enterprises in China would have the right to trade in all goods throughout the customs territory of China, except for those goods listed in Annexure 2A of the Protocol, which continue to be subject to state trading in accordance with this Protocol.
19. China would ensure that import purchasing procedures of state trading enterprises were fully transparent, and in compliance with the WTO Agreement, and would refrain from taking any measure to influence or direct state trading enterprises as to the quantity, value, or country of origin of goods purchased or sold, except in accordance with the WTO Agreement.
20. China would also provide full information on the pricing mechanisms of its state trading enterprises for exported goods.
21. China would, upon accession, comply with the TRIMs Agreement, without recourse to the provisions of Article 5 of the TRIMs Agreement. China would eliminate and cease to enforce trade and foreign exchange balancing requirements, local content and export or performance requirements made effective through laws, regulations or other measures.
22. Import and export prohibitions and restrictions, and licensing requirements affecting imports and exports would only be imposed and enforced by the national authorities or by sub-national authorities with authorisation from the national authorities.
23. China would notify the WTO of all licensing and quota requirements remaining in effect after accession, listed separately by HS tariff line and with the quantities

associated with the restriction, if any, and the justification for maintaining the restriction or its scheduled date of termination.

24. China would allow prices for traded goods and services in every sector to be determined by market forces, and multi-tier pricing practices for such goods and services shall be eliminated.
25. Price control would not be extended to goods or services beyond those listed in Annexure 4 of the Protocol, and China would make best efforts to reduce and eliminate these controls.
26. China would eliminate all subsidy programmes falling within the scope of Article 3 of the SCM Agreement upon accession. China would not maintain or introduce any export subsidies on agricultural products.
27. China would ensure that customs fees or charges applied or administered by national or sub-national authorities, shall be in conformity with the GATT 1994. China would ensure that internal taxes and charges, including value-added taxes, applied or administered by national or sub-national authorities shall be in conformity with the GATT 1994. China would eliminate all taxes and charges applied to exports unless specifically provided for.

What did all these mean for China? In other words, what were the implications of WTO accession for the Chinese economy? To put it in a simple way: economic reforms, undertaken during the period 1978–2000, were far from enough. The transition to a market economy was not even half complete. A lot still had to change. In 2000, the Chinese economy was far from liberalised, going by the standard of multilateral norms. The WTO fraternity had agreed to take China in its fold, but was not satisfied with the speed of transition. Substantially more was expected of China, within a decade. The Accession Agreement, agreed upon by China, was essentially a long list of things to do by 2011. What has been happening in China since its accession to WTO is liberalisation and opening up of the economy as per the multilateral mandate, almost beyond the influence of the party. Internal debates notwithstanding, China has to open up its economy.

All these would undoubtedly have an impact on many things in the economy, but two elements will have to undergo major restructuring, namely, the SOEs and the banking sector. For the government, entry into WTO meant enormous challenges of managing the transition and maintaining the equilibrium on several fronts. We shall talk of these challenges in appropriate places in the subsequent chapters, but first let us see how much China has achieved so far, and how its economy has responded to the changes that have already taken place.

NOTES

1. For instance, in a major overhauling of the government machinery, 14 ministries and commissions were dissolved and then ones created. Many of the ministries that were dissolved were converted into business enterprises responsible for their own profits and losses. Similarly, state councillors, whose number was reduced from 11 to 9, were chosen from among technocrats known for their professional expertise.
2. The irritant was mainly internal law and order. For instance, the call for the 'Independence of Tibet' and riots in the streets of Lhasa, expression of support for the exiled spiritual leader, the Dalai Lama, etc., were perceived as threats to stability in the border area.
3. The phrase underlines a key point. The Chinese people would themselves deliberate on what needed to be done for the economy, when and how, and not be pushed and pulled by external pressures.
4. The strategy for transition to a market economy was a purely indigenously developed one under the leadership of Zhao Ziyang, who had mobilised a carefully selected team of experts, who were trained abroad at government costs.
5. This was due to state control and/or requisition of private enterprises during the initial decade of communism in the Mao era.
6. There is a popular myth in most countries about labour policy in China. It is believed by the industry leaders in most countries that in China, labour can be easily hired and fired. The reality, however, is that this is extremely difficult. It is quite costly on the part of an enterprise to sever a contract prematurely in China.
7. This should help one understand the complexities of the taxation system as well as those of the subsidies in China. The local governments, including the municipalities, impose most of the taxes.
8. VAT stands for value added tax imposed on the quantum of value added in the process of production and provision of services. It is imposed in lieu of excise duty.
9. The system basically meant that the corporations were required to earn foreign exchange through exports in order to meet the import expenditure.

Five

China's New Economy

An Overview

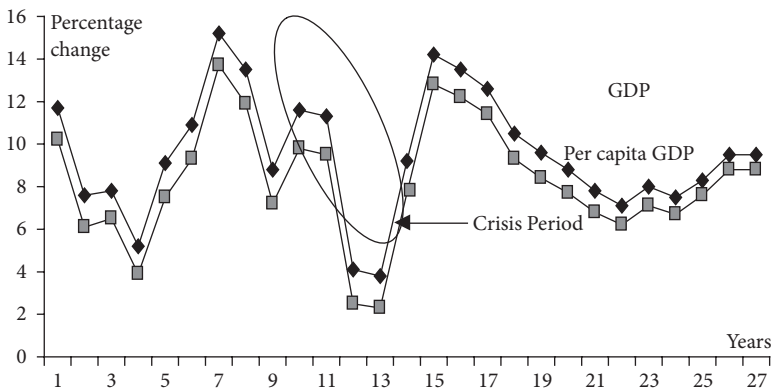
Nearly three decades of economic transition to a socialist market economy have brought about profound changes in the Chinese economy, in a way that no other economy has witnessed. As most Chinese people are now prone to saying, 'Twenty-five years ago there was nothing.' This is no exaggeration. In 1978, China had an impoverished, and, if one may say so, autarkic socialist economy, wherein over 950 million people produced a gross domestic product (GDP) of USD 215 billion and more than 43 per cent lived in absolute poverty. In 2005, 1.3 billion Chinese had a per capita GDP of over USD 1700, an eight-fold increase over 1978. The size of the real economy in 2005 (at USD 2.2 trillion) was more than ten times size in 1978. On top of this, the economy grew by 10.7 per cent in 2006, and pushed the GDP to over USD 2.4 trillion, and the per capita GDP exceeded USD 1800. Since 1978, the per capita private consumption has increased eight-fold in real terms. In 2005, the per capita consumption of urban households was 10,493 yuan, and the total retail sales of consumer goods were worth about 6,718 billion yuan, backed by a real growth of 12 per cent over the previous year. These indicate substantial improvement in the living standards and quality of life of the average Chinese.

A few indicators may be helpful in providing an overview of improvements in the consumption level and standard of living of the people. In 2004, the spending on private household consumption exceeded USD 1 trillion, which is perhaps larger than the combined GDP of the whole of South Asia during that year. The market size had been expanding at the rate of 7.6 per cent since the mid-1990s. As for the living standards, in 2005, an average Chinese spent USD 3.4 on detergents, USD 7.5 on bottled water, USD 4.3 on soft drinks

and USD 2.3 on skin care products, among other things. As far as consumer durables were concerned, during the same year, the population per thousand in China had 416 TV sets, 301 cellular subscribers, 59 motorcycles and 14 passenger cars. Modern retail trade accounted for 36 per cent of the total retail market¹.

What has made all these developments possible is the sustained high growth in GDP following the introduction of reform in 1978, since when real GDP² has been growing at an average annual rate of 9.8 per cent. Since China's entry into the World Trade Organization (WTO) in 2001, the country's average annual growth rate has further increased to over 10 per cent. In 2006, the growth rate at 10.7 per cent³ was fifty basis points above the short-term trend. The growth of the economy has been remarkable in view of its sustained continuity for over such a long period. Beginning with 1980, China had adopted a policy to control population through the introduction of the one-child norm⁴. This policy succeeded in bringing down the population growth, and made a significant contribution to the 7.8 per cent annual growth in the country's per capita GDP. All this, however, does not mean that the economy has had no problems. On the contrary, there have been several pitfalls, leading to a crisis, in the transition during the first phase of economic reform (see Figure 5.1), when the growth of the GDP, and consequently of the per capita GDP, witnessed violent swings.

Figure 5.1
Annual Changes in GDP and Per Capita GDP (1978–2004)



Source: Prepared from the database of National Bureau of statistics, People's Republic of China, by Shashwati Ghosh.

However, the government had succeeded in managing the situation, through effective policy interventions. Broadly speaking, however, China witnessed a trying period of growth during the first phase of reform. A more realistic performance of the economy has been observed beginning with the 1990s.

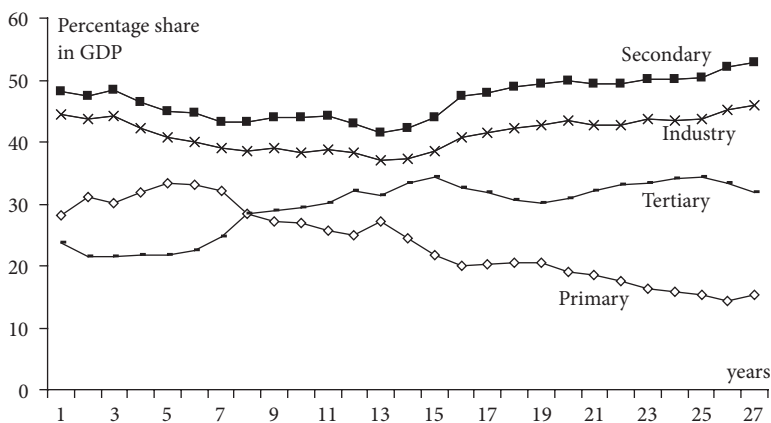
STRUCTURAL CHANGES IN THE ECONOMY

Economic reform and growth combined to bring about several significant structural changes in the economy. Following the encouragement provided to the growth of private initiatives in agriculture as well as in industry, the share of state-owned enterprises (SOEs) and state-invested enterprises (SIEs) in the national industrial value-added, which was as high as 72 per cent in 1998, came down to 47.8 per cent in 2003 and further to 45 per cent in 2005. The share of pure private domestic and foreign enterprises (not including collectively-owned ones) was about 50 per cent in 2003. In the marketplaces, the controlled economy now accounts for only 3 per cent of the retail market, down from about 98 per cent in 1978.

On the macro-side of the economy, structural changes were reflected more in terms of the reduced relevance of the primary sector in the economy, with its share in GDP coming down from 28 per cent in 1978 to 12.4 per cent in 2005 (see Figure 5.2). Industry has always had a high share in the GDP in China. During Mao Zedong's regime, on account of the emphasis on development of heavy industries and the thrust on rapid industrialisation, this sector's contribution to the GDP was already 40–44 per cent. Post-reform, this contribution further went up to 49 per cent in 1980, and was 47.3 per cent in 2005. However, if we look at the secondary sector (industry plus construction), the share went up from 48 per cent in 1978 to about 53.4 per cent in 2005. The construction sub-sector (largely reflecting the developments in real estate and infrastructure) doubled its share in the GDP to about 8 per cent during the same period.

Another significant development was the growth in the tertiary sector activities, which always signified a low-key activity during the Mao era. During the period 1960–80, the contribution of this

Figure 5.2
Structural Changes in the Economy (1978–2004)



Source: Prepared from the database of National Bureau of statistics, People's Republic of China, by Shashwati Ghosh.

sector came down from 32 per cent to 21 per cent, mainly due to stringent controls amounting to a ban on private initiatives and markets. However, beginning with 1980, reform favouring private initiatives led to the proliferation of tertiary activities of all kinds and the contribution of this sector in the GDP doubled. See Table 5.1 for details of sectoral growth during different time periods. Exceptionally high growth of 11.7 per cent during the first phase of reform was the initial effect of unshackling the initiatives of the people. However, as we have seen in Figure 5.1, there were severe fluctuations in the annual GDP growth.

Table 5.1
Average Annual Growth of Real GDP (1978 = 100) in China

(in percentage)

Periods	Real GDP	Primary Sector	Secondary Sector	Industry	Tertiary Sector
1979–90	9.1	5.5	9.8	9.8	11.7
1990–2004	9.7	3.7	12.6	12.9	8.9
1979–2004	9.5	4.5	11.4	11.5	10.1

Source: Calculated from the data available from the National Bureau of Statistics (NBS), People's Republic of China (PRC).

Note: The secondary sector includes industry and construction.

The consistent decline in share of the primary sector was symbolic of rapid industrialisation in post-reform China. Specifically, the share of agriculture, the largest component of the primary sector, declined more rapidly. The growth rate in agriculture was 5.3 per cent in the 1980s, which declined to 4.3 per cent in the 1990s, and further to 3.7 per cent during the period 2000–05. This sector has seemingly reached the growth limit in view of several structural rigidities, which shall be discussed later. Grain production increased at a reasonably good rate between 1978 and 1999, from 320 million tonnes to over 508 million tonnes, but it is currently suffering from several constraints.

More than stagnation in grain production, which is pulling down the growth in the primary sector, there is concern about the overall growth prospect in those provinces where there is a substantially large dependence on the primary sector. As regards the employment structure in various provinces (see Annexure XV), it has been observed that out of 31 provinces, as many as 14 provinces are highly dependent on the primary sector for employment. These 14 provinces accounted for about 28 per cent of the national GDP in 2003. In the absence of faster industrialisation, some provinces are witnessing large migration to other provinces having higher levels of industrialisation.

DRIVERS OF GROWTH

While the primary sector has been losing its growth momentum and its significance in the overall economy, the industry and tertiary sector activities, primarily the former, have been the main drivers of overall growth. While the structural transformation of the economy has been significant, resulting in the conversion of a primarily agrarian economy into a rapidly growing industrial economy (and today by all measures, China is basically an industrial economy), economic reform has created a highly vibrant and diversified corporate sector in China. In 1978, China did not have private entrepreneurs or private enterprises. The emergence of the private sector since the launch of economic reform occurred not through privatisation of the SOEs, but through the private initiatives of individual households, collective enterprises, joint

ventures with foreign enterprises and, of course, through wholly foreign-invested enterprises. As has been mentioned in Chapter 4, the reform measures relating to the SOEs focused primarily on capitalisation and improvement in corporate governance. Economic reform has brought about dramatic changes in China's corporate landscape, now represented by a diversified range of corporate entities in the secondary and tertiary sectors.

By the end of 2004, the country had 1.451 million industrial corporations of various types, employing about 96.5 million people, in addition to over 5.3 million individual and household enterprises employing over 25.6 million people. Accordingly, as regards the nature of ownership, there are various types of industrial corporations of varying significance in terms of industrial output and employment. In 2005, there were 14 different ownership-based corporations.

The declining influence of the State is reflected in the number of private domestic-funded enterprises (Nos. 11 and 12 in Table 5.2), accounting for about 67 per cent of the total number of corporations. If foreign enterprises are taken into account, the share of solely private sector-owned enterprises goes up to about 75 per cent. The state-owned/controlled/influenced corporations⁵ account for about 44 per cent of the total employment and are more employment-intensive as compared to purely private corporations. However, domestic private enterprises constitute the largest employer in the industrial sector, followed by the limited liability corporations and the enterprises owned by the non-resident Chinese from Hong Kong, Macao and Taiwan.

The distribution of corporations according to activities undertaken shows that the bulk of the corporations (91.6 per cent) are engaged in manufacturing establishments and employ about 83 per cent of the total workforce employed by industrial corporations of all types (see Table 5.3). The range of products manufactured by such corporations is vast, and each of the manufacturing activities has attracted a fairly large number of enterprises. For instance, at the end of 2004, the numbers of corporate enterprises (other than individual and household enterprises) were as follows: 87,000 in textile, 120,000 in pharmaceuticals, 32,000 in food products, 80,000 in chemicals and chemical products, 86,000 in metallic

Table 5.2
Distribution of Industrial Corporations and Employees: 2005
(by type of ownership)

<i>Types</i>	<i>No. of Corporations (in 10,000)</i>	<i>No. of Employees (in 10,000)</i>
1. State-owned	2.8	921.0
2. Collective-owned	15.2	729.8
3. State Holding Co-operatives	5.2	212.4
4. State-joint	0.1	10.3
5. Collective-joint	0.3	15.1
6. Joint State-collective	0.1	10.1
7. Other Joint Ownership	0.2	10.9
8. State Dole-funded	0.2	370.7
9. Other Limited Liability Corpus	10.5	1356.5
10. Share-holding Limited	1.8	516.9
11. Private Enterprises	94.7	3370.9
12. Other Domestic-funded	2.5	61.3
13. Enterprises with Investments from Hong Kong, Macao and Taiwan	5.9	1070.3
14. Foreign-funded Enterprises	5.5	987.6

Source: NBS, China, Communiqué on Major Data of the First National Economic Census (No. 2), 3 March 2006.

products, 57,000 in transport equipments, etc. This should help one understand why China produces everything in large quantities—too much entrepreneurship in every field of manufacturing. Led by the entrepreneurship of the people and helped by the foreign enterprises (including those run by the ethnic Chinese from Hong Kong, Macao and Taiwan), China has undergone revolutionary transformation in its industrial economy, which has been at the forefront of her modern economy. It is the industrial sector that has been the main driver of high growth. Between 1990 and 2004, the industrial value added recorded an average annual growth of 12.9 per cent, but between 2001 and 2005, the growth rate accelerated to 13.8 per cent. Since 2003, the growth rate has further accelerated to 16.5 per cent, taking the GDP growth rate along with it to over 10 per cent per annum.

Table 5.3:
Activity-wise Distribution of Industrial Corporations (of All Types): 2005
(in 10,000 nos.)

<i>Activity—Types</i>	<i>No. of Corporations</i>	<i>Employment</i>
1. Mining and Quarrying	8.2	888.8
2. Manufacturing	132.9	8390.5
3. Electricity, Gas and Water	4.0	364.5
4. Total	145.1	9643.8

Source: NBS, China, Communiqué on Major Data of the First National Economic Census (No. 2), 3 March 2006.

Beyond the registered segment of the industrial establishments, there is a parallel industrial economy represented by the individual and household enterprises, which also contribute significantly to the industrial output and the GDP, though much of it is not reported. In 2004, they had earned a revenue of about 2,532 billion yuan, that is, over USD 300 billion or roughly 44 per cent of India's GDP during that year. According to the Economic Census of 2004, the number of such enterprises (known/classified as self-employed individuals) was 39.2 million, of which about 5.9 million were engaged in the secondary sector. The contribution of this segment of industry, wherein the asset value of units is less than 5 million yuan, is not adequately captured in the official data. Another way of looking at this is that there exists a large unorganised sector.

Table 5.4
Production of Select Manufactured Items in 2005
million nos. (unless otherwise specified)

<i>Item</i>	<i>Production</i>	<i>Item</i>	<i>Production</i>
Colour TV sets	82.83	Micro-computers	80.84
Household Refrigerators	29.86	Rolled Steel	396.92 m. t.
Room Air Conditioners	67.65	Non-ferrous Metals	16.35
Motor Vehicles	5.70	Cement	1060.00
Mobile Phones	303.54	Fertiliser	52.20

Source: NBS, Statistical Communiqué, 28 February 2006.

What is noteworthy is the existence of a far-flung network of manufacturing activities throughout the country, which is symbolic of the spirit of entrepreneurship among the people who have been unshackled by the reform process. The small-scale enterprises (of the self-employed), the township and village enterprises (TVEs) and thousands of domestically-funded private enterprises have ushered in a manufacturing revolution in the country. The depth of this revolution can be appreciated in acknowledgement of the fact that manufacturing alone contributes about 41 per cent to the GDP. According to a World Bank Survey (2006), covering 12,400 firms, in 120 cities that account for 70–80 per cent of China's GDP, there were 31 broad categories of firms, ranging from agricultural products to handicrafts, but the sectors that attracted a large number of firms were: food processing and agro-products, textiles (mainly garments), chemical and chemical products, general machinery, transport equipments, non-metal mineral

Figure 5.3

Growth-wise Distribution of Industries in China (1978–2000)

Consumer goods	Cigarettes	Sugar, Beer	Household refrigerators, Air conditioners, Household washing machine, Colour television sets, Cars, Micro-computers, Integrated circuit
Intermediate goods	Yarn, Cloth, Silk, Machine-made paper and Paper board, Chemical fertiliser, Chemical pesticide	Steel products, Sulphuric acid, Soda ash, Caustic soda	Chemical Fibre, Plate glass plastics
Basic goods and others	Coal, Crude Oil, Natural gas, Electricity, Metal cutting machine Tools	Hydropower, Pig iron, Steel	Cement

Low $\leq 5\%$

Medium > 5 but $< 10\%$

High $\geq 10\%$

Source: Prepared from basic data of NBS.

products, electrical equipments and machinery, electronics and telecom equipments, etc. The other aspect of manufacturing concerns the scale of production. China's manufacturing sector is known for its mass production nature of almost every product, irrespective of the category. The actual production figures of some items in 2005 can be cited as examples (for details, see Annexure XII).

There has, of course, been regional variations in the spread of manufacturing. As mentioned earlier, several provinces show a pre-dominance of the primary sector in their respective economies. The share of the secondary sector in GDP (2004) varied from 9.1 per cent in Yunnan to over 40 per cent in Tianjin, with a median value of 20.3 per cent. Regional variation in the contribution of the industrial sector has been accompanied by local concentration with respect to certain manufacturing activities. However, broadly speaking, all the provinces have taken promotional measures to attract private investments. Every province has also been found to be attracting FDI in varying amounts. According to the same World Bank Survey, in 2004, nine provinces had per capita FDI ranging between USD 1–5, six between USD 5–10, nine between USD 10–100, and the rest got more than USD 100. While the disparities are on account of the phased and selective liberalisation of foreign investment policy, FDI is now gradually penetrating the interiors of the country.

A very significant transition, however, has been by way of compositional change in the manufacturing sector. Since the launch of economic reform, the bias has clearly shifted away from traditional heavy and intermediate industries to consumer goods. This shift, a consequence of allowing the TVEs to manufacture everything and of de-reservation of the sectors earlier meant only for state investment, can be traced to the annual growth rates in certain sectors (see Table 5.5).

A highly significant aspect of development in China's manufacturing sector pertains to technological mobility, that is, the growth of high-tech industries, on one hand, and upscaling of technology in old industries on the other. With respect to the first, high-tech industries have shown remarkable growth since the mid-1990s. The value-added in high-tech industries such as medical and pharmaceutical products (including biotechnology), transport

Figure 5.4
Growth and Character-based Distribution of Industries

Very High > 15%			
High 10-15%			
Medium 5-10%			
Low < 5%			
	Purely Resource-based	Labour-intensive	Technology-intensive

Source: Prepared from basic data of NBS, by Shashwati Ghosh.

Note: The database did not have data on typically labour-intensive low value added items.

equipments, electronics and telecom equipments, computers and office equipments, etc., are found to have grown phenomenally since 1995 (see Table 5.5). While Table 5.5 gives data on the value added in select high-tech industries, the size of each industry can be determined from the fact that the value added is generally about 26 per cent of the value of the output (Wang and Szirmai, 2003).

In this context, it may be appropriate to point out a few things about how China perceived the role of technology in economic development. High GDP growth has not been without technological advancements. The latter has been one of the 'Four Modernisations'⁶ that the authorities had accepted as guiding principles of modernisation and faster growth. Technological advancements in manufacturing technologies (especially in key areas) had always been a matter of priority for the government, but it is the approach that mattered. The approach was simple: development was not possible without technology diffusion. Technology innovation was both costly and time-consuming, whereas technology diffusion involved the import of cheaper

Table 5.5
Value Added in Some High-tech Industries in China (1996 Constant Prices)
(billion yuan)

	1995	2001	Growth Rate (%)
Total	111.2	326.9	19.7
Medical and Pharmaceutical Products	27.3	76.3	18.7
Aircraft and Spacecraft	8.2	13.1	8.1
Telecon Equipment	20.2	78.3	25.3
Broadcast and TV Equipments	0.5	0.8	8.1
Electronic Apparatus	12.6	23.4	10.9
Electronic Components	9.8	32.6	22.7
Electronic and Tele-equipment	55.9	171.4	20.5
Computers and Office Equipment	9.6	45.6	29.6
Medical Equipments and Instruments and Meters	10.3	20.4	12.1

Source: L. Wang and A.S. Szirmai, 2003.

technology, followed by large-scale diffusion of the same in the relevant sector and making it accessible to competing producers, who would then modify or improve on it through research and development (R&D). In other words, the import of technology for the purpose of large-scale diffusion was adopted as a strategy for technological advancements. It basically amounted to encouraging the outright copying and violation of Intellectual Property Rights (IPR), but initially China could not care less. R&D was basically about the absorption of imported technologies.

This explains why, unlike in a typical low-income developing economy, in China, the industry's share in the total R&D expenditure (67 per cent in 2004) is as high as those in the industrial economies. It is a different matter that much of technology diffusion took place through the violation of intellectual property protection, but it helped China enter into technology-intensive industries such as telecom equipments, consumer durables, etc. The country imported technologies (usually at cheaper prices), adapted them and modified/improved them through process innovations. This was then supplemented by the inherent comparative advantages that the country enjoyed, enabling it to churn out low-cost products on a massive scale.

SAVINGS AND INVESTMENT

A hallmark of China's high GDP growth is high savings and investment ratios in relation to GDP. These ratios initially acted as growth propellers, and subsequently as drivers of growth. During the period of initial reform in agriculture, there was a big spurt in rural household savings that found outlets as investments in the TVEs, and propelled private investments. Apart from financing investments, the high savings ratio and especially household savings, it can be argued, also acted as a cushion against the risks of over-heating, as is natural for an economy in its early transition phase. While financial and fiscal de-centralisation enabled the local governments to mobilise tax revenue, it also helped channelise household savings into bank deposits⁷, which, in turn, facilitated massive bank lending for the purpose of investments.

The domestic savings/GDP ratio was traditionally high, but it rose from about 38 per cent in 1978 to 48 per cent in 2005, when private consumption expenditure/GDP ratio was around 45 per cent only. What is notable is that the savings ratio has been high right from the beginning of the reforms. The state did not compel people to save, as is sometimes the case in low-income/poor developing economies. The people themselves preferred economic security over current consumption. Besides, it is through the personal savings available at their disposal that the people wanted to take steps to ensure faster economic prosperity. A combination of savings and hard labour, rather than government doles, was considered as the key to economic well-being⁸. Needless to say, the households had been significant contributors to domestic savings. However, the state as well as non-state enterprises too made good contributions. Currently, the enterprises have emerged as the largest savers. In 2005, the enterprise savings/GDP ratio was as high as 20 per cent, followed by household savings at around 15 per cent.

This, however, does not mean that there has been a decline in the savings propensity on the part of the households—not at all. From the data on bank deposits, it can be observed that household savings constituted a major contribution to steady growth in bank deposits. The figure for enterprise savings in the form of bank deposits is about two-thirds of that of the households. The Chinese households are habitually thrifty, and, because of historical

experience, are paranoid about any kind of economic insecurity. The paranoia comes from centuries of economic hardships, and a deep-rooted aspiration for economic security. They would like to be financially secure all the time. De-centralisation of the financial sector and development of commercial banking in the early 1980s had opened up avenues for secure savings, and acted as a big boost for the growth of household savings. Of course, rising household income, alongside the paranoia about economic insecurity, had facilitated a steady growth in household savings. As households, the Chinese usually prefer to park their savings in the banking system. In recent times, the people have been seen to be slowly developing a risk-taking tendency, as the stock markets are seen to be attracting household savings. What is more, in a slow sign of paranoia giving place to ambition, visible cravings are being observed these days amongst the individuals to buy stocks, with some of them even be willing to mortgage physical assets like houses and jewellery to finance the stock purchases. Apparently, they now want a savings-investment mix that would ensure higher levels of well-being for them, besides economic security.

What is important to mention here is that in China, people have long ceased to be Mao's *socialist persons*' and have instead begun to indulge in the aggressive pursuit of material prosperity. Now that the enterprises are also saving a lot, the savings ratio is increasing steadily and rapidly, in the process, however, ushering in an expanding deposit-loan gap. In 2005, financial institutions had a deposit-loan gap of over 9 trillion yuan. The declining deposit rate of interest (from about 9 per cent in 1991 to less than 2 per cent in 2003) has been of little help in curbing the deposit growth. At current prices, the size of household saving deposits increased from about 7.4 trillion yuan in 2001 to over 14 trillion yuan in 2005.

While the people were accumulating savings, the local governments, and the enterprises, in particular, were investing in fixed assets. The rate of capital formation (in relation to the GDP) had always been high, and grew consistently. The average annual domestic investment ratio was 37.6 per cent during the period 1978–2000, but further increased to 42 per cent during the Tenth Plan period (2001–05). The proportion of fixed assets in gross capital formation increased steadily from about 78 per cent in 1978 to over 86 per cent during the 1990s and to 99.1 per cent during the

Tenth Plan, indicating massive investment flows into infrastructure. During the Tenth Plan period, the average annual investment in fixed assets was over 5.9 trillion yuan, that is, about USD 702 billion). Such had been the scale of investments in fixed assets. The Tenth Plan had substantially added to the already large stock of fixed assets (see Table 5.6).

Let us have a look at the distribution pattern of investment as observed in 2005, when the fixed assets investment was about 9 trillion yuan (at current prices). Urban areas (with a share of 42 per cent of the population) accounted for almost 7.5 trillion yuan, that is, about 85 per cent of the total. Of the total investment in urban areas, the investment made by the SOEs and state-holding enterprises was over 4 trillion yuan, that is, 45 per cent of the total. The inter-sectoral distribution of the total investment was as follows: the primary sector, 82.3 billion yuan (less than 7 per cent), the secondary sector, 3,159.8 billion yuan (35.7 per cent) and the tertiary sector, 4,267.5 billion yuan (48.2 per cent). Of the total investment in the secondary sector, construction (including real estate) had a share of 50 per cent. It is this massive scale of investment that is behind the boom in the real estate sector. As an indicator of the real estate boom, it may be observed that in 2005, the complete floor space of commercial buildings (about 488

Table 5.6
Addition to Fixed Asset Capacity during 2000-05

<i>Items</i>	<i>Units</i>	<i>Capacity Added</i>
Power Generation	Million kwh	176.55
Power Transformer	Million kwh-amps	406.66
New Trunk Railways	'000 km	7.63
Double Track Railways	'000 km	3.56
Electrical Railways	'000 km	5.94
New Highways	'000 km	351.17
Cargo Handling Capacity at Seaports	Million tonne	452.32
Telephone Switchboards	Million tonne	232.54
Optical Fibre Cable Length	Million km	2.14
Digital Cellular Mobile Phones	Million subscribers	351.48

Source: NBS, Statistical Communiqué, 28 February 2006.

million sq. m.) was up by about 15 per cent over the corresponding figure in 2004, and forward-delivery housing accounted for as much as 64.5 per cent of the total sales revenue from residential houses. With rising prosperity, demand for more spacious and luxury apartments has been on the rise in the country.

There can be little doubt that investments have played a very significant role in pushing the economy to a high growth plane, and in accelerating the growth momentum. With acceleration in the pace of industrial sector reform and further opening up of the economy, the rate of investment has accelerated since the 1990s. Particularly, the pace of investments in fixed assets has been growing at an annual rate of nearly 30 per cent, making investments a major driver of growth. There are certain associated questions here, namely, is China over-invested? Or has investment growth affected the efficiency of capital and so on. We shall not go into these questions here as these involve detailed empirical investigations, but generally speaking, China has a relatively higher incremental capital-output ratio, or plain capital-output ratio.

Among the main drivers of investment, enterprises, largely the SOEs, played a key role, and accounted for about three-quarters of the total gross capital formation in 2005, followed by the households (with 14 per cent of the total) and the rest coming from the government (excluding the SOEs). The contribution of government however, would be found to be much higher, if investments by the SOEs are taken into account. They invested much more than the rest of the enterprises, especially the foreign fund enterprises (FIEs) and other private enterprises (see Table 5.7). In other words, if investments are considered as major drivers of growth, then government-controlled SOEs have been the real growth drivers. Within the overall framework of the government, it is the SOEs, which, notwithstanding criticisms about their structural weaknesses, have played a key role in the high economic growth. Particularly, a major chunk of investment in infrastructure came from what is called internally generated savings of the SOEs. Local governments often made the SOEs cough up the extra finances, but that was a different matter.

What about the role of FIEs? Beginning with the mid-1990s, the flow of foreign direct investments (FDIs) began to increase at a galloping pace. In 1990, the utilised value of FDI was less

Table 5.7
Structure of Urban Fixed Assets Investments (FAIs)

	<i>Share in Total FAI (%)</i>		
	<i>2003</i>	<i>2004</i>	<i>2005</i>
Urban FAI	100	100	100
1. State-controlled Firms	64.3	57.5	53.3
o/w SOEs	44.8	39.1	56.1
2. Other	35.7	42.5	40.7
o/w FIEs	10.6	11.9	11.1
Private Enterprises	8.4	9.9	12.4

Source: Steven Barnett and Ray Brooks, November 2006. What is Driving Investment in China? IMF Working Paper.

than USD 5 billion. It shot up to about USD 38 billion in 1995 and further to USD 45 billion in 2000. Between 2001 and 2005, the accumulated stock of utilised FDI was USD 274 billion, with the average annual inflow being USD 54.8 billion. Out of an FDI of USD 60.3 billion in 2005, about USD 42.5 billion was in manufacturing, followed by about USD 5.5 billion in real estate. FDI did not go to infrastructure building. However, it supplemented the domestic investment, and contributed enormously to increased globalisation of the Chinese economy, especially by way of rapid growth in external trade. For instance, out of an export turnover of USD 760 billion in 2005, as much as USD 444.2 billion, that is, over 58 per cent, was made by the foreign-funded enterprises alone. Their net exports, that is, the net of imports, were worth about USD 57 billion. In other words, the FIEs helped China build a trade surplus and in piling up of foreign exchange reserves.

EXTERNALISATION

The opening up of China's economy to the external world has helped in the overall economic growth in several ways, namely, by way of the steady inflow of FDI, increased exports, building foreign exchange reserves, transfer of technology, R&D capabilities, etc. Some of these aspects are briefly mentioned below.

Ever since the launch of its open door policy, China has emerged as the most aggressive exporting nation, with an average long-term annual export growth of over 17 per cent. The absolute export turnover increased from a paltry USD 9.8 billion in 1978 to over USD 762 billion in 2005 (see Annexure XIX), while the exports/GDP ratio increased from about 5 per cent to nearly 35 per cent. Imports too increased from USD 10.9 billion to over USD 660 billion during the corresponding period. With accelerated liberalisation of the external sector, and particularly the relaxation of exchange controls beginning in 1994, the trade balance has been consistently favourable. In 2005, the size of the surplus was over USD 101 billion. As a measure of progress in the externalisation of the economy, it may be mentioned, the trade/GDP ratio, which is also a measure of the extent of dependence of the economy on trade, increased from about 9 per cent in 1978 to about 65 per cent in 2005. The ratio would be much higher, if we consider the totality of exports and imports, that is, the total of goods and services.

For an economy with a large population, this is an exceptionally high level of externalisation. The corresponding ratios for USA and Japan were 18.6 and 19.8, respectively. In other words, like the economies of its counterparts in East Asia, the economy of China has been much more dependent on the global market than those of USA and Japan. In other words, the global market has played an important role in China's economic growth, which basically thrived on global demand growth. Between 1978 and 2005, while the real GDP grew at an average annual rate of nearly 10 per cent, exports grew at the rate of 17.5 per cent. More than half of the incremental GDP came from exports. During the same period, domestic consumer spending grew by about 8 per cent a year. The contribution of domestic spending to incremental GDP was about 25 per cent. If we take the average annual growth of exports as being indicative of its contribution to the GDP, it will be observed that exports have been playing an increasingly greater role in the Chinese economy.

The average annual export growth was 11.2 per cent in the 1980s, 12.1 per cent in the 1990s and 25 per cent during the period 2000–05. What is notable is that the annual export growth of China has doubled since the country's entry into the WTO, indicating the

manner in which it has benefited from the multilateral system of freer trade. If the present growth rate continues, China will soon emerge as the largest exporting nation. At the same time, if import growth is taken as a measure of opening up of the economy, it can be observed that over the 27 year-period since the advent of its open door policy, its imports grew at an average annual rate of 16.4 per cent. During the initial decade of reform, imports grew at a much higher rate of 18.4 per cent, which declined to 12 per cent during the 1990s, on account of the tightening of exchange control measures in the aftermath of the Asian financial crisis and overheating of the economy in the mid-1990s, but the annual growth doubled to 24 per cent during the period 2000–05, which can also be attributed to the rapid opening up of the economy ever since China's entry into the WTO.

Since the beginning of the twenty-first century, China's economy has been externalising at a very rapid pace. The trade ratio increased from 60 per cent in 2000 to 65 per cent in 2005. While the FDI/GDP ratio is currently about 3 per cent, it is 8 per cent of the gross investment. While exports are driving the GDP growth, imports are lubricating the growth machine. Foreign exchange reserves as a percentage of the GDP rose from 17 per cent in 2000 to about 41 per cent in 2005. Against a per capita GDP of about USD 1,800, there was a per capita reserve of about USD 770. Perhaps people of no other nation enjoy this privilege. The only problem, however, is that the Chinese cannot enjoy this privilege very much, in the absence of the adequate convertibility of the currency. The bulging

Table 5.8
Phases in Exports, Imports and GDP Growth

<i>Periods</i> (1)	<i>Average Annual Growth (%)</i>			<i>Elasticities w.r.t. GDP</i>	
	<i>Exports</i> (2)	<i>Imports</i> (3)	<i>GDP</i> (4)	<i>Exports</i> (5)	<i>Imports</i> (6)
1980–89	11.2	18.4	8.8	1.27	2.09
1990–99	12.1	12.0	10.2	1.19	1.18
2000–05	25.0	24.0	10.0	2.50	2.40

Source: Data for Column (4) taken from Morgan Stanley Research, June 2006, and for Columns (2) and (3), from NBS, China.

reserves and strength of the currency indicate that the Chinese now deserve some luxury of convertibility.

The role of the FIEs, as mentioned earlier, has been primarily that of making China a fast-growing exporting nation. The contribution of the FIEs to China's GDP growth is limited by the role of exports in overall growth. Probably, a realistic way of measuring their contribution to overall growth would be to look at their net export earnings, which in 2005 were worth USD 57 billion, that is, 56 per cent of the trade surplus. It is fair to argue that foreign investors, that is, the FIEs have made a rather limited contribution to China's overall growth. Their contribution in such vital areas as infrastructure building has been extremely limited, if not nil. This, however, is not to ignore or undermine the role of such enterprises in the rapid globalisation of the economy and in securing the country's economy a place of significance in the global economy. In this context, one has to particularly recognise the role of the non-resident ethnic Chinese who were the first to bring in capital and invest in their homelands⁹. The investors from the Western world were rather slow in responding to China's call for external capital.

PRODUCTIVITY FACTOR

With respect to the overall economic growth, and its sources, a pertinent question remains about the quality of growth, which has been commented upon by many observers. What we notice is that growth of the Chinese economy has been largely due to the input factors, namely, capital and labour. It is observed that the rate of capital accumulation has been huge in absolute terms. China is intrinsically a labour-surplus economy, with a high rate of unemployment. The industrial enterprises in China have not been large absorbers of the labour force. For instance, employment in the industrial sector increased at an annual rate of only one per cent, as against over 3 per cent in the tertiary sector over the long period of 1978–2004. This being the case, capital spending has played a major role in the high rate of GDP growth. As a result, the incremental capital-output ratio has gone up, and so has the capital stock per unit of labour input.

What then can be said about the role of factor productivity? Is factor productivity improving along with GDP growth? Alternatively, what has been the contribution of productivity in GDP growth, that is, how much of the GDP growth is coming from productivity growth? These questions assume significance in the context of the issue of the sustainability of growth, which has been yet another highly debated issue. When growth takes place without, or with little, growth in productivity, it is inefficient by nature and not sustainable. The issue of productivity growth has been studied by several scholars, using different techniques of estimation. In simple terms, the productivity issue can be outlined as follows.

Given a certain stock of capital and labour inputs in an economy, it is possible to get different output levels from varying combinations of capital and labour inputs, and we get a frontier of possible production levels, called a 'production possibility frontier'. However, with increased efficiency in the use of either capital inputs, or labour inputs, or both, it is possible to shift the production possibility frontier, and reach higher levels. Herein comes the concept of factor productivity via technical and/or technological efficiency. The total factor productivity (TFP) (the ratio of the index of aggregate output to the index of aggregate inputs) is a term often used as a tool to measure the productivity of an economy. If the long-term GDP growth of an economy is, say, 10 per cent, it is possible to determine the contribution of TFP in that growth.

Studies on productivity growth in China differ on the extent of the actual growth of productivity, both on aggregate as well as disaggregated (provincial) basis, but all the studies support the view that there has been a perceptible growth in productivity since the introduction of economic reforms. Broadly, 40–45 per cent of the long-term national GDP growth is explained by productivity growth. This varies among the provinces, with the poorest region (the west) experiencing the lowest productivity growth. The latter, incidentally, also has the lowest capital stock per unit of labour, but has the highest employment growth. In the fastest growing region (the east), productivity growth accounts for 55–58 per cent of the GDP growth, as compared to 10–15 per cent in the poorest region. For the country as a whole, factor productivity increased at the rate

of 0.0094 per cent annually during the period 1978–98. During the same period, while capital and labour accounted for 37.8 and 4.2 per cent, respectively, of GDP growth, TFP accounted for 41.3 per cent. The rest 16.7 per cent is explained by other factors, such as the scale effect. As regards the overall quality of growth in China, the following observations can be made:

1. Growth has been influenced largely by additions to capital stock and productivity.
2. Both capital stock and productivity have comparable levels of contributions.
3. Capital inputs have played a much bigger role than labour inputs, with a very high capital stock per unit of labour.
4. In relation to capital and productivity, the scale effect, that is, the return to scale, has been low.
5. Fast moving provinces have made a much higher contribution in terms of productivity to the GDP growth, as compared to the slow moving provinces.

The last point delineated above explains the inter- as well as intra-regional differences in growth, to a large extent. However, this also tells us why the high GDP growth in China can be sustained over a longer period. There are two possibilities. One, the fast moving provinces may continue to sustain their productivity growth, if not increase it to still higher levels. Second, the productivity laggards will likely further improve their productivity. In both the cases, the average national productivity is likely to grow further. There is also scope for improvement on the scale effect of growth. The inter-provincial and/or inter-regional differences in productivity levels, in our view, do not constitute an indicator of inequality, but rather an indicator of potential incremental growth in productivity that the national economy may derive in the future.

REGIONAL DISPERSION AND INEQUALITY OF GROWTH

In a developing economy, growth can hardly be expected to be equitable, and is rather often accompanied with a certain degree of inequality. This is especially so, when the economy concerned is

large and the initial economic conditions were exceptionally bad, as was the case in China. People may debate on the issue of the possibility of equitable growth in the initial stages of development itself, but we need not go into that debate here. All we can say is that in the context of China, things were very different from what is commonly found in typical low-income developing economies. Further, during the course of transition, China focused not on equitable growth but on faster growth.

As has been pointed out in many ways, in 1978, China was a low-income socialist economy. Given the nature of the socialist economy, and the way in which it was managed under communism, it made no sense to talk of inequality in that situation. Every household was equalised at the lowest level of well-being. Socialism in China was all about the distribution of poverty. In this backdrop, inequality in well-being was deliberately chosen by the new leadership as a strategy for growth. Deng Xiaoping did not mind if some people became richer, nor if some provinces moved faster. During the initial stages, reforms were both gradual and experimental. Various measures such as the introduction of the household responsibility system (HRS) in agriculture, selectivity with respect to the choice of open cities, a gradual increase in the number of special economic zones (SEZs), encouragement offered to the growth of TVEs, financial and fiscal de-centralisation, etc., had the effect of creating regional as well as intra-regional inequalities.

It is, therefore, no wonder that the high GDP growth has been accompanied by growing inequalities among the regions, between rural and urban areas and among the households. What appears most prominent, however, is the extent of inequality. In 2004, inter-regional gaps in per capita GDP were quite evident (see Table 5.9). The average per capita GDP of the regions differed with a gap of nearly 15,000 Rmb, which was larger than the national per capita GDP. In the prosperous south-east, the average per capita GDP was more than double the national average. The latter, in turn, was over 52 per cent higher than the average of the poorest region of the south-west.

The south-west region, the poorest of all, had a per capita GDP of less than one-third of those in the wealthiest south-east, while the per capita GDP in the poorest provinces (Guizhou) was

Table 5.9
Regional and Intra-regional Gaps in Per Capita GDP: 2004

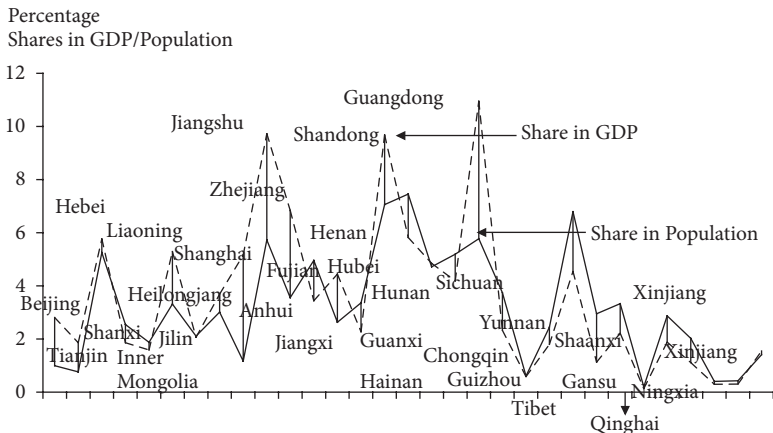
Regions	Per Capita GDP Rmb (US Dollar)	Intra-regional Gap Lowest (with Highest = 100)	Highest/Lowest Gap Rmb (US Dollar)
North-east	14,080 (1,701)	86	5,370 (648)
Bohai	17,013 (2,055)	45	15,881 (1,918)
South-east	21,863 (2,641)	40	25,573 (3,089)
Central	8,754 (1,057)	71	3,032 (366)
North-west	8,800 (1,063)	52	5,345 (645)
South-west	6,902 (833)	44	5,300 (640)
National	10,530 (1,272)		

Source: World Bank Survey, 2006.

less than one-tenth of the richest province of Shanghai. It is also obvious from the last column of Table 5.9 that there are wide intra-regional GDP gaps.

In a display of yet another kind of inequality, measured in terms of the shares of the provinces in the country's total population, on one hand, and their shares in national GDP, on the other hand, it is observed (see Figure 5.5) that some provinces (Shanghai, Jiangshu,

Figure 5.5
Inter-provincial Variations in Share in GDP/Population: 1999



Source: Prepared from NBS data, PRC.

Guangdong, Shandong, Zhijiang, Liaoning and Beijing) contributed much more to the GDP than their shares in the population. At the same time, there are provinces whose contributions to the GDP have less than their shares in population, and may be termed as deficient provinces or provinces that could not benefit much from the reform process. A total of 13 out of 31 provinces fell in this category in 1999.

If we examine the differences in sectoral employment structure together with the economic structure, that is, the sectoral contributions to the GDP of the provinces, we get a broad idea of the extent of modernisation of the Chinese economy, besides an idea of the impact of economic reform across the provinces. From the details of sectoral composition of employment across the provinces, as given in Annexure XV, it can be seen that mainly Beijing and Shanghai have achieved employment structures similar to those in the industrial economies. The upcoming provinces in this sense are Tianjin and, to some extent, Jiangshu, Guangdong and Zhejiang. As of 1999, rest of the provinces still had largely traditional economic structures. At least eleven provinces still had the employment structures that the national economy had in 1978. The structures of the rest of the provinces resembled the pre-1949 status. Only Beijing, Shanghai, Guangdong, Tianjin and Jiangshu symbolised the face of the fast moving industrialised China.

On the whole, the aggregate picture of economic transition in China in 2005 was mixed and a bit complex as well. On one extreme,

Table 5.10
Sectoral Contributions in Provincial GDP and Employment: 1999

<i>Sectors</i>	<i>Employment</i>		<i>GDP</i>	
	<i>Low</i>	<i>High</i>	<i>Low</i>	<i>High</i>
Primary	6.9 (Beijing)	71.3 (Yunnan)	1.98 (Shanghai)	37.44 (Hainan)
Secondary	9.1 (Yunnan)	40.1 (Tianjin)	20.14 (Hainan)	54.8 (Heilongjiang)
Tertiary	19.6 (Yunnan)	66.7 (Beijing)	30.2 (Henan)	57.3 (Beijing)

Source: Prepared from NBS database.

there are pockets of the modern industrial economy. On the other, there are typical traditional economies like those of Yunnan, Hainan, Henan, etc. In between the two, there is a large number of provinces that are partly traditional and partly modern, with tertiary sector activities building the connect between the two.

Even after nearly more than a quarter century of economic reform, the overall structure of the Chinese economy in 2005 was like that of an industrialising developing economy, the difference being that it was the fastest moving developing economy. Nearly half of the working population was still dependent on the primary sector, that is, the typically low-wage sector of the economy. The secondary sector had been growing at the fastest rate, but the gross employment growth in this sector was not adequate enough to absorb the steady flow of migrating workers from the villages. Between the years 2000 and 2004, the secondary sector created only about 7 million new jobs.

The factors that explain the differences in the levels of development among the provinces are not too difficult to identify. They originated from the incremental and selective approach to liberalisation during the initial phase of reform. Under this approach, there was no scope for competition among the provinces, nor was there any level-playing ground. Similarly, the government also did not extend any preferential discrimination in favour of the relatively less-endowed or disadvantaged provinces. While the open-door policy had favoured the provinces in the eastern region having a comparative locational advantage, there were no matching policies for provinces in the central and western regions. For a long period of about fifteen years since 1978, even the fiscal policy, especially the Central-local government fiscal relationship, had the effect of widening disparities among the provinces.

However, it must be pointed out that regional and inter-provincial disparities simply meant that while all the provinces registered growth, some grew faster than the others. Alternatively, it can be put this way. While some provinces registered high to very high rates of growth, others registered moderate-high rate of growth. In 1999, only a few provinces had an exceptionally high per capita GDP, otherwise the per capita GDP in most provinces clustered around the median value of 5,350 yuan. Now that the

open door and other economic policies are being applied without discrimination, and the government is interested in a balanced/equitable development, one can expect the disparities to be lessened, and consequently, an equalising effect may be seen in the future. The existing pattern of regional disparities need not be necessarily seen as a bad patch as such in the high-growth story that the economy projects.

INCOME/EXPENDITURE INEQUALITY

The bad patch, and a serious one, however, is the pattern of income/expenditure distribution, reflecting rising inequality in the level of well-being of the people. The extent of inequality can be best explained by the data on income/expenditure distribution for the country. The current pattern of distribution of household consumption expenditure shows that the bottom 20 per cent of the population accounts for 4.8 per cent of the total consumption expenditure, while the top 20 per cent accounted for nearly 50 per cent of the total consumption expenditure. If we take private household consumption expenditure at 45 per cent of the 2006 GDP of USD 2.4 trillion, that is, USD 1,080 billion, then the bottom 20 per cent of the population, that is, roughly 260 million people had a per capita annual consumption expenditure of about USD 199 or USD 0.54 per capita per day (below the World Bank definition of the Below the Poverty Line [BPL] population). The bottom 10 per cent, accounting for only 1.8 per cent of the total consumption expenditure, had a per capita annual expenditure of about USD 149. Against this, the top 10 per cent of the population, with a share of 33.1 per cent, enjoyed an annual per capita expenditure of USD 2,750, more than 18 times the consumption level of the bottom 10 per cent. This is a striking level of inequality, even by the standard of a least developed economy. Behind the glare of a booming consumer goods market, in urban areas, there exists a ghetto of penury and shoddy marketplaces.

This extreme inequality makes one wonder about the real state of progress in China. China's economic growth has been undoubtedly dazzling. Goods with the label 'Made in China' are

invading the global market. China is the fourth largest national economy (second on a purchasing power parity [PPP] basis), and destined to be number one some day in the future. The country's foreign exchange reserves have exceeded USD 1 trillion. The shopping centres in the cities and towns of the country are swarming with prospective buyers, like bees around honeycombs. For most people, however, these do not mean much. China is the fastest growing economy, wherein a large number of people do not have enough money to buy enough goods. The per capita GDP of China at about USD 1,800, it may be mentioned, is well below that of Thailand's USD 2,400, and puts China in the World Bank category of low middle-income developing economies.

A prominent aspect of income inequality is rural-urban inequality. In the initial stage of economic reform, there was a spurt in growth in rural income and consumption, in view of agricultural reform being the starting point of change and the phenomenal growth in the number of TVEs. Rural-urban inequality was favouring the former. However, with the beginning of urban reform since the mid-1980s and especially due to the open door policy, the inequality had reversed in favour of the urban areas. Since the mid-1990s, urban-rural disparity has been widening at an alarming rate. For instance, in 2005, the per capita disposable income of urban households was about 10,500 yuan, up from 6,860 yuan in 2001. In comparison, the same for rural households had increased from 2,366 yuan to 3,255 yuan. The proportion of the urban: rural household disposable income is, thus, 3:1. In other words, in terms of the level of well-being, the average urban household is about three times better off than an average rural household.

There are many factors responsible for the rising rural-urban income/consumption gap post-1990, but mention can be made of a few important ones. First, most of the fixed assets investments have gone into urban areas (on an average 80–85 per cent of the total). As has been mentioned earlier, in 2005, out of the total fixed asset investment of 8,800.4 billion yuan, rural areas had got only about 15 per cent. It appears to be a case of over-emphasis on urbanisation, but the excessive tilt in favour of urban fixed asset accumulation is an outcome of the strategy for faster growth aimed at catching up with the West. Reform measures had a bias for

globalisation and rapid industrial development. The over-emphasis on investment in urban areas has, no doubt, resulted in rapid urbanisation, but has also been responsible for large-scale migration from rural areas and from agricultural to industrial operations.

The scale of migration can be understood from the fact that between 1979 and 2004, the net addition to the urban population was over 370 million, and in 2004, the size of the urban population was 542.3 million. The urbanisation ratio increased at an annual rate of 0.92 per cent during the period 1979–2004, taking the ratio to 41.8 per cent in 2004. As the rate of urbanisation increased, the rural-urban migration also increased, in spite of the barriers to such migration arising out of the institutional split between the rural and urban population, besides the discriminatory treatment of the rural migrants in urban areas. The number of job-seeking rural farmers, migrating to urban areas, increased from 20–30 million in the 1980s to 124 million in 2004. The migrant farmers in urban areas, it may be mentioned, made a significant contribution to growth in the urban income, by way of working longer hours at low wages. But this does not spare them from discriminatory treatment.

In rural areas, on the other hand, the farmers diversified their activities in favour of non-farm occupations, and consequently, there was an increase in the share of wage income in the total income of the rural households. Between 1995 and 2002, wages accounted for 50 per cent of the incremental rural household income, followed by 19 per cent in the case of farm income. The share of non-farm enterprises was 16 per cent. Money transfer by the migrant urban workers also facilitated an increase in the share of wage income in the incremental rural income. The gap in per capita consumption expenditure between urban and rural areas would be found to be much higher, if the data is adjusted for the transfer income. With respect to farm income, it also needs to be mentioned that beginning with the mid-1990s, the annual growth in farm income declined substantially, affecting the terms of trade between farm and non-farm activities, and without a matching shift in the division of employment between the two sets of activities. In addition, a reduction in net subsidies (that used to be a major source of rural income) further affected the growth in per capita rural income, and expanded the gap vis-à-vis the households in the urban areas.

Actually, there are several 'Chinas' within the booming national economy. For instance, there is a China that is just managing to survive, with a per capita consumption expenditure of less than a dollar a day. There are about 300 million people in this China, of whom about 130–140 million survive on USD 0.55 a day. They are rural people with limited mobility across economic occupations or into urban areas. Above the surviving China, there is a poor China consisting of a low-income group of about 135 million people, with the per capita consumption of USD 350–500. Another 10 per cent of the population, with a per capita consumption of USD 500–1000, constitutes the middle of the middle-income group. The rest of the population of about 700 million has a per capita consumption of over USD 1,000.

In this last category, however, there is again a stark inequality. For instance, the per capita consumption of the top 10 per cent of the population, at USD 2,750 in 2005, was double the per capita consumption of the next 10 per cent. The top 20 per cent of the population, however, constitutes the real consuming China. It is thus around 260 million Chinese who make the showcase of a glittering China. The income of this segment of the population grows at a much faster rate of 10–12 per cent than that of others. The average spending power of people in this segment (the top 20 per cent) in 2005 was USD 2,064, whereas the bottom 20 per cent of the population had an average spending power of only USD 199.

Collectively, the average spending power of the people in China, at USD 831, is a small fraction of the average purchasing power of their counterparts in the advanced industrial economies, but substantially above that of the comparable developing economies like India. China is not yet a nation of shoppers. If the per capita retail spending is taken as a measure of the consumption boom in an economy, then a figure of USD 346 a year in China is one-thirtieth of that of Japan, double that of India but half of that of Malaysia and Thailand.

A CASE OF UNSTOPPABLE GROWTH

Notwithstanding such a disparaging picture of China's market size, the undeniable fact, however, is that the economy is moving

at the fastest possible pace. It is a big economy with a disproportionately low market size. The economy and its market (consumers) are not in tandem. It is an economy that is growing to save more, and saving more to invest more. Inequality has a historical basis, and is not quite out of tune with the social moorings. With its high growth and highly skewed income distribution, China looks more like a speeding over-crowded bus. The fortunate few have got seats, with a large number standing inside, always trying to maintain the balance by holding on to overhead supports, while the rest are precariously hanging out with one foot barely on the entry steps, crying for a halt in the quest for an adjustment opportunity.

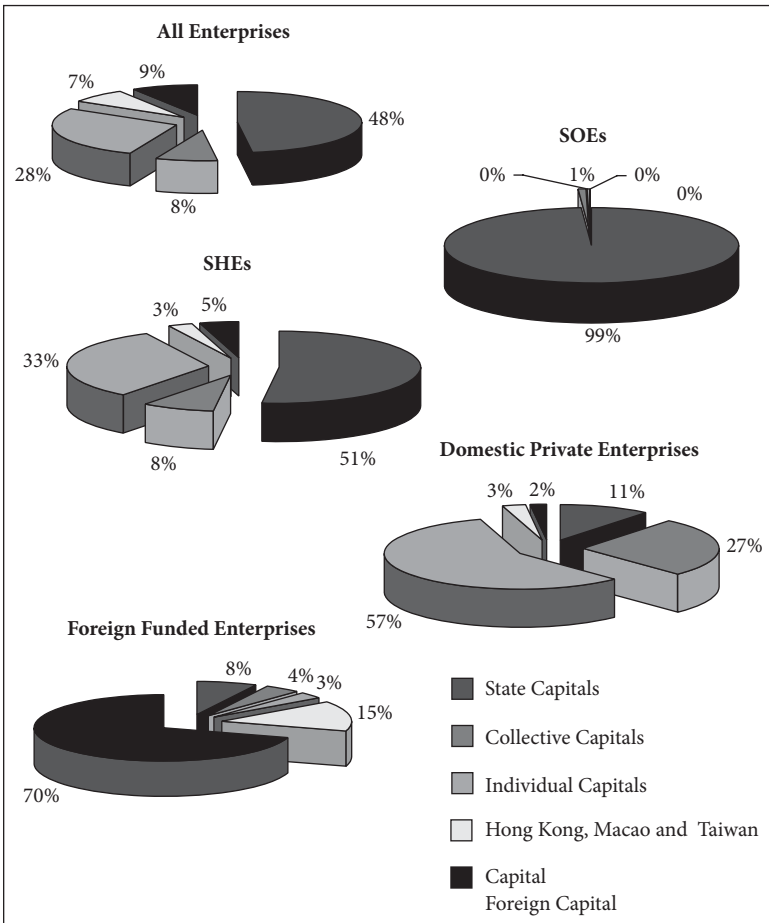
The government is doing its bit to slow down the pace of growth. But during the current year (2007) again, the economy was expected to grow at a rate of 10 per cent plus. As shall be seen later, the GDP grew at the rate of 11.1 per cent during the first quarter of 2007. There are two issues here. First, can the government control the growth rate? Second, should the government go overboard to control the growth rate? To a great extent, the economy has seemingly slipped out of the government's control, and it is not within the means of the government to contain the growth rate. China has moved far away from its socialist identity.

The SOEs now represent about 40 per cent of the industrial production. Only about 3 per cent of the market is under state-controlled prices. Private investments account for over 55 per cent of the fixed assets investment. Significantly also, much of the Fixed Assets Investments (FAIs) are now self-financed, partly through the capital market, and partly through own savings. Households and enterprises are the major contributors to bank deposits. The banking sector, though under renovation, is gearing up to meet the expectations of a market economy, and getting out of the strangulating clutch of the directed credit policy.

If the government has to cool down the economy, the available options are primarily in the realm of monetary and fiscal policy instruments, though there is no guarantee that those instruments would be very effective. For instance, the government may like to leverage the interest rate to curb investment growth. But the major investors, namely, the enterprises of all types, are ploughing their retained profits (which are growing at high rates) into investments.

They are not dependent on the government-controlled financial institutions (see Figure 5.6). This explains the phenomenon of low growth in the loan rate relative to FAI growth. Monetary policy can at best have a limited role in the Chinese context. It is, perhaps, the right moment for the government to get rid of the burden of subsidies, and withdraw fiscal and financial support to the enterprises. In any other developing economy, this (monetary and fiscal

Figure 5.6
How Enterprises Meet Capital Needs



Source: NBS, Communiqué No. 1, 6 December 2005.

measures) would have curbed the growth in investment, but not in China. Subsidies are not driving the investment growth. For the domestic investors, many factors are driving investments. To put it briefly, it is the great Chinese hunger for catching up with the Western lifestyle and Western level of development. For foreign investors, it is the lure of the huge market of 1.3 billion people. For them, China is an ideal location from where they can not only cater to a large captive market but also penetrate the Asian markets.

Given the line of the market, there is little that the government can do to hold back the growth in investment. Further, the huge domestic savings are rising faster than the growth in GDP. The gross domestic savings is almost half of the GDP. Probably, curbing the growth in domestic savings could be one way of halting the pace of investment growth. But there is a possibility that the effect of slow investment growth may be more than offset by the growth in the domestic consumption demand, and GDP growth may simply get yet another propeller. In any case, in order to reduce dependence on the global market, China would need to encourage growth in domestic private consumption. Further, in order to dissuade the households from saving more, the government investment and revenue capital expenditure would have to be increased substantially in favour of social security measures. It is well known that post-reform, the people have lost social security to a great extent, particularly in terms of reduced access to basic healthcare facilities, education and other social benefits.

A reality about China's economy is that its high growth is largely self-propelling, wherein a combination of factors are mutually reinforcing each other. It is also important to note that disparities and inequalities too can be positive forces under certain circumstances. Regional disparities, for instance, could mean that the backward regions would soon be in the catch-up race. As has been mentioned earlier, the existence of regional disparities in China's context simply means that while some provinces are moving very fast, others are moving at a slower pace. Given the degree of autonomy enjoyed by the provincial and local governments, the catch-up race is a distinct possibility. Similarly, as we read about the growing income inequality in China, there are also plenty of stories of how the migrants in China's cities are struggling to

secure a good living. Such stories tell us about the intrinsic urge among the poor to catch up. The poor in China are enormously motivated, and ready to face any amount of hardships, if there is a prospect for better living. Poverty in China is often misunderstood. The poor people in China are the surviving Chinese, and are now struggling for a better life. In the process, they are also oiling the growth machines in the urban centres. It is unfortunate that this aspect of the Chinese economy, especially the role of the poor struggling people, gets little appreciation.

It is quite likely that China would continue to maintain its high growth for at least some more years. Its average annual growth may not continue at its current rate of 10 per cent-plus, but it may still be high. A decline of a few basis points need not be seen as a sign of cooling. How much of China's current rate of growth is not natural? This question has not been debated enough. But it makes sense to look into this question, rather than trying to predict a possible (hard or soft) landing of the economy. It is our view that, though very high, China's current rate of growth is not really its potential rate of growth, but is rather well below it. The growing productivity (explaining about 45 per cent of the GDP growth) and the high rate of unemployment (meaning the huge stock of potential output and productivity) explain our conviction.

The next question follows: if the current rate of growth is less than the potential rate of growth, should it then be prevented? Alternatively, should China try to curb its rate of growth? The risk involved in trying to curb growth is that it may hurt the poor most, and impair the growth prospects of the less developed regions. Probably, better balancing of growth across the regions and income classes would help it stabilise the growth at its current level. It is the problem of skewedness of growth, rather than growth *per se*, that needs to be addressed. Of course, there is an issue of sustainability from the point of view of physical resources, environment, etc., but this shall be discussed later.

THE GALLOPING ECONOMY

As of now, China's economy is in robust health, and there is hardly any sign of strain. The Chinese economy is indeed far from

showing any sign of growth weariness. Its growth machines are running ceaselessly and untiringly, with an accelerating pace of growth since the beginning of the present decade. During the first quarter (Q1) of 2007, the GDP grew at 11.1 per cent, 0.4 per cent higher than the 10.7 per cent rate of growth for the whole of 2006, and 0.7 per cent higher than the Q1 of 2006. In absolute terms, the GDP in Q1 2007 was USD 653 billion, roughly 68 per cent of India's GDP in 2006. Much of the current growth momentum came from the remarkable success of the Tenth Plan, which ended in 2005.

Despite complications in recent years in the domestic and international circumstances, the Chinese government was able to undertake several consolidation measures during the Plan period, and strengthen the forces of growth. Reforms were deepened, and the process of opening up continued unhindered. There was a renewed surge of growth on all fronts, namely, industrial value added, investments, consumption, FDI, exports and imports. During 2007, all these continued to remain the main drivers of growth.

Let us depict the overall picture of growth, as it was in the Q1 of 2007. While the GDP stood at USD 653 billion, among the sectors, the divide was: the primary sector, USD 47 billion or 7.2 per cent, the secondary sector, USD 332.5 billion (51 per cent) and the tertiary sector, USD 273.5 billion (41.8 per cent). The break-up, as reflected in the GDP of 2007 Q1, it may be mentioned, was significantly different from what it was in 2005 (see Table 5.12).

The figures are not strictly comparable, because while the sectoral shares for 2005 related to agriculture, industry and services, those of 2007 Q1 related to the primary sector (agriculture and mining),

Table 5.11
Quarterly GDP Growth of China's Economy

2004	Q3	9.1	2006	Q1	10.4
	Q4	9.5		Q2	11.3
2005	Q1	9.9	2007	Q3	10.4
	Q2	10.1		Q4	10.6
	Q3	9.8		Q1	11.1
	Q4	9.9			

Source: Dragonomics, 2006 and Xinhua Business Weekly, Vol.11, No. 15, 16–22 April 2007.

the secondary sector (industry and construction) and services. And yet the change had been very significant. The growth has been distinctly industry-led. China is no longer the agrarian economy that it used to be. The tertiary sector is emerging, but is still very much a laggard in growth in comparison to the secondary sector. In 2006, while industrial value added grew at the rate of 17 per cent, that of the tertiary sector grew at a rate of 9.5 per cent only. During the first quarter of 2007, the former grew by 18.3 per cent, while the latter grew by 9.9 per cent.

Within the industrial sector, heavy industry grew by 19.6 per cent, and reflected continued buoyancy in demand on account of manufacturing investments, mainly in the light industry segment, wherein the output rose by 15.6 per cent. This was a clear sign of further addition to production capacities. Even as output increased at such a high rate, the enterprises were able to sell over 97 per cent of their production, thanks to support from both investment and domestic consumption demands, besides external demand. And industrial profits (of enterprises with sales revenue of more than 5 million yuan) rose dramatically. At USD 38 billion in 2007 Q1, the registered profit was about 44 per cent higher as compared to a corresponding figure of USD 22 billion in 2006 Q1. In China, it may be noted, higher the profit, the higher is the level of enterprise investments.

Even as the rate of growth has slowed down a little bit in recent times, fixed assets investments are continuing to rise at a very high rate in any case. The average annual rate of growth in FAI was about 28 per cent during the period 2003–06. In the Q1 of 2007, it increased by 23.7 per cent, but the FAI grew by 25.3 per cent in urban areas and by about 17 per cent in rural areas. The total FAI

Table 5.12
Recent Changes in the GDP Structure

	<i>Percentage of GDP</i>	
	<i>2005</i>	<i>2007 (Q1)</i>
Agriculture	12.6	7.2 (Primary)
Industry	47.5	51.0 (Secondary)
Services	39.9	41.8 (Tertiary)

Source: Same as for Table 5.11.

investment during the first three months of 2007 was nearly USD 228 billion. The regional distribution of this investment shows that the less developed western, and some parts of the central, regions are showing much higher rates of growth in FAI. Sectorally, real estate investments, including housing, were maintaining a higher rate than the overall rate of growth. Overall, investment demand is maintaining a high rate of growth, and the size of demand was 35 per cent of the GDP in 2007 Q1.

As far as the household consumption demand is concerned, retail sales increased by nearly 15 per cent on a year-on-year basis, and the total spent at USD 275 billion was over 42 per cent of the same GDP. But retail sales in the urban areas increased by 15.5 per cent. According to The China General Chamber of Commerce, the size of China's retail sales was likely to be around USD 1,130 billion in 2007, showing a growth of 14.5 per cent, in view of the continuing rise in disposable income. The government's strategy to offer free and compulsory education in rural areas and to cover the entire country with minimum allowances and pension and medical insurance has been facilitating the process of a rise in disposable income. According to the Xinhua Business Weekly (16–22 April 2007), the average disposable income of the urban residents rose by 19.5 per cent to 3,935 yuan (USD 511) in the first quarter, while the cash income of the rural population jumped 15.2 per cent to 1,260 yuan (roughly USD 164).

The domestic demand (investment as well as household consumption) is, thus, buoyant. Rising disposable income in the hands of the households is likely to take care of some slowdown in growth in investment, as is being currently observed. Export growth remains strong, and has, in fact, been stronger in recent years, with the average annual growth in exports being 30 per cent (2003–06). In absolute terms, export earnings increased from USD 438.2 billion in 2003 to USD 930 billion (estimated) in 2006. Imports, on the other hand, increased from USD 412.8 billion to USD 785 billion (estimated) during the same period. Consequently, the trade surplus jumped from USD 25.4 billion to USD 145 billion. This was expected to exceed USD 200 billion in 2007.

As of now, while the demand side forces are in robust health and the economy is enjoying demand-led growth, industry, on its part, is ever ready to meet the growing domestic demand, and is

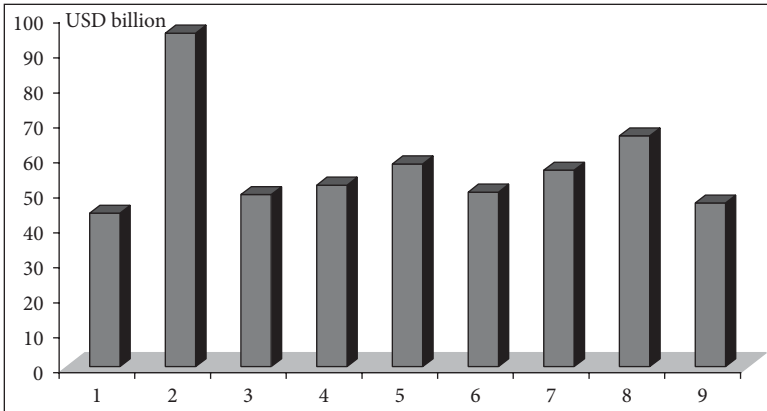
building new capacities every year (as reflected in the high growth in production of heavy industries). Production is rising at high rates across the industrial sectors. Industry is keeping up the supply side buoyancy, besides helping maintain price stability. The year-on-year changes in price indices as in June 2006 were: Consumer Price Index (CPI) 1.5 per cent, industrial goods 3.5 per cent, raw materials 6.6 per cent and investment goods 3 per cent. While the overall inflation (as represented by the implicit GDP deflator) was low at 2.5 per cent, what was of concern was the rising prices of raw materials. The CPI showed some tendency to rise during 2007 Q1: 2.7 per cent as compared to 1.5 per cent during 2006 Q1. This was due to soaring food prices, which rose by 6.2 per cent. There were, thus, two sources of inflationary pressure in the economy, namely, raw material prices and food (mainly grain) prices.

Despite the sustained high long-term growth and current acceleration in growth, China's is still not a hot economy, that may flare up any moment. The macro-economic parameters are very much within control. China has entered an era of sustained high trade surpluses, and bulging current account surplus (estimated at around 8 per cent of the GDP). There has been a marked shift from capital-based surplus to trade-based surplus. Short-term capital inflows have almost disappeared. This shift is significant in the sense that unlike in the past, the rise in foreign exchange reserves, which had crossed USD 1.2 trillion in March 2007, is now more due to rising trade surpluses and not due to short-term capital flows. What this means is that the government can, accordingly, accept some reasonable appreciation of the currency, especially vis-à-vis the US dollar. In any case, the yuan has been gaining on the US dollar at the annualised rate of 6 per cent ever since China moved out of the fixed dollar peg in July 2005. What is notable in this context is the pace of accumulation of foreign exchange reserves in recent years—roughly USD 57.5 billion on an average during every quarter between Q2 of 2004 and Q2 of 2006 (see Figure 5.7).

FOUR POSITIVES

Broadly speaking, China's macro-economy has four positives, which characterise its high growth, namely, (i) a sound fiscal

Figure 5.7
Quarterly Addition to Foreign Exchange Reserves (Q2, 2004 to Q2, 2006)



Source: Dragonomics, Q4, 2006.

situation, (ii) a large and growing current account surplus, (iii) bulging foreign exchange reserves (almost half of the GDP), and (iv) high productivity growth (higher than wage growth). Low inflation can also be added to this list, but we refrain from doing so due to the underlying inflationary pressure. There is some uneasiness in the government on this issue, in view of the risk of over-heating of the economy. The risk, however, is somewhat misplaced for at least two reasons. First, when the GDP continues to grow at a very high rate, there are chances that the demand-supply gap may widen, causing over-heating of the economy. We do not see cause for any such possibility, since continued high investments have been creating huge production capacities in all the industry sectors. Apart from the growing domestic production, domestic availability is further augmented by imports. This rules out the possibility of any demand-supply imbalance.

Second, an economy also runs the risk of over-heating if the wage levels tend to rise and build up pressure for cost-push inflation. In a competitive economy, cost-push inflation impacts the competitiveness of firms, affects export competitiveness and, if the economy is perfectly open, domestic firms tend to lose out in competition to imports. In the case of China, wage rates are seen to be increasing in real terms at double-digit rates and at higher

than the real GDP growth. There is some risk here, but two factors need to be considered. One is that productivity growth is much higher than the real wage growth, and this acts as a cushion against any possible loss of competitiveness. The other factor is the high rate of unemployment, especially in urban areas, which is having sobering effects on the demand for higher wages.

The risk of over-heating is also remote in view of the economy's moderated growth in money supply (M_2), with the average annual M_2 growth during the period 2003–06 being 18.2 per cent and the elasticity of money supply in relation to the GDP being about 1.75. The average annual growth of loans disbursed by financial institutions, mainly commercial banks, at about 14 per cent during the period 2003–06 is well below the money supply growth, as well as the growth in deposits at 25.4 per cent. The outstanding loans, in absolute terms, increased from 15.9 trillion yuan in 2003 to 22.1 trillion yuan in 2006 (Q1–Q3), but as percentage of the GDP, it declined from 117 per cent to 107 per cent. What all these developments reflect is that greater prudence is being exercised in matters relating to the allocation of loans. The commercial banks are now going to the capital market with IPOs to raise resources for the purpose of restructuring, and are accepting market pressures for improving their profitabilities. Profitability is important, because much of the restructuring costs have to be, henceforth, borne by the banks themselves. There is still considerable implicit government support in that the interest rates are still administered, and there is provision for reasonable interest spread to the extent of 3.25 per cent in favour of the loan rate. Further, the bank stocks are capital-guaranteed stocks and indexed to GDP growth. Given this kind of guided restructuring, rehabilitation and ultimate transition to a competitive financial market, there is little chance that the banking sector would face any serious challenge in the near future.

The other point that undermines the risk of over-heating is the high rate of savings. The high propensity to save is a cushion against the sudden proliferation of demand. Household consumption demand has, no doubt, been increasing in recent years, but the savings ratio is still exceptionally high (about 49 per cent) and will take many years to come down to the average East Asian level of 36 per cent.

NOTES

1. JP Morgan Stanley Equity Research, June 2006.
2. Real in terms of 1978 prices (1978 = 100).
3. We understand that the revised growth estimate was 10.9 per cent.
4. For the first time since 1949, it was realised that population control was necessary to sure the faster well-being of the people. Mao Zedong, on the contrary, used to think of people as manpower that could be used to achieve any objective. However, the one-child norm had the effect of a serious social trauma and led to certain socio-demographic distortions, about which a lot has been written by various scholars and analysts.
5. State-influenced corporations are influenced in their operations by way of funding contributions from the state.
6. As was outlined in 1975, and later on adopted by the CCP in 1978 as an objective of economic transition.
7. Before financial sector reform, there were a large number of moneylenders, characterising the informal financial sector and undertaking banking practices.
8. This, in our view, is a historically developed attribute of the Chinese people, who have hardly had any experience of a truly benevolent state.
9. Investment from the Western countries had begun to flow in, in a significant way, only from 1994 onwards, that is, after more than 15 years since the opening up of China's economy.

Six

Seven Challenges

Sustainability and Development Issues

Truly, the Chinese government has the dual task of maintaining high growth in a sustainable manner and that of establishing a balanced society. China needs its high rate of growth to continue, because on the basis of per capita GDP, it is still a low-income developing economy. It will, perhaps take several years of 10 per cent plus growth before the country's per capita gross domestic product (GDP) would reach a respectable figure of USD 10,000. There are still some fundamental weaknesses that the economy suffers from, and need to be addressed.

BANKING SECTOR AND THE SOEs

One such significant economic weakness lies in the banking system, and its relationship with the state-owned enterprises (SOEs). Although this issue is not quite within the scope of this chapter, let us explain this a little bit. China's modern banking system is fairly new. Banking reform is passing through the second crucial phase of reform. The first phase, spanning over two decades from 1983 onwards, was primarily about transforming the socialist banking system into modern commercial banking norms and practices. The second phase began in 2003, when the government seriously took to restructuring the system in conformity with international banking norms, and this is where a lot is yet to be achieved. It took several years before the government could address the problem of huge non-performing loans (NPLs). The problem dented the exchequer due to massive re-capitalisation, and it is still persists, in a disguised way.

In 2005, the outstanding loan was about 106 per cent of the nominal GDP, or about 19.5 trillion yuan in absolute terms. By 2003, all major commercial banks had their bad loans hived off at huge budgetary costs, but the lending and investment patterns of the banks have hardly changed and continue to make their operations less profitable. The problem of NPL is now associated with the problem of profitability. The system has considerable liquidity, and the banks must improve their lending operations. The problem, however, is as follows. The private corporate sector is not highly dependent on bank loans. The private enterprises re-invest their retained profits. Given this situation, the SOEs, the state-controlled enterprises (SCEs) and individuals remain the major clients for the banks. Further, there are limitations on the government's borrowing from the banking system. It is because of all these that there are constraints to loan growth, which is just 2 percentage points above the nominal GDP growth and well below the deposit growth.

What this means is that high GDP growth can continue without creating any serious inflationary pressure. At the same time, however, one has to recognise that the banking system has limited options with regard to diversification of the loan portfolio and thus the enhancement of profitability. There are also limits to exposure to the capital market. Given this, they have turned to the real estate sector, which is booming on the strength of rising demand for commercial properties and urban housing. This sector attracted considerable private and individual investments, worth about 8.6 per cent of GDP in 2005, up from 2.5 per cent in 2001. Interestingly, most of the construction companies in China are either SOEs or state-invested enterprises (SIEs), and the banks have high exposure to such companies.

Generally speaking, the banking industry in China has a doubtful health. There is also lack of transparency on the seriousness of the ailment afflicting the industry. On the part of the government, there is a manifest shyness and uneasiness about disclosing the real picture. The problem especially concerns four major state-owned commercial banks, which own over 57 per cent of the total assets held by the banks and other depository institutions. No accurate information is available as to how much of the outstanding loan runs the risk of becoming NPLs. The question assumes significance,

since non-market considerations still influence over half of the lending decisions in the form of *guanxi* loans and *policy* loans. About 65 per cent of all outstanding loans are held by the SOEs and the SIEs. It may be mentioned here that the State Council and the National Development and Reform Commission (equivalent of the Indian Planning Commission) approve all equity securities and corporate debts securities. Accordingly, the bulk of the approved securities go to the SOEs and the SIEs.

This is what keeps many people guessing about the actual and potential size of NPLs. According to the China Banking Regulatory Commission (CBRC), as on 31 March 2006, the NPLs had fallen to USD 164 billion, or to 6.6 per cent of the GDP, and those of the depository institutions amounted to USD 42 billion, while the total NPLs amounted to 7.3 per cent of the GDP. The estimates of external non-official agencies are severely frowned upon by the government. However, the gravity of the NPL problem can be understood from the fact that between 2003 and 2005, the People's Construction Bank of China (PBOC) injected around USD 60 billion of foreign exchange reserves towards the re-capitalisation of four major commercial banks, and in 2005, foreign financial service firms acquired USD 18 billion in minority B shares in various Chinese banks.

The health of China's banking system is, thus, intimately linked to the performance of the SOEs/SCEs. Such enterprises continue to maintain their dominance in the economy. In 2005, they accounted for over 74 per cent of the FAI, produced about 45 per cent of value-added by the industrial enterprises, and employed 242.5 million people (including 142.7 million in rural areas). More importantly, they employ over 5 million party members as executives and senior managers. But there is a large number of insolvent and unprofitable SOEs/SCEs, which account for 20 per cent of the workers, 30 per cent of the fixed assets and 40 per cent of the outstanding loans. In addition, there are marginally profitable SOEs, accounting for 18 per cent of the outstanding loans.

These SOEs/SCEs use their *guanxi* (connections) to get loans from the banking sector at lower rates. They are, in this sense, the real stumbling blocks to the reforming the SOEs as well as the banking sector. What makes matters worse for the banking sector, however, is the poor performance of these enterprises on account

of inefficiencies. The total factor productivity (TFP) of private enterprises is more than 120 per cent higher than that of such enterprises. Even the enterprises subject to indirect state control have 46 per cent higher productivity. What does all this mean for the banking sector? In simple terms, there is a huge potential of NPLs, especially in the four major state-owned commercial banks, which is ripe for explosion in the event of a burst in the boom in the real estate segment or slowing down of economic growth.

In relation to NPLs and the weaknesses of the banking sector, there is a larger issue concerning the economy at large. A large amount of bad loans, coming out of high deposit growth, simply means that the resources available with banking sector and other depository institutions are not being efficiently deployed. The overall pattern of resource allocation is inefficient. Inefficiency in the allocation of resources means that the economy is not able to generate as much growth as the deployed resources are meant to ensure. As a result, there is a loss of potential growth. Given the huge investments taking place in the economy, China could generate much higher returns on investment. Further, by eliminating or by reducing the extent of non-market loans, the commercial banks could provide the depositors much higher returns on deposits. Currently, the low deposit rate (of less than 3 per cent) is largely on account of inefficient lending. More importantly, it is depriving the individual depositors of the desired level of return on their deposits.

Further, in view of its World Trade Organization (WTO) commitments on financial sector liberalisation, China indeed has a serious challenge to overcome. As per the Accession Agreement, the government is committed to open its domestic banking industry to foreign banks by the end of 2007, and allow the latter to give loans to, and receive deposits from, the households and firms. It is after the achievement of this commitment that the banking sector will face the real cost of *guanxi* and *policy* loans, as these are likely to put both the Chinese Party Congress (CPC) and the SOEs in a difficult situation. We have to wait and see how the government would respond to the emerging challenge. The point that needs to be emphasised here is that China need to put its domestic banking industry on a sound footing at the earliest, by way of accelerated reform. The continuation of high growth is necessary, because

even as it may face the risk of over-heating, high growth acts as a cushion against any possible failure on investments. A drop in growth may accentuate the risk of NPL. Further, the longer the continuation of high growth, the greater is the chance for the SOEs to sustain their profitability and investments.

There is yet another reason why China needs to maintain its high rate of growth. This is in view of the imperative of establishing an equitable economic order for its people and the provinces. If the growth rate slows down, there is a risk of further widening of inequality in the distribution of income and expenditure. The percolation effect of growth tends to receive a setback when overall growth declines. For the percolation theory to work effectively, it is necessary that growth should not only be high, but sustainable as well. Let us now examine some of the problems and issues concerning the economy, arising out of the developments during the last two and a half decades in China.

THE GRAIN ISSUE

An important issue, which is a fallout of urbanisation-led growth, is about the prospect for grain production and grain security. Since the launch of agrarian reforms in 1978, China has achieved remarkable progress in agricultural production. Apart from boosting production to higher levels, and providing the initial stimulus to industrialisation, the agricultural sector has contributed significantly to the alleviation of poverty and elimination of starvation. Further, agricultural reform has diversified agricultural production, and prepared the primary sector for a market economy. After nearly three decades of reform, however, the agricultural sector now stands at the crossroads, with the grain issue posing the serious challenge of feeding the country's large population.

Supply side constraints, it may be mentioned, are acute and have very little flexibilities. Grain production has reached the point of saturation around a level of 500 million tonnes. For an understanding of the situation, let us revisit the domestic supply side situation, that is, the production side scenario. The net cultivated area under foodgrains was 101.6 m. ha in 2004, down from 120.6 m. ha in 1978, since when diversification in agricultural

production led to the considerable transfer of lands to non-grain remunerative products. Aggressive urbanisation, among other things, resulted in the rapid encroachment of agricultural lands, often facilitated by the local governments in view of their pursuit of industrial development and urban construction. If the pace of urbanisation maintains its present trend¹, the availability of land for agricultural operations may shrink further. China has about 35 m. ha of wasteland, of which about 14 m. ha can be reclaimed. The question, however, is: where will this additional land go on completion of the reclamation activities? Will it be brought under grain production, or be consumed by the urbanisation requirement?

The intensive application of technological inputs does help in improving productivity of the available acreage, but China has already increased its consumption of technology inputs to a very high level, and is probably at its limit, with 456 kg of chemical fertilisers, 12.7 kg of pesticides and 6.30 kwh of energy per hectare. Cultivation is highly intensive in the use of water, which is already in short supply. The intensive use of technology inputs has given rise to serious environmental problems, by way of water pollution as well as the degradation of soil conditions. There are variations in productivity across the provinces as also within the districts, but the authorities argue that there is scope for a more balanced pattern of technological spread, which may help in increasing the average productivity level. However, it is also a possibility that while areas with lower yields can improve further on productivity, those with higher yield levels may witness diminishing returns to scale, and the net average yield may either not increase at all, or may increase by small margins only. The crucial question of China's ability to add to, or more correctly maintain, productivity growth therefore remains. In other words, with respect to the economics pertaining to the supply side of grain, the crisis of inelasticity is a serious one.

The crisis may further escalate in view of yet another factor, which comes from the adverse effect of the growing rural-urban income inequality. The inequality has given rise to two sets of problems, which have been mentioned in Chapter 5, namely, (i) massive migration of the workforce from rural to urban areas in search of better income prospects, and (ii) shift in occupational pattern within the villages in favour of non-farm wage occupations.

It is true that the primary sector still accounts for the bulk of employment and a large percentage of the population still depends on agriculture for livelihood. The fact, however, is that rural, and especially agricultural, occupations are steadily losing attractions, in view of their low-income realisation.

Within the farm occupations, grain production is the least attractive of all the other operations. Given this situation, grain farming is faced with the prospect of losing manpower to other farm occupations and non-farm operations, both within and outside the villages². This is already happening. Menfolk, in particular, are migrating to other occupations, or to urban centres, leaving farm occupations in the hands of women and children. This phenomenon, growing rapidly as it is, has its significant social costs (see Box 6.1), but we will not go into that aspect of development here. What we would reiterate, instead, is the emerging threat of an acute manpower shortage in agriculture, especially with respect

Box 6.1

Family Ties vs Money—China's New Value System

In the Henan province, 9-year old Manman is not very sure if her parents love her or not. Her parents' fault is that they want to earn money for sustenance and want her to stay with her grandparents. While Xiao Quingtong, Manman's 34-year old father, has at least been able to take time off to celebrate the Lunar New Year holiday with his family, his wife has been unable to do so. Manman misses her mother, but does not want to visit her in Kunshan, a city 480 kilometers away from Guihua, where Manman stays.

In the rural province of Anhui, 16-year old Zhao Yan is left to fend for herself, as her dad has gone to Shanghai to make money. The teenager tends to the family's rice farm, goes to school and waits for her father's periodic visits home. Meanwhile, an elderly woman living next door and a dog are her constant companions. In emergencies, she borrows money from neighbours and gets medicine for herself when she falls sick.

China's economic boom has left the children behind. There are an estimated 200 million migrant workers in China. And Chinese authorities estimate that 22 million youngsters in China have been left

(Box 6.1 Contd.)

(Box 6.1 Contd.)

at home while their parents migrate to other cities to find work. The result is that the children are left behind with little or absolutely no supervision. Not only are these children unable to keep up with the schooling standards, classes and regular activities, but they have also started showing behavioural problems leading to cheating, fighting and petty stealing. The *hukou* (registration) system is playing havoc with the people's lives. The farmers moving to China's cities to work are placed under separate educational and housing regulations. They cannot apply for public housing and their children have to pay higher fees to go to school. It is thus better for the migrant workers to leave their children at home rather than face hardships in cities.

The farmers are not, however, too worried about the degenerating family ties, if that brings the money. As Zhi Jifang, 81, staying in Yan-yan, puts it, "Fifteen years ago, we did not have enough food to eat, let alone profit. In order to have a better living condition, in order to have economic development, there is no other way. It's true migrant work makes family less cohesive, but we have to do that." Although migration has helped lift millions out of poverty, it is wearing out the fabric of rural society. That money now takes precedence over family has been an unspoken fact of life in China, but it is a view often obscured by the popular notion that the Chinese are, above all, family-focused and family-centric. As Mrs Jifang says, "When I was young, no one left home to work. Sometimes I ask myself wasn't it good that we all stayed together? But there's no other way. They have to go out and make money. This is the price that we have to pay."

Note: Adapted from a news item in *Asian Wall Street Journal*, 25 January 2007 and 21 February 2007.

to grain farming. This poses a serious threat to the future food security of China.

Given the constraints on the supply side, the questions that arise are: How is China likely to respond to the emerging scenario? And what is the thinking within the government? At the official level, the thinking is that there may not be a serious supply-demand mismatch if: (i) there is a stability in acreage in terms of the sown area, that is, taking into account multiple cropping, and (ii) in the longer term of 2030, the productivity growth remains in the range of 0.7 to 1.0 per cent per annum.

It is also felt that the grain output per hectare can be increased by more than 1500 kg, through upgradation of medium and low-yield land, strengthening of water management projects, and expansion of irrigated areas. Further, it is also believed that the contribution of science and technology in China's agriculture, currently estimated at around 35 per cent of the increase in production, is less than its full potential, and can be increased to about 60 per cent, that is, to the level of that in developed countries. Similarly, the grain loss in the process of harvesting and post-harvesting operations (estimated at 10 per cent of the production), it is presumed, can also be recouped.

There can be no doubt that the government is very much seized with the problem confronting grain production, and has an elaborate plan in place to overcome the problem of supply inelasticity. Apart from ideas on how to increase the grain production, it is understood, the government also has plans for demand management, wherein, it is believed, cautiously guided measures to bring about a shift in the food consumption pattern in favour of non-corn food items, may help overcome the threat of food insecurity. According to conventional wisdom, with rising income, the consumption of non-grain food tends to increase in relative terms. It is hoped that the gradual shift in the food consumption pattern would cause some decline in the consumption of staple foods like rice, and an increase in the consumption of non-staple food items, namely, fruits, meat, aquatic food, etc. The proportion of food expenditure in the total consumption expenditure is also, accordingly, expected to decrease with rising income. Taking this into account, the demand for grain was projected by the government to increase as shown in Table 6.1.

Table 6.1
Official Estimate of Demand for Grains

<i>Year</i>	<i>Population (projected)</i>	<i>Consumption Grain (kg/person)</i>	<i>Total Demand (million tonnes)</i>
2000	1.3 billion	385	500
2010	1.4 billion	390	550
2030	1.6 billion	400	640

Source: People's Daily, 15(1).

However, notwithstanding changes in food habits, the demand for grains would, in any case, increase, and so would the per capita consumption. The question is as to how much of the additional demand can be met by production growth and how much by way of imports. There are a couple of other pertinent issues. For instance, natural calamities such as droughts and floods are very frequent and often seriously hamper grain production, besides claiming large casualties of human and cattle population, and causing the erosion of capital stocks. Natural calamities are major sources of instability in grain production in the country. Often, the production losses due to natural calamities are very substantial. In addition, there is a limit to the application of technology. As has been already mentioned, China has reached the limit of intensive cultivation, in view of the already high technological coefficients. Further intensification of the use of technological inputs poses the serious risk of extensive environmental hazards and their adverse side effects.

The other problem is that the local governments are not so much in favour of promoting agriculture at the cost of urbanisation. As noticed earlier, the primary sector as a whole gets only about 15 per cent of the fixed assets investment. In several provinces, the share of the primary sector, and particularly of agriculture, in fixed assets investment (FAI) is even less. It is also the local governments that encourage the forceful conversion of agricultural lands for non-agricultural purposes³. Both inter-regional and intra-regional disparities are working against the interest of larger investments in agriculture. While the central government in Beijing may be interested in augmenting the production and supply of grains, the local governments have little interest in doing so. Further, still larger issue concerns the willingness of the grain farmers. Will the people be keen to spend the extra money and labour inputs, more so when the return from grain production is low? Given that their priority is the maximisation of their income rather than feeding the nation, they cannot be expected to contribute to further modernisation and upgradation of grain production facilities, unless they are offered substantial market-based incentives.

The modernisation of grain production, through more intensive application of science and technology, may be difficult without an effective incentive mechanism. The question is: What kind of

incentives would be acceptable to the farmers? Subsidies alone will be of little help, in the absence of assured matching returns from grain cultivation. Farmers have to be held back from the temptation to migrate to non-farm occupation in cities. For this, the rural-urban wage gaps have to be kept under control, but this cannot be accomplished easily. The government may have to take some calculated risks, and allow the full play of market forces in determination of the grain prices, so that the terms of trade favour the grain producers.

At the same time, there are problems associated with the full play of market forces in the determination of grain prices. Apart from the political hazards of the policy, it may adversely affect the industrial wages and the consumer price index (CPI) inflation. The economy, in that case, faces the risk of the severe problem of wage-push inflation and of losing competitiveness in industrial goods. Further, the operation of market forces does not necessarily guarantee increased farm income. On the contrary, there are risks and other consequences of market failures.

In this context, one has to, however, acknowledge some of the positive initiatives, undertaken by the government in recent years for the purpose of boosting farm income. Mention can be made of the decision to eliminate agricultural tax within five years beginning from 2004. Subsequently, it was decided to further reduce the time frame. As of now, almost all the provinces have eliminated agriculture tax in a bid to boost farm income. The extent of the additional income that would accrue to the farmers as a result can be understood from the fact that prior to the implementation of the tax elimination policy, agriculture tax revenue collection was USD 7 billion. On the other hand, within the permissible limits of WTO rules, input subsidies have been stepped up with respect to seeds and farm machinery.

Other initiatives include: (i) gradual elimination of protection prices (support prices at which government procures a set quota of grains from farmers), (ii) privatisation of domestic grain marketing, and (iii) development of market infrastructure such as the introduction of futures trading. The government has also taken initiatives to increase the availability of farm loans, which were earlier squeezed by increased loans to rural factories. A network of about 35,000 rural credit co-operatives (RCCs) has been revamped to make more

loans available to farm households, mainly small amount (USD 2,500) loans of short-term (3–6 months) duration, to be used for the purchase of inputs and to finance modest investments.

These measures are, no doubt, favourable for ensuring higher rural income. The question of the impact of such measures on income growth, however, has been a matter of debate. According to a USDA study (February 2005) on China's farm subsidies, in 2003–04, while direct subsidies and tax reduction accounted for 5 per cent and 2 per cent, respectively, of the growth in rural per capita household income, non-farm business income accounted for 14 per cent of the growth in income. The sale of agricultural commodities, buoyed by higher farm prices, accounted for 49 per cent of the growth, while non-farm wages and salaries accounted for 29 per cent. The study further noted that in 2004, 'rising prices increased rural income by 60 billion yuan, twice the gain realised from subsidies and tax reduction'. In other words, while subsidies and tax reduction measures help in increasing farm income, higher prices for agricultural products are far more potent incentives than the former.

This being the case, we are back to the question of the limit on higher prices. What is the sustainable level of 'higher' price? Also, what is the price level at which grain farmers would be motivated to take measures to increase output, and allocate higher financial and physical resources in favour of grain production? There are no answers to such questions. The problem is that the Chinese farmers are keen prosperity seekers, and want to be at par with their counterparts engaged in non-farm occupations. Economic transition has divided the society into numerous income classes, whereby the farm households are placed at the bottom of the strata. This is a very significant change from the socialist era, when the society was almost classless and economic well-being was equalised at the lowest strata of the peasantry. In the new paradigm of economic liberalisation, the farming community's immediate priority is to ensure economic security and enhance prosperity. The country's grain insecurity is not their concern, all the more so since the large-scale appropriation of farmlands for the purpose of urban housing and factory construction, has left millions of farmers landless. In this context, any possibility of a significant improvement in grain production appears highly doubtful.

Similarly, the scope for management of the demand side, through diversification of the consumption basket in favour of non-grain food items, is also limited. As the situation stands today, notwithstanding various measures taken by the government, China faces the threat of a serious scarcity situation with respect to grains. A multi-pronged strategy is essential for the purpose of augmenting the supply side, but fundamental to such a strategy is an acknowledgement that the highly urban-focused development model is untenable in the long run. Development must have an appropriate rural-urban balance. Further, the terms of trade between farm and non-farm sectors has to be managed to restore greater parity in favour of the former. This necessitates a re-think on the current growth pattern and its skewedness, much of which is on account of the highly skewed distribution of fixed assets investments. Tackling the existing rural-urban dualities is a precondition for averting any possible grain crisis. What is all the more important is the official recognition of the impending threat. Specifically, the local governments must acknowledge this threat.

A significant point that needs to be highlighted here is that China is the second largest producer of foodgrains. At the same time, it is also the largest consumer of grains. What could happen if the giant is faced with a grain crisis? The annual grain consumption in China is one-fifth of the world's total. If China fails to ensure steady growth in grain production and goes to the world market as a major buyer of grain, it is likely to cause serious dislocations in the supply-demand order of the global grain market, hampering the much-needed food aids for food-deficit developing economies, besides pushing up the global prices. This is not difficult to understand in view of the limited global capacity to expand productions. For instance, the prevailing average annual growth in foodgrain production is 1.7 per cent. The major producers of cereals are USA, China and India, together accounting for about 46 per cent of the total global production. Another 35.6 per cent is contributed by 20 countries, while the remaining comes from rest of the world.

In value terms, China's share in world agricultural imports increased from 5.4 to 6.6 per cent during the period 1999–2004. In 2004, China was the third largest importer of agricultural products, after USA and the United Kingdom, with an import value of about USD 42 billion, growing at over 12 per cent a year since the

Table 6.2
Production of Major Cereals—World and China: 2004

<i>Cereals</i>	<i>World</i>	<i>China</i>	<i>China's Share</i>
Wheat	629.9	91.9	14.6
Rice	608.4	180.5	29.7
Coarse Cereals	1032.1	140.7	13.6
Maize	724.5	130.4	18.0

Source: FAO Statistics, 2004, United Nations.

triennium of 1999–2001. While China accounts for one-fifth of the global cereal consumption, it was also earlier producing one-fifth of the total, but is currently producing about 18 per cent of the global production. The country's import dependency ratio for cereal consumption under normal conditions, however, is about 5 per cent.

Given this scenario, the imperative for China is to keep its import dependency under control, as otherwise it is likely to seriously impair the food balances of the world. Particularly, for the food-importing low-income developing countries, China's coming to the global market for grains as a major buyer may be a serious disaster.

URBANISATION, HOUSING AND RELATED ISSUES

As indicated earlier, the grain issue is related to the rural-urban income inequality. To put it more directly, the grain issue is almost a direct consequence of the rapid growth of urbanisation, fostered by rapid industrialisation and massive investment in urban infrastructure. Urbanisation in China is not so much a product of conscious planning, but a by-product of the growth pattern. When urbanisation takes place, it has certain fallouts such as housing shortage, deficiencies of civic amenities, creation of urban ghettos, etc. In the case of China, as has been mentioned earlier, urbanisation has been accompanied by the rapid flow of migration from rural areas (people urbanisation), and, as a result, much of the current urban population consists of the migrants, who do not

get the facilities that are available to the urban citizens. Migration does not entitle people to urban citizenship. This has given rise to serious intra-urban disparities between the migrants and the non-migrants. The problem of intra-urban duality is compounded by the discriminations suffered by the migrants due to restraints of the *hukou* (residential permit) system⁴ that denies them permanent urban residence quotas, besides denying them access to social security and transfer of property rights, among others. It may be mentioned here that in the wake of economic reform, the impact of *hukou* by way of social disorder has been much more serious (see Box 6.2).

The migrants in urban China have created a huge reservoir of surplus labour, and a large informal labour market, as a

Box 6.2
No One had Imagined This!

Beijing is being built up overnight in preparation for the Summer Olympics of 2008. The skyscrapers, malls, subways, hotels, airport terminals are literally growing in front of one's eyes. The pace of development in the city is beyond imagination. While the city is setting an example for every other mega city of the world, it is quietly paying the price by building up a society of migrant workers—an unbalanced group of human forces, who do not belong to the city, and are not recognised by it, but without whom the so-called development of Beijing would come to a full stop.

Worse, these migrant workers are not even allowed access to the basic amenities required for a human being. Away from their families and children, these workers are lured into the city for high incomes that they can send back to their homes, but at the same time, they lose contact with the very families they toil for. The cost of this development and the need for a good life proves too heavy for them. One of these workers, Wei Zhongwen, a 41-year old construction worker, is a proud father but does not really know what his daughter likes.

The uncertainty of life, the need to provide a better life for the family and the lure of some extra money have kept Wei away from home for nearly three years. While he misses his family, Wei is considered quite well off in his rural hometown in Yushu county in north-eastern Jilin province. His family lives on a farm and the family home consists of five bedrooms, while the drawing room boasts of a 21" television set—the only one in the neighbourhood.

(Box 6.2 Contd.)

(Box 6.2 Contd.)

Even as Wei misses his family, his employer has roomed him up in a wooden shack with ten other workers, more like pigs rather than humans. Even water is not available to these construction workers. They go on working for days, smelling of sweat and discharge. While their clothes are never washed, only worn till the end and thrown off, they take a bath rarely, mostly as a treat to themselves at the cost of 60 cents each. The food again given to them consists of the bare basics and no meat is affordable. The invisible army, which builds up Beijing, slowly degenerates itself—in body and soul.

Since the city authorities do not even acknowledge the existence of these workers, they obviously see no need to provide cheap temporary dwellings for them. Most of them work on oral understanding, rather than any contracts. They have no insurance against accidents (construction has the highest rate of accidents after mining), no surety of getting paid and even no medical help. Despite so many day-to-day problems being faced by the workers, Wei complains about only one thing, 'The biggest problem of this job is loneliness'. The Beijing authorities, however, have made it clear that they want these migrant workers out of the city by December 2007, so that the city's glamour is not affected by these poor workers.

Source: Adapted from *Asian Wall Street Journal*, 27 December 2006.

consequence. The per capita income of the migrants is about half of that of the urban dwellers, that is, those with permanent *hukou*, even as the former's contribution to the output is well over 50 per cent. By virtue of their higher contribution to output, the migrant workers also make significant contributions to the tax revenues of the city governments, and yet they continue to encounter severe social discriminations. One wonders if this is one of the hidden secrets behind the country's high economic growth. The bogey of migrant workers, who are not entitled to minimum income or cheap rental housing, is a source of cheap labour.

There is hardly any income and/or housing security for the rural migrants in urban areas. Income security is dependent on the availability of job opportunities in the multiple informal, and often illegal, production sites, besides construction activities, where there is no security or stability of jobs. They are also not covered by the provisions relating to social welfare and various institutional arrangements meant to promote labour welfare. In

a bid to contain the overall growth and driven by the threat of an environmental crisis, the government often imposes limits on capacities in several resource-intensive industrial sectors such as steel, cement, electricity, petro-chemical products, etc., whereby units whose capacities are below certain specified levels are required to be closed.

The disqualified units, however, still exist and operate illegally, usually at odd hours of the day, evading the sight of the official watchdogs (see Box 6.3). Apart from instigating corruption, the existence of illegal units (and they are large in number) has generated a huge informal labour market, wherein workers are ready to work longer hours at low wages, and without any kind of social security. Any drastic step to clamp down on the operation of such units is likely to cause a serious problem of joblessness among the migrant workers, and threaten the social stability within the urban areas. However, social stability is, in any case, under threat, in view of the discriminations suffered by the migrants on account of the hukou system.

The problems of the migrants in urban areas are not officially recognised at the level of the local governments, even as the problem of settlement is quietly rising to menacing proportions,

Box 6.3

Illegal Operations: Arm-twisted by Growth

Wang Chenliang from Sichuan province, had just finished his shift in the Wangyu mine in Central China near Shanxi province, when there was a sudden explosion. Four tonnes of demolition explosives had caught fire and destroyed the mine, killing around 35 workers from the night shift. Even as Chenliang helped in the rescue work, he knew that the families of his fellow workers were doomed. They were all working in an illegal mine. They were not entitled to any support from the government, as the mine owner did not implement the safety standards.

This story is not a stray one. Plenty of such incidents occur throughout the country. The economic developmental strategy of China was masterminded by Beijing long back in 1987, but the pace of that development seems to have outpaced the authorities in the last 20 years. With the country clocking in an average 10 per cent growth

(Box 6.3 Contd.)

(Box 6.3 Contd.)

for the last few years, the quest to Westernise and consume has crept inside even rural China. The result is a massive energy demand, of which one-fifth is supplied by illegal power plants and coal mines, and most importantly, Beijing has lost control in the face of this massive demand.

As income levels rise, the energy demand per person has started catching up with that in the developed countries. America consumes about eight metric tonnes of energy a year, Japan consumes half of it and China's per capita consumption is 1.2 metric tonnes. According to mathematical interpolation, for every Chinese, to live the energy-intensive lifestyle of an American, it would require a doubling of the world oil production or more coal than China could dig up—a feat that is impossible to ever achieve. As the Central Government has no answer to the tricky question, which is one of the fallout of high growth, local governments have decided to push the small power plants, often illegally, to encash on the high growth. The Xinfeng power plant in Inner Mongolia is one of the ten such mushrooming unauthorised coal burning plants, which are generating a total electricity of 8.6 gigawatts. While the modernisation process is being fuelled, it is the environmental pollution and untimely death that are paying for it. The unsafe hazardous coal mining used to fuel these power plants routinely claims around 4,000 annual deaths.

While the electricity that these illegal units supply is necessary for China's growth, the uncontrolled manner in which they operate, most of the time under the support of the local government, is a testimonial to the growing imbalances fuelled by development. Beijing's efforts to reduce the number of illegal coalmines is a farce as thousands have sprung up in place of the hundreds that have been shut down. Even the country's efforts to reduce the dependence on coal have largely failed. China is third in terms of coal reserves after the US and Russia with an estimated 114.5 billion metric tonnes of recoverable reserves. Natural gas, planned nuclear power production and hydropower, all prove to be much more costly in the face of such huge readymade reserves. Like the natural resources, it is the miners who are in the frontline of the battle to meet the energy needs. One-third of China's coal production comes from these small, inefficient and illegal mines. They are so important in keeping the economy rolling that even the government has halted its plans of cracking down on these mines. And the power plant owners are confident that every illegal power plant will be legalised in the coming years, otherwise China will face serious power outages. Beijing may just be arm-twisted by growth to accept the illegal construction.

Source: Adapted from a news item in *Asian Wall Street Journal*, 28 December 2006.

besides adding to the problem of urban pollution and squalor. This is one aspect of distorted urbanisation. There is yet another dimension of distortion that arises out of the urban housing policy. We may call it housing inequality, which is a reflection of not only income inequality but also of position-based divides maintained by the society⁵.

In socialist China, housing was an integral aspect of social welfare benefits that were almost free, and was provided either by the state or the state agencies (such as work units). Since it was decided by certain administrative criteria such as job ranks, position as a party cadre, etc., people had no say in how much space they needed. While there was housing inequality in the sense of per capita room space, there was security of shelter for all. This has changed ever since the introduction of housing reforms in 1988, allowing for privatisation. On the demand side, housing reform has granted households the freedom to have housing choices and adjust their housing needs, by way of either renting or purchasing new housing units. The result has been the emergence of a full-scale housing market. On the supply side, there have emerged two categories of suppliers—the public and the private, and two types of housing, namely, public housing and private housing. With respect to public housing, the state followed a dual system of ‘new policy for new housing stock, old method for old housing stock’.⁶

The housing reform has been successful in the sense that it has helped augment the supply of housing stock. At the same time, however, it has raised the issue of accessibility. The overall housing consumption (in terms of housing space or room per person) has increased, partly due to the rise in income, partly due to the shrinking size of the households and partly due to the secondary (traded) market, but discrepancies have cropped up in view of several other factors. In order to understand this, we need to understand the distribution side of the housing stock.

Investment in housing is dominated by commodity housing, that is houses constructed by the private builders. Commodity houses are meant primarily for those in the upper end of the income classes. The prices of these houses are almost free from official intervention. Needless to say, such houses are high value houses. The potential buyers are the ethnic Chinese from Hong Kong and Taiwan, executives in the multinational corporations (MNCs)

and other rich households. However, the private developers carry the obligation of making 20 per cent of the investments for the purpose of building affordable houses, the stock of which is also augmented by public sector investment. For the purpose of such housing, a principle of less than 3 per cent profitability is usually applied. In 1999, the average price of such houses was 1,093 yuan per sq m, as compared to 4,503 yuan per sq m for commodity housing. It constitutes the 'affordable housing', which concerns the bulk of the households, for whom this is an opportunity for improving their housing conditions.

While this is one aspect of affordable housing, the other aspect of it is that of the existing public housing⁷. With respect to the latter, the occupants were encouraged to buy their flats at subsidised rates with limited property rights. The full right of the property can be obtained later, on full repayment of the subsidy amount. In this way, people can own the units they have already been living in. At the same time, the households themselves build their own housing units in accordance as their ability to afford them. Both the systems are, however, open only to permanent *hukou*. The public housing system is usually operated through public work units, and is available to persons/households having affiliations with the work units.

Although such housing units are cheap and affordable, their accessibility is limited on account of the *hukou* system. People working in the private sector, migrants with rural or temporary *hukou* and those renting houses, in general, do not qualify for affordable public housing. Further, cheap rental housing is available only to households with permanent urban *hukou*, having a certain level of minimum income. The distribution of subsidised public housing, on the other hand, is according to job ranks and seniority that allow for certain discounts based on ranks and seniority.

On the whole, the housing markets in the Chinese cities present a highly complex scenario. Housing reform has helped develop a housing market, but institutional factors such as *hukou*, hierarchy, etc. have created imperfect market conditions that favour the high-income households and those enjoying the privilege of permanent *hukou*, affiliations with work units, job ranks, etc. It is the imperfect nature of the market that explains high prices in the housing market. More importantly, developments in the urban housing market are inherently discriminatory, and supportive of

widening disparities. The overall developments do not indicate progress towards a socialist market economy.

WATER CRISIS

China has over 600 cities and a total urban population of about 600 million, or 42 per cent of the total population, all being subjected to open and deliberate discriminations, if one may so. This, together with the rapid growth in urban manufacturing activities, is one of the primary factors behind the growing problem of urban water and air pollution. China has the largest number of most polluted cities in the world. According to a 1998 World Health Organization (WHO) report on air quality in 272 cities worldwide, seven of the ten most polluted cities were in China. While this data pertains to air pollution, 90 per cent of the urban water bodies in China are also severely polluted. Although it is not clear how, various estimates suggest that pollution costs the economy as much as 7 per cent of the GDP each year.

Apart from the problem of water pollution, China is faced with a severe problem of water shortage, especially in the developed North China. According to a World Bank report (2001), focusing on the water situation in North China, 'Nowhere in China are water shortages more evident than in the Yellow (Huang), Hai and Huai (3-H) river basins, that contain 424 million people'. The 3-H basins are the bread baskets of China, 'producing 67 per cent of China's wheat, 44 per cent of its corn, 72 per cent of its millet, ...65 per cent of peanuts, 64 per cent of sunflower, ...42 percent of its cotton, 31 per cent of the industrial output value, while the basins have only 10 per cent of China's water resources'. Many rivers in the 3-H basins, the report says, are dry for five to eight months in a year. Further, the present demand for water in the 3-H basins (169 bcm per year) exceeds the supply by 37 bcm per year. The overall situation in the 3-H basins, producing 37 per cent of the GDP, has been projected in the report in these words, 'As water tables fall, springs dry up, streams cease to flow, rivers run dry, and lakes disappear. Hebei province once had 1052 lakes. Only 83 remain.'

As of now, the concern is largely about water scarcity in the 3-H basins, whose economic importance has been highlighted in

the World Bank report. The excess of use of water over the sustainable supply in the basins has been estimated at 40 billion tonnes per year. The deficit is being met through intensive groundwater mining, which is leading to the rapid depletion of ground water. Unlike in other countries, in China, it is industry and urban household consumption, and not agriculture, which receive priority status for the purpose of water supply. Accordingly, industry and the urban areas consume the bulk of the water supply. The problem of water scarcity in north China is essentially a problem emanating from rapid industrialisation and urbanisation. The scarcity problem has been further compounded by the increasing water pollution, again an outcome of rapid industrialisation and the resultant urbanisation.

The government has responded to the situation by doing everything that needs to be done, namely, by introducing an effective pricing mechanism, focusing on re-cycling for the purpose of re-use, and water conservation, besides making attempts to augment the supply in the north by setting up south-north (S-N) projects. All these measures, however, may have little impact on the scarcity situation in the north, unless the fundamental issues that lie at the root of the crisis are addressed, that is, inefficiency in the use of water, rapid urbanisation, etc.

At its current rate of growth, the Chinese economy is destined for a very significant structural shift in the coming years. The share of agriculture in the GDP is likely to fall further, the services sector is likely to emerge as the largest contributor to the GDP, while the industrial sector is likely to see some decline in its importance. The possible structural shift is a pointer to the continuation of rapid urbanisation. From its current level of 42 per cent, the urbanisation rate is expected to exceed 60 per cent by 2020. According to the same World Bank report, this may go up to 80 per cent by 2050. The rate of industrial growth is, similarly, expected to be maintained, as more and more regions accelerate their pace of industrialisation. At this rate, the whole of China is likely to suffer from a severe problem of water scarcity and water pollution. In the absence of a substantial improvement in efficiency and other demand control measures such as re-use, effective pricing mechanism, etc., demand is likely to be significantly in excess of the sustainable supply. It is agriculture which, however, is likely to be the biggest casualty of any strategy for crisis management, especially of the

use of a pricing mechanism that may increase the cost of irrigation to a prohibitive level. Further, with the local governments being primarily focused on industrialisation/urbanisation, the needs of agriculture may not get due attention. This may further imperil the prospect of grain security in China.

PUBLIC HEALTH ISSUE

Also, while economic reform has generated a high rate of growth, the nature and execution of the reform has resulted in distortions in certain vital social institutions such as the public healthcare system. As we already know, economic growth has not made any significant impact on the quality of life for a large section of the population. The pace of improvement in the parameters representing health indicators is found to have slowed down considerably during the post-reform period. During the Mao era, longevity (life expectancy at birth) had improved from 40.8 years during the period 1950–55 to 65.3 years during 1970–75, that is, in a span of two decades. During the post-reform period, it improved further from 66.6 years to 71.5 years during 1978–2005. In other words, during the post-reform period, the life span of the average Chinese has increased by 4.5 years.

This could have been higher, if the reform process had not weakened the public healthcare system that was established under the socialist regime. On an aggregate basis, the improvements in health indicators have been impressive. There have been significant improvements in the broad parameters such as maternal mortality, infant mortality, under-five mortality, the number of doctors (per hundred thousand population), etc., though the corresponding rates are much lower when compared with those in the developed countries. However, China has lost the balance in the delivery system of healthcare ever since the beginning of its transition to a market economy. The rapid marketisation of healthcare delivery and the rapidly rising rural-urban and inter-regional income inequalities have given rise to acute health inequalities across the provinces, and between rural and urban areas.

According to a report titled 'China: Health, Poverty and Economic Development' (December 2005) by the WHO office

in Beijing and the Social Development Department of China State Council Development Research Centre, 'While infant and childhood mortality rates in developed coastal areas mirror those of industrialised countries, rates in most western provinces are 3–5 times higher...'. Rates for maternal, infant and under-five mortality in rural areas were three times greater than those in urban areas... . Life expectancy was much lower in provinces with higher share of the country's rural population...'. The disparities extend beyond life expectancy rates. The indicators of China's human development have shown inequality on many levels (see Box 6.4).

Box 6.4

Disparities in China's Human Development

REGIONAL DISPARITIES

While all 33 provinces are now in the UN's medium human development category, Shanghai's human development index (HDI) is almost 55 per cent higher than Tibet's. Nationally, HDIs are steadily rising, but in some central and western provinces such as Tibet and Yunnan, human development achievements are deteriorating. The maternal mortality rate is 9.6 in Shanghai, 111 in Gulzhou and 399 in Tibet. The rates of occurrence of vaccine-preventable diseases such as measles are 5–6 times higher in the western provinces as compared to the eastern provinces, reflecting uneven immunisation coverage.

RURAL-URBAN DISPARITIES

The duration of schooling is, on an average 2–3 years shorter in the rural areas as compared to the urban areas. About 20 per cent of the rural population still drinks unclean water and the rate is over 50 per cent in the poorest rural areas, as compared to nearly zero in urban areas. The prevalence of malnutrition in rural areas is two to three times higher than in urban areas. Over 60 per cent of the rural residents report no access to information on health. Job creation in rural areas has been stagnant and even declining in the secondary sector.

Source: Policy notes prepared by WHO in co-operation with other UN agencies and Health Partners for China's Eleventh Five Year Plan.

The report concluded:

Differences in health outcomes, however, are not an unavoidable result of the transition from planned to market-based economy even in a country as populous and complex as China. Major improvements in health outcomes could be achieved with relatively modest increases in public spending. For instance, over 75 per cent of maternal deaths and 70 per cent of mortality among children under 5 years are preventable with better access to basic inexpensive healthcare...

This clearly indicates that the basic healthcare system suffered neglect in the process of economic transition. While growth had been of overwhelming concern at all levels of governance, development was either overlooked or assumed as something that should automatically follow. Budgetary supports were significantly reduced. While during the 1970s, government budgetary supports covered the full cost of operating public health institutions, post-reform allocations to healthcare facilities were fixed at a certain rate, and were not guaranteed to cover full costs of the institutions, compelling the system to rely on their own revenues. In 2003, subsidies covered only 10 per cent of the expenses of the state-owned hospitals.

Over the years, China has, in fact, developed a double burden of the healthcare problem, typically reflecting the income inequality. While one of the burdens is related to access to basic healthcare and the prevalence of preventable and communicable diseases as are typical in a low-income developing economy, the other is related to non-communicable diseases that are common in the developed countries. The latter are fallouts of urbanisation, industrialisation and the evolving lifestyle. Talking about the health risks, the report observed:

The major health threats in the under-developed areas of rural China include under-nutrition, vitamin and mineral deficiencies, unsafe water, lack of sanitation and indoor pollution...as much as 80 per cent of rural households have no access to a sanitary lavatory, and 20 per cent of rural households depend on water that is unsafe to drink. As far as urban areas are concerned, environment and work plans are 'emerging health threats'.

For the poor, in both the rural and urban areas, the problem is acute in view of the induction of market economy principles in the

working of the healthcare system, which has compelled millions to either avoid or reduce the use of medical services, in view of their excessive costs. A National Health Services Survey (2003) reported that 38 per cent of those surveyed did not seek any medical service while sick, and 70 per cent had refused hospitalisation even on the doctor's referral in view of financial limitations. Coverage rates for social medical insurance declined drastically during the decade beginning 1993 in rural as well as urban areas. The coverage rate in urban areas had declined from 70 per cent to 42 per cent.

The problem was particularly acute in rural areas, where the total (social as well as other) medical insurance coverage was only about 22 per cent in 2003. A new scheme, the Rural Co-operative Medical Scheme (RCMS) was introduced in 2002, and was designed to provide rural households relief from the excessive financial burden. It also provided funding for catastrophic illness and in-patient medical services. However, the scheme was based on voluntary participation and required up-front payment of medical bills. To make matters worse, the reimbursement rate was as low as 20–30 per cent of the bills. Consequently, the RCMS suffered from low utilisation and rural insurance cover remained low. Medical Financial Assistance (MFA), introduced in 2000 was also meant to cater to the health needs of the poor in urban and rural areas. The financing pattern of MFA varied. In urban areas, the scheme was funded by the municipal government budgets, surplus of urban health insurance programmes and proceeds from social welfare lotteries. In rural areas, MFA was supported by financial contributions from the Central government as well as local government budgets, lotteries, donations, etc. The system, however, remained less developed in rural areas, as it was not properly connected with RCMS Demographic Trend.

As health risks continued to increase with rapid industrialisation, access to healthcare facilities remained limited. Worse, it was the basic healthcare facility that remained under-provided, and became a victim of official apathy. The implications of this scenario may be understood well, if we consider the demographic trend in the country. Almost simultaneously with the launch of economic reforms, the government launched the one-child policy with a view to contain population growth. At that time, it was a critical need for a country that wanted to raise the level of well-being of

its people. As mentioned earlier, but for strict implementation of this policy, China's population would have surged to 1.6 billion by the end of the twentieth century. The policy was relevant in this context.

However, while the policy has had some economic benefits, such as an improvement in living standards, the on-going demographic trends, as set by increasing longevity, low fertility rate and reduced mortality, now pose several challenges. The total fertility rate declined from 6.06 during the period 1970–75 to 1.7 during the period 2000–05, which is well below the population maintenance rate. The working age population (15–64 years) is likely to peak by 2015, and then decline thereafter. Boosted by higher living standards, the longevity of the average Chinese is likely to go up further, as the projection goes, from 71.5 years during the period 2000–05 to 73.3 years during 2010–15, 74.4 years during 2020–25 and to 78 years during 2040–45. Given the decline in the fertility rate, the percentage of elderly (65+ years) people in the total population is likely to go up to about 25 per cent by 2045. If we take those who are 60+ as elderly, then the percentage is likely to be around 35, which may be a significant demographic imbalance. By way of passing reference, there is another imbalance on the rise, on account of the sex ratio, expressed by way of male: female ratio. This was 117: 100 in 2000, and it is worsening. This phenomenon of worsening gender inequality is an outcome of the one-child policy, and social discrimination in favour of the male child. The tilt in the age distribution towards the ageing population is likely to further accentuate the gender inequality.

As far as the ageing population is concerned, some distinguishing features may be mentioned. First, while the population may be ageing, the bulk of them may not be rich, meaning thereby that there may be a high incidence of poverty among the elderly people, which implies a huge budgetary burden for the government. Second, the majority of the ageing population may be living in rural areas. Third, given that the younger population has a high propensity to migrate, the ageing population is likely to suffer increasing helplessness. The implications of the rising proportion of the ageing population in the country are easy to understand. From the economic angle, besides the increased dependency ratio, the ageing population poses numerous challenges for both

sustainability of growth and competitiveness of the economy. In the absence of adequate economic and healthcare security, this may also mean that people may continue to lay emphasis on savings for old age. In other words, China may continue to remain a high-saving low-consumption economy. At least, those in their middle ages and above will remain major savers, while the younger ones may constitute the consuming class. Since the country has high exposure to several non-communicable diseases, the age structure of the population poses a serious challenge to the healthcare system. Gender imbalance, on the other hand, poses the high risk of many unwanted social problems like commercial sex, sexually transmitted diseases (STDs), HIV Acquired Immuno Deficiency Syndrome (AIDS), etc., besides violence and trafficking.

From the point of view of the ageing population, there is another aspect of social risks of a different kind. During the pre-reform period, the age structure hardly mattered. Everyone, irrespective of age and sex, had to work. In the age of the market economy, however, elderly people may not have access to gainful employment, even if they want to; all the more so, in view of the high unemployment among the youth. In the absence of gainful occupation, the elderly people may possibly ask for, in addition to economic securities, certain social freedoms (such as freedom for religious practices, freedom for forming associations, etc.) and pastime facilities. The Chinese system is not very much geared to meet such new demands, as they may have serious social and political implications such as fostering democracy movements, transparency in governance, etc. Perhaps, it would be the elderly people, who would create increasing internal pressure for political liberalisation.

CORRUPTION

Another significant fallout of liberalisation and high growth has been the alarmingly high level of corruption, which, besides being the cause for headache for the Central Government, has attracted wider global attention. Corruption, a fallout of economic reform and high growth, has generated as much concern as that of containing the risk of a possible hard landing of high growth. Economic transition and corruption have, in fact, moved hand in

hand. This should not lead one to conclude that there is a positive correlation between economic transition and corruption, or that corruption necessarily follows economic transition. In the case of China, corruption was inherent in its social traditions, and almost a historical feature.

Throughout its history, the state-society relationship in China had been based on the subordination of people's interests to those of the state. The establishment of bureaucracy during the period of the early dynasties, had generated a third layer in the feudalistic social order between the ruling elites and the people, and helped develop a deeper nexus between wealth and power. The Confucian thoughts relating to governance and a hierarchy-based social order, and its impact on the mindset of the bureaucracy, promoted a relationship based on an iniquitous social and economic order, which favoured hierarchical privileges, so much so that privileges and the exercise of power were very much an accepted social tradition. It is no exaggeration to say that in China, corruption was never considered a social evil.

Some difference came about during the Mao era, when a completely different social order was established. It was not that Mao Zedong wanted to establish a classless harmonious society but he created a society that was strictly managed and operated by the party authority, whose functioning was autarkic in style and practice. As for corrupt practices, Mao himself believed that fish could not grow in clean ponds, and did not mind letting some limited corrupt practices flourish that were very much in vogue at the local levels of governance. However, by and large, Mao had sought to establish an egalitarian socio-economic order for his version of a socialist China. Towards the end of his regime, the feeling of economic deprivation among the people, however, was at its extreme, so much so that they were desperate for a life of economic comforts at any cost. Economic freedom, which was ushered in through reforms, was instantly acclaimed with high hopes. Notwithstanding initial difficulties within the Party, this freedom was wholeheartedly appreciated by the people. Particularly, the official sanction in favour of economic inequality, not only between the regions but also among people, was not only not opposed but was perceived as a kind of licence for the people to do what they liked to do in their pursuit of well-being. There

was an implicit official sanction to corruption, at least during the initial years of economic transition.

The nature of the initial economic reforms had also favoured corruption. For instance, the sanction to corruption lay in the dual track approach in everything that was done to facilitate the transition to a market economy. The dual track approach with respect to reforms in agriculture, industry, the pricing policy, fiscal and financial reforms, etc. all favoured corruption. The two-track pricing system encouraged shrewd operators (and there were no dearth of such people) to buy key commodities at low planned prices and then sell them at huge profits in the open market. Since the system did not attract much objection, profiteering tendencies flourished freely. On the positive side, this helped in the growth of private capital, which was getting invested in individual entrepreneurial ventures, but corruption was the basis of it. Similarly, during the initial years, agricultural reform encouraged the malpractice of under-reporting of land under cultivation and gave rise to the phenomenon of 'black land'. In fact, every aspect of reform measures, in some way, had opened up opportunities for corrupt practices.

The thinly spread de-centralisation and empowerment of local governments and their low level officials was, and still is, a major source of corruption. It encouraged re-activation of the unholy network of connections (*guanxi*) between the local government officials and the businessmen and/or enterprise managers. Rent-seeking became a rampant practice among the local bureaucrats, who had the advantage of being far from the view of the Central investigating bodies. The discretionary practices indulged in by the local bureaucrats offered numerous scopes for corruption ranging from the certification of business categorisation to the allocation of resources and the costs at which the resources were to be made available. The following extract from an article by Chengze S. Fan and Herschel L. Grossman in *The Provincial Journal* (3 May 2001) is quite apt in this context:

When a junior bureaucrat from Beijing arrived at his new assignment as a middle level local official in Sichuan province, his close subordinates instructed him in the local norms for taking bribes. They told him how often he could become ill and how often he could accept invitations to ribbon cuttings, both being occasions at which he could accept gifts,

without... worrying about being accused of corruption. Also, he learnt that these gifts could amount to as much as USD10,000 a year, which would be much more than his nominal salary.

This story is illustrative of how economic reform has been associated with corruption among local government officials. Apparently, there was a certain degree of permissible, or ignorable, corruption, linked to one's nominal salary, perhaps by way of compensation, so that they, who serve the cause of high growth, could also prosper. But there was more to it.

Truly speaking, economic reform in China has not been about the reduced role of the government. Only the exercise of power was shifted to local governments. There was empowerment of the local bureaucracy, through discretionary powers vested in them. The state continued its role as the driver of economic transition. The actual management of economic transition was conducted in such a manner that connections played important roles not only in the formulation of business decisions but also in matters relating to day-to-day business operations. Having connections or finding a way into the established network of connections is important for doing business in China. This applies equally to local as well as foreign businesses.

In recent years, however, the government in Beijing has been highly active in curbing the menace of corruption among government officials. Several high-level officials have been punished on charges of corruption. However, there are a few things that may be mentioned here. First is the phenomenon of the permissible level of corruption, often allowed as incentives. What is the logic behind this phenomenon? To put it straight, most of the local officials are Party members. If economic reform is opening up opportunities for the people to improve their well-being, there should be opportunities for the Party members as well. There is an underlying political reality here.

Due to the gradual weakening of the Party apparatus since the launch of economic reform, the leadership was faced with the delicate task of maintaining internal stability within the Party. This involves keeping the Party members under watch while, at the same time, giving them some incentives that would ensure their continuing loyalty to the Party. By giving them employment in

the local state-owned enterprises (SOEs) and other governmental outfits, and allowing them to be corrupt to some extent, the Party could keep such members under control. It is a case of mutual accommodation and understanding. But then the question arises as to what this means for the credibility of the Party itself.

Undoubtedly, the Party faces the serious challenge of managing the forces of economic transition, but the state (especially at the local levels) and the bureaucracy have become stronger and are playing powerful roles in the economy. China, it may be mentioned is far from the kind of market economy with a diminished role of the state. The economy of China symbolises a unique case of a state-controlled market economy. If it is a capitalist economy, it is a typically Chinese style of capitalism, where there is a close government-business relationship, based on the accommodation of mutual interests, and it is here that China has an interesting resemblance with its neighbouring East Asian economies. It is China Inc. of a different sort, where reform and economic growth have created new interests, often closely binding the bureaucrats and entrepreneurs by way of *guanxi*. The legitimate channels of communications mostly do not exist. This also explains, for instance, several other ailments such as the phenomenon of illegal enterprises, often operating behind the façade of government agencies or the SOEs.

Other problems of corruption arise due to the incompleteness of several reform measures (the banking sector is one example of this), and inconsistent application in practice. Some of the basic elements of the market economy such as property rights, a market-friendly legal framework, etc., were poorly defined. Bureaucratic and political interventions in key functional areas such as the enforcement of tax policies, banking and finance, etc., have also been breeding grounds of opportunities for favouritism, kickbacks, etc. The scale of corruption in China is variously estimated, but for the government, the cost of corruption by way of revenue loss is estimated at around 15 per cent of the GDP.

EXCESSIVE RESOURCE-INTENSIVE GROWTH

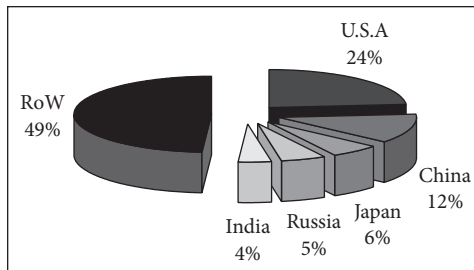
One of the worst features of China's sustained high growth relates to the growth pattern, which is extensive in the consumption of

natural resources, and, as a consequence, among other things, the high GDP growth has been responsible for faster environmental degradation. According to the State Environmental Protection Administration (SEPA) of China, as much as 18 per cent of China's GDP growth is attained through an overdraw of resources and environment. The China Green National Accounting Study, 2004 estimated the environmental pollution cost at USD 64 billion for that year, roughly 3.1 per cent of the GDP, in which water pollution, air pollution and solid wastes accounted for 56, 43 and 1 per cent, respectively. In other words, growth has caused a massive invasion on nature. The invasive nature of growth on environment, as has been pointed out earlier, is largely on account of the rapid pace of industrialisation and urbanisation in China.

Some examples of the intensity of material consumption in China may be relevant here. In 2005, China produced 484 million tonnes of grain and consumed 465 kg of chemical fertilisers per hectare, which is the second highest in the world after Japan. On the industrial front, it produced 339 million tonnes of steel during nine months in 2006, an increase of nearly 24 per cent over the corresponding months of 2005, and yet imported 14 million tonnes in order to meet the domestic consumption demand. Besides its own increased production, the country imported iron ore of about 300 million tonnes in 2005, pushing up the international price by 71.5 per cent. About 250 million tonnes of imports took place during nine months in 2006, pushing up the world prices by a further 19 per cent. The demand for iron ore was so high that investment in domestic mines went up by 114 per cent in 2005 and by 56 per cent during the first eight months of 2006.

While the growth of the steel industry itself provides a good example of the resource-intensive nature of the country's GDP growth, we may also look at the developments in the energy sector in view of its close relationship with one vital natural resource, namely, coal, the consumption of which has serious implications for the environment. Both the production and consumption of energy outputs have a direct bearing on the environment. Over the years, China has been making massive investments in electricity generation. In 2006, the total installed capacity at 600 GW was up from 353 GW in 2002. In other words, an average of 49.4 GW a year was added during the five years leading to 2006. Electricity

Figure 6.1
Worldwide Distribution of Electricity Generation: 2005



Source: China Economic Quarterly, 2006 Quarter Four, *Dragonomics*.

consumption, on the other hand, increased from 1,647 billion kwh in 2002 to 2,415 billion kwh in 2005 and to about 2,730 billion kwh in 2006. As of now, China is the second largest in electricity generation after USA, and may be the largest producer by 2010, if the current rate of growth in electricity generation is maintained.

Where China is different from the developed world is that over 90 per cent of its total electricity generation comes from coal, which is also the largest source of primary energy in the country⁸. In 2006, nearly 2 billion tonnes of coal were burnt. As Tom Miller, Deputy Editor of CEQ, put it in his short article ('With a Huff and a Puff in CEQ, 2006):

The country may no longer be the sick man of Asia, but it is the filthiest. It burns more coal than any other nation. Last year it consumed more than 1.5 billion tonnes of coal, a figure that will almost double by 2020 if current rates of consumption growth are maintained. But much before this, China would be the largest polluter in terms of emission of CO₂ gases and may endanger the climate in a big way.

NOTES

1. The current rate of growth in urbanisation is 0.9 per cent a year.
2. The share of farm income in rural household income in 2005 was already as low as 14 per cent.
3. The forceful acquisition of agricultural land is often done at the behest of the local and municipal governments, and is facilitated by the fact that the farmers have no ownership right over the land.

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4. Under the system, people acquire the utility about one's place of birth, that is, village or urban. Only people registered at birth in urban areas get the status of a permanent *hukou*.
5. The position-based divide of the society is as old as China's history and is so much a part of the country's accepted culture that even communism under Mao could not erase it.
6. This means that while the government invested in the creation of new housing stocks, old stocks were hived off to the occupants at subsidised rates.
7. These houses were built mostly during the regime under Mao Zedong.
8. The sources of primary energy consumption in China are: coal 76.4 per cent, oil 12.6 per cent, natural gas 3.3 per cent and the rest 7.7 per cent. This is in stark contrast with the world average of 25.1 per cent, 34.3 per cent, 20.9 per cent and 19.7 per cent, respectively.

Seven

Thought Adjustments for Harmony

Making of a New China

Continued high growth has brought China, its people, the government and the economy, to a critical turning point. The single-minded pursuit of growth has changed the economy dramatically, and firmly placed it on the fast lane to a prosperous economy. Economic reform has lifted millions out of poverty, improved the living standards of many Chinese, and made China a significant power in the global economy.

On the other hand, the fall-outs of high growth have also been significant. As has been pointed out earlier, in terms of income distribution, China displays extreme inequality, wherein the rich are becoming richer and the poor are struggling hard to rise. Further, as has been observed, high growth is taking a heavy toll on the environment and ecology, eroding the quality of life and exposing people to unprecedented health risks, besides threatening the sustainability of growth. The sub-optimal quality of growth has been provoking wider discontentment, which is reflected in the growing number of protests, especially in the countryside.

It was because of high growth and the visible sparks of prosperity in some provinces of the country that all these years the government could brush aside criticisms about the multiple problems afflicting the society and the people. It was reasoned that as high growth would begin to trickle down to the lower levels, its benefits would far outweigh the problems, and the country would move towards an egalitarian order. Since the problems have increased manifold, and the distortions have been too glaring to ignore, this reasoning can no longer be sold. All this called for massive governmental intervention and the need for a re-think on the growth pattern.

It became clear that high growth by itself was not enough, and that the economy now needed a three-pronged focus: Growth, Equity and Sustainability. Growth still needs to be pursued, as at the current level of the per capita GDP, China remains a low-middle income developing economy. However, in the interest of sustainability of the current growth momentum, as also in the interest of ecological and environmental sustainability, the primary drivers of growth have to be innovation and efficiency, rather than mere investments and resources. All this necessitates changes in the growth pattern. Similarly, in view of growing internal pressure, the equity aspect of growth has to be at the forefront of future development. There is need for strategic shifts in policies in favour of balanced development. In a way, China has to start once again, which would mean building on the achievements so far, and preparing for yet another New China—more homogeneous and harmonious in its development.

THE ELEVENTH PLAN

China's Eleventh Five Year Plan (2006–10) recognises the need for changes in the development strategy, and is meant to prepare the economy for a 'historic starting point', at a time when it is faced with many severe internal as well as external challenges. Apart from the internal challenges that have been discussed in the earlier chapters, the external challenges come from China's rapid integration with the global economy, especially with the global market for goods and services as well as capital. According to China's National Development and Reforms Commission (NDRC), '*based on scientific approach to development*' (emphasis added), 'we should focus on independent innovation, improve institutions and mechanisms, promote social harmony, and enhance China's overall national strength, international competitiveness and risk handling capacity in an all-round way', with a view to '*building a moderately prosperous society in all respects*' (emphasis added).

This, in a nutshell, is the objective of the Eleventh Plan (see Table 7.1). The Plan is not about sectoral resource allocation, nor about growth targets. It only *anticipates* the likely GDP growth and other related parameters. At the same time, there are some obligatory

targets that highlight the government's concern for sustainability of development. Concern about the risk of over-heating of the economy, which the government is keen to avoid, is reflected

Table 7.1:
Major Indicators of Economic and Social Development in the Eleventh Five Year Plan Period

Category	Indicators	Annual			Attribute
		Year 2005	Year 2010	Growth rate (%)	
Economic Growth	GDP (Trillion Yuan)	18.2	26.1	7.5	Anticipated
	Per Capita GDP (Yuan)	13985	19270	6.6	Anticipated
Economic Structure	Ratio of Added Value of Service Industry (%)	40.3	43.3	(3)	Anticipated
	Employment Ratio of Service Industry (%)	31.3	35.3	(4)	Anticipated
	Ratio of Expenditure on R&D to GDP (%)	1.3	2	(0.7)	Anticipated
	Urbanisation Rate (%)	43	47	(4)	Anticipated
Population Resources and Environ- ment	Total Population (10,000 People)	1,30,756	1,36,000	< 8%	Obligatory
	Reduction of Energy Consumption Per Unit GDP (%)			(20)	Obligatory
	Reduction of Water Consumption Per Unit Industrial Added Value (%)			(30)	Obligatory
	Efficient Utilisation Coefficient of Agricultural Irrigation Water	0.45	0.05	(0.05)	Anticipated
	Comprehensive Utilisation Rate of Industrial Solid Wastes (%)	55.8	60	(4.2)	Anticipated
	Total Cultivated Land (100 m. ha.)	1.22	1.2	-0.3	Obligatory
	Reduction of Total Major Pollutants Emission Volume (%)			(10)	Obligatory
	Forest Coverage (%)	18.2	20	(1.8)	Obligatory

(Table 7.1 Contd.)

(Table 7.1 Contd.)

Category	Indicators	Year	Year	Annual	Attribute
		2005	2010	Growth rate (%)	
Public Services and Quality of Life	Average Schooling Years of Citizens (Year)	8.5	9	(0.5)	Anticipated
	Population Covered by Basic Persons in Urban Areas (billion people)	1.74	2.23	5.1	Obligatory
	Coverage of the New Rural Corporates Healthcare System (%)	23.5	> 80	> (56.5)	Obligatory
	Newly Increased Urban Employment in Five Years (10,000 people)			(4,500)	Anticipated
	Rural Labour Force Transferred in Five Years (10,000 people)			(4,500)	Anticipated
	Registered Urban Unemployment Rate (%)	4.2	5		Anticipated
	Per Capita Disposable Income of Urban Households (Yuan)	10,493	13,390	5	Anticipated
	Per Capita Net Income of Rural Households (Yuan)	3,255	4,150	5	Anticipated

Source: National Development and Reforms Commission, Government of the People's Republic of China.

Note: Figures of GDP and urban resident income are of the 2005 price; those in () are accumulative figures in five years. Major pollutants refer to sulphur dioxide and COD.

in the modest anticipation of GDP growth for the Plan period. Incidentally, it is by the end of this Plan period that the country is expected to complete its transition to a socialist market economy. The period of the Eleventh Plan is very significant in this context.

The focus of the Plan has been on a scientific approach for achieving balanced and sustainable economic and social development; the word 'scientific' signifies an integrated approach for building inter-linkages and strengthening inter-dependence, not only between rural and urban areas but also between the cities

and provinces. China's domestic economy, it may not be incorrect to say so, is essentially a bunch of several disjointed provincial economies with limited inter-linkages. The local governments pursue their own, though similar development paths, independent of each other. It is only recently that the Central Government has understood the significance of an integrated economy, which the Eleventh Plan would seek to achieve, within the limits of basic principles and guidelines for scientific development, which have been enunciated by the NDRC.

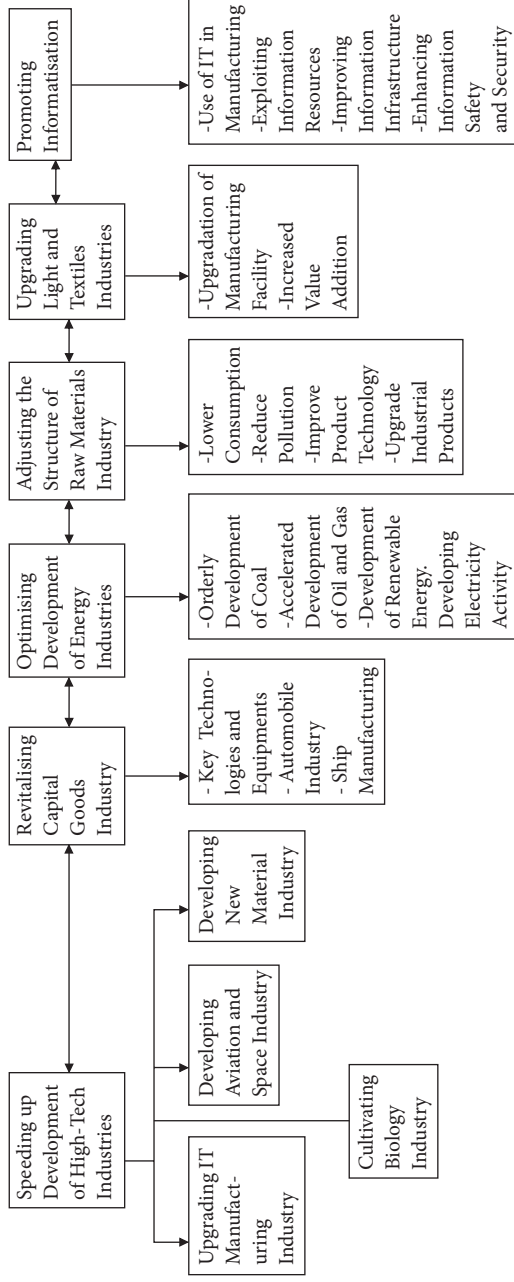
SCIENTIFIC DEVELOPMENT: PRINCIPLES AND GUIDELINES

As has been mentioned, over the five-year period of 2006–10, China seeks to establish a paradigm of a balanced and sustainable economic and social development, which would presumably deliver a harmonious society. This is to be achieved through fairly rapid economic development, transformation of the growth pattern, increased capability for domestic innovation, deepening of economic reform and persistent opening up of the economy. Two things are worth noting in this context. First, there is an implicit understanding at the official level that the present imbalances and inequalities are less due to flaws in the reform executed so far, and more due to incompleteness of the reform process and lack of depth in the transition. The deepening of reform is, therefore, expected to play a key role in achieving balanced growth and harmony.

Persistent opening up of the economy, it is believed, is not incompatible with the objective of balanced development. The second fact to be noted is the focus on transformation of the growth pattern. This will amount to considerable restructuring in every sector of industry. This is already underway in certain sectors, such as steel, coal, electricity, petrochemicals, etc., which are primarily resource-intensive in character.

Optimisation of the industrial structure has been one of the integral aspects of the new development strategy, and is considered as an *'adjustment of thoughts'* on promoting development. Optimisation of the industrial structure is prompted by the imperatives of

Figure 7.1
An Outline of Strategy for Industrial Restructuring (2006–10)



Source: National Development and Reforms Commission, Government of the People's Republic of China.

competitiveness building as well as environmental control. Apart from the closure of small and inefficient plants, and the consolidation of the larger ones, which is likely to result in the efficient use of resources, the strategy would be to depend more on imported raw materials whenever necessary, though on the consideration of quality and price. With respect to coal, for instance, China adjusted its export and import policies beginning the year 2007, whereby the export rebate was reduced to discourage export, and policy restrictions on imports were removed to facilitate the import of low-cost-better-quality coal from Australia, Indonesia and Vietnam. Several small coal mines, with a combined output of around 40 per cent of the total output, have been closed since the beginning of 2001. This has resulted in a steep increase in the prices of domestic coal, compelling some of the major coal-consuming industries such as iron and steel, fertiliser and power generation to import better quality coal at competitive costs, and enabling the country to conserve its coal. This is a unique example of adjustment of thoughts on the promotion of industrial development in a sustainable manner. This indeed is a significant adjustment in that it will herald a very different approach to the industrialisation pattern, whereby resource-intensive industries are likely to be more intensive, as opposed to extensive, in the use of resources and in achieving efficiency gains.

For the purpose of improvements in industrial/manufacturing efficiency, domestic innovation has been identified as a key component of strategy. Research and development (R&D) (see Table 7.1), would gain in its share of the GDP. As noted earlier, so far the emphasis had been on the absorption of (outright) purchase of technology. China imported cheaper technologies and learnt the same, often through outright copying, even amidst rising allegations of the violation of patent and copyrights protection. While the strategy of technology absorption has helped China in the spread of manufacturing activities, besides achieving scale of production and diversification, it has hindered technological advancement which sustained double-digit industrial growth was expected to bring about. What China could acquire as a result of its earlier approach was general purpose technologies. Lack of mechanisms for provision of adequate protection to intellectual properties such as patents, copyrights, etc., came in the way of

acquiring core technologies. In view of growing international intolerance (especially due to constant US pressure), of inadequate protection of intellectual properties and difficulties in accessing core technologies, the government now recognises the unsustainability of the technology acquisition and development strategy.

It is also realised that the overall technology status of the economy is far from compatible with the speed of growth of the economy and its rapid globalisation. For instance, while Chinese products have spread across the length and breadth of the global markets, high-tech products account for only about 30 per cent of the total exports, and the bulk of this 30 per cent comes from the foreign-owned enterprises operating from the country. The size of the high-tech enterprises is small, and their contribution to the GDP is only about 5 per cent, as compared to 40–60 per cent in the OECD countries. For the last several years, there has been growing emphasis on the imperative of higher spending on R&D. The government has been doing what it is best at, namely spending large sums on R&D. In 2006, it spent USD 136 billion, making China the second largest R&D spender. But the question that arises is regarding the quality of the expenditure.

The bulk of the spending is on development work, that is, on product alteration and diversification rather than on basic scientific research. This is what makes the Western world jittery about the working of the IPR regime in the country and about its effectiveness. The nervousness of the West is all the more in view of the encouragement provided by the government to the domestic private enterprises for a larger focus on the development of high-tech industries, without a matching commitment to the greater protection of the IPR. In 2003, China's private domestic scientific and high-tech industries spent about USD 181 million of the operating funds on scientific and technological activities. At the end of 2003, there were 1,20,000 such companies (Pillsbury, 2005). However, the encouragement to private domestic enterprises to undertake R&D activities in a big way is only a part of China's R&D strategy. What is important to note here is that the leadership in China has a new perception of the role of science and technology in re-shaping the growth pattern for the future, and in that innovation-oriented R&D activities have been assigned special significance in view of, among others, maximisation of the

resource use efficiency, upgradation of industrial technology and improving of the general competitiveness of the economy.

Much of the planned re-shaping of the overall growth pattern of the economy would mean optimisation and upgradation of the industrial structure, through an emphasis on the development of certain high-tech industries such as integrated circuit and software, advanced computation, new materials, biopharmaceutics, civil aircraft, satellite application, etc., besides revitalisation of the capital goods industry. The broad strategy outlines for upgradation of the industrial structure are shown in Figure 7.1. As can be seen in the Figure, the primary focus of the proposed industrial restructuring is efficiency and competitiveness through optimisation in every sphere of the industrial sector, but primarily with a view to ensure sustainability of growth as well as of the environment.

Another area of thought adjustment, for changing the existing growth pattern, is about the role of the domestic market, that is, domestic demand, which was practically neglected all these years, as investments and exports were leading the growth. As has been mentioned earlier, the high export growth (primarily growth in the export of manufactured goods) has been crucial to the high GDP growth. There was steady growth in the export/GDP ratio, relative to private household consumption (see Figure 7.1). As a contributor to the GDP, the latter was relegated to a position of secondary significance. Again, as can be seen from Figure 7.1, the household consumption/GDP ratio declined substantially during the decade of 1995, while the export/GDP ratio is about to catch up with the consumption ratio.

While persistently high growth in exports has accelerated the pace of globalisation of the economy, it is now recognised that excessive dependence on exports for economic growth has its own risks. A slowdown in the world economy, for instance, is likely to affect the growth of the domestic economy. But given its population size, that is, the large size of its domestic market, China can very well withstand any shock in the global market without impairing its growth prospects. This requires *'adjustment of thoughts'* with respect to the role of domestic demand. One of the objectives of the Eleventh Plan, accordingly, has been to promote development by encouraging growth in domestic demand. Since the domestic investment demand is already very strong, and has been a major

driver of growth, the emphasis has to be on the expansion of domestic household consumption demand.

For several reasons, this is a difficult task to perform, especially since the people spend just about 40 per cent of their disposable income on consumption. As mentioned earlier, the people have to be motivated to spend more on present consumption, and they will do so only if they are guaranteed adequate social and economic security. The inequalities such as rural–urban and inter-regional inequalities have to be curbed. Investment imbalances have to be rectified, the problem of unemployment has to be lessened, and social sector investments have to be stepped up. Accordingly, all these issues now receive the attention of the government and constitute a basic objective of the Eleventh Plan.

As regards the issue of rural–urban income and development disparities first, it is observed that the basic malaise, that is, discriminatory treatment to agriculture, has been correctly identified. The development of modern agriculture is, accordingly, the core strategy for bridging the widening rural–urban strategy. The NDRC is quite clear: the development of modern agriculture will not be at the cost of urbanisation, which in any case, would be pushed forward actively and soundly. The idea is to build a socialist countryside by promoting strategic agricultural restructuring and improving the overall agricultural production capacity, increasing farmers' income, changing the landscape of the countryside, etc.

As can be seen, the strategy for building a socialist countryside is a comprehensive strategy for the development of agriculture and rural areas, with the basic features being modernisation, capacity building, creation of employment opportunities and a kind of welfare system that the reform process had eroded. Agriculture and the rural economy are likely to see a massive transformation through increased investments, and more importantly, the deepening of reform. Some of the priority programmes in this connection include:

1. Rural drinking water safety,
2. Rural roads,
3. Village electrification programme and the Green Energy Country Programme,

4. Rural health service system,
5. Rural family planning service system,
6. Rural labour transfer and employment,
7. Large-scale production bases of grain, cotton and edible oil,
8. Land enrichment programme, and
9. Animal epidemic prevention system, among others.

With a view to address the problem of regional disparities in development and to ensure balanced development among the regions, strategies have been developed to reflect the concerns on the level of differences in development, on one hand, and the imperative of sustainable development, on the other. As the NDRC put it, 'Based on the bearing capacity of resources and environment, development foundation and potential, and full play of regional comparative advantages...form a pattern of balanced structure of regional development...' . The strategy as required for the purpose has been identified as below:

1. Advancing the western region development,
2. Revitalising north-east China and older industrial bases,
3. Promoting the rise of the central region,
4. Encouraging the eastern region to take a lead in development, and
5. Supporting the development of old revolutionary bases, ethnic minority areas and border areas.

For the purpose of environmental sustainability, the following development priority zones have been categorised:

1. Development-optimised zone: Regions with high density of land development and declining resource and environment bearing endowment.
2. Development-prioritised zone: Regions with relatively strong resource and environment bearing endowment, as well as favourable gathering conditions of the economy and population.
3. Development-restricted zone: Regions weak with regard to (ii) above.

4. Development-prohibited zone: Natural reserves of all kinds established in accordance with the law.

The initiatives go beyond the development of priority zones, and aim at developing a circular economy, with a focus on conservation, through the efficient utilisation of resources of all types, that is, land, water, materials and energy, besides the re-use/recycling of resources. The idea is to shift the present growth pattern, based on the high intensity of resource consumption, to a pattern that would be based on the principle of 3 Rs: reducing, re-using and recycling, and for the economy itself to function on a low-input, high-output basis. In other words, it amounts to complementing the current high rate of growth with full efficiency and competitiveness, that is, cementing high growth with sustainability.

Finally, a few words need to be said about the government's primary concern of building a harmonious society, where society and the economy are apparently not functioning in tandem with each other. As the country is already described by many as a vast chamber of commerce, the establishment of harmony in the society and the economy is the key to China's socialist credentials. The approach to building a harmonious society is not just about addressing the concerns of income/consumption inequality and regional disparities, but has to be seen in the context of a larger backdrop, wherein, besides the imperatives of stability and order, the issues of direct interest to the people have to be addressed, in accordance with the rules of socialist democracy and the rule of law, justice and equality. Needless to say, growing discontentment among the people about the existing economic and social order have greatly influenced the leadership, and prompted it to take steps for an equitable socio-economic order. The approach to building a harmonious society has been based on a five-pronged work programme, as explained below:

1. *Population Work*: It is proposed to keep the population growth low, meaning that there would be no deviation from the one-child norm, but the focus will be on the quality of the newly born population, so as to improve the quality of the human capital. Since better quality of human

capital means more productivity and efficiency, improving the quality of human capital is the answer to the concerns about the emerging demographic trend that points to a larger ageing population, an issue that has been we have discussed earlier. The thrust on improving the quality of human capital would be reinforced by measures to protect the rights of women and children.

2. *Improving the Living Standards:* For this purpose, the government would focus on increasing employment, enhancing regulation of income distribution, expanding and improving social security, reinforcing poverty reduction, and expanding the consumption among both the rural and urban population. As we understand, the thrust on improving living standards would be implemented through a labour-friendly employment and wage policy, on one hand, and the expansion of an affordable social security system, on the other. Increasing employment and ensuring greater accessibility of social security are also supposed to facilitate growth in consumption.
3. *Improving Public Health:* This issue is considered important, as China is confronted with huge health risks because of rising pollution and environmental problems, besides multiple occupational hazards. The government wants to improve the existing medical care system through a variety of measures, but primarily by way of reform of the healthcare system, so as to address the problem of limited healthcare resources and expensive medical care, and increase accessibility of the people to healthcare provisions.
4. *Strengthened Public Security:* This is viewed as an imperative for building a harmonious socialist society. As the NDRC puts it, ‘...to fulfil tasks of reform and development, it is imperative to maintain social environment with long-term stability.... Efforts will be made to improve capacity of public security, protect life and property safety of the people and ensure social stability.’ The priority programmes in this regard include social relief and welfare, community services, flood control and disaster management, safe production and emergency rescue, and local political and legal infrastructure.

5. *Improving the System of Social Administration:* While the tasks of social administration have so far been carried out by various Chinese Party Congress (CPC) Committees, it is now proposed to encourage the development of autonomous grassroots organisations and the orderly development of non-governmental organisations (NGOs). Besides, in a significant step towards the promotion of a socialist democracy, the government wants to build a clean and honest government and encourage an all-round socialist legal system, besides promoting the cultural and spiritual lives of the people.

This last aspect of building a harmonious society is very significant in that it is an indication of the shape of things to come in a country, where society and economy are apparently not in tandem. Economic transition was undertaken with the single-minded pursuit of faster economic growth whereas economic liberalisation took place without much concern for social and political liberalisation. To use Russian terminology, there was *glasnost* but no *perestroika*. There were several political re-organisations within the Chinese Communist Party (CCP), but those were only to push the cause for economic transition and liberalisation. Bureaucratic reforms were also pursued primarily for the same cause. There is, however, a deep connection between economic growth and socio-political transition, especially when economic growth has its foundations in openness of the economy and its integration with the global economy. Trade liberalisation, foreign investments, communications, etc. tend to expose people to new lifestyles, new technologies and liberal ideas. More importantly, with improvements in economic conditions, people begin to aspire for the freedom to participate in the developments around them. They want to influence the decisions relating to their destinies. Economic liberalisation, in this sense, provides, or creates, a counterweight to governmental power.

In the case of China, as we have observed, throughout the country's history, the people were always subordinate to the government. The extent of subordination was, however, at its worst during the Mao era of communism. Economic reform had given the people freedom of choices concerning their economic lives, but

with little relaxation in terms of carrying on their socio-political lives. On the economic front, the access to freedom of choices was not open to all. Accordingly, growing income disparities between the rich and the poor, and between villages and towns, were creating tensions at the bottom of the society. The educated middle class, on the other hand, wanted the kind of social and political freedoms that only Western-style democracy could offer. Pro-democracy movements had, therefore, started gaining momentum. But there was another development that had resulted from liberalisation and commercial competition. This was the growing external pressure for political liberalisation, especially for the protection of human rights. The need for access to the markets of the Western world, foreign capital, negotiations for establishing a normal trading relationship on a permanent basis, etc., had made China highly vulnerable to external pressures on how the country should run its affairs. It was because of all these factors that the leadership itself was waking up to the changing realities of a progressive economy. Within the CCP, there has been a dramatic shift in the perception of realities and in favour of, though somewhat guarded, liberalism in politics. The thrust on development at the grassroot level has to be understood in this context.

At this point of time, apart from its roaring economic success on all fronts, China is poised at a historic point. Building on the achievements of the past three decades, it is now gearing up for a homogeneous and balanced market economy. The Chinese have their own understanding of what a market economy is, and they are confidently moving in that direction. It is only for the outsiders to debate how far China is from the goal of a full-fledged market economy. The term 'socialist' is also peculiarly Chinese. This should be obvious, if we consider China's approach to the most pressing problems of inequality. Inequality, we learn from China, cannot be curbed by extorting money from the 'haves' and distributing wealth to the 'have nots'. On the contrary, besides empowerment, the solution to the growing menace lies in providing opportunities to the latter. Similarly, if some provinces are lagging behind in development, there is need to invest more in these provinces, and for this there is no need to restrict the growth process in the regions that are prospering. This indeed symbolises a refreshing adjustment in the thought process of the

government, while seeking solutions to the country's economic problems.

Currently, China is undergoing massive social engineering, and the economy is roaring with its various successes. If the experience of the Tenth Plan suggests anything, it can be argued that most of the intended developments may be achieved ahead of time, and China's international standing would be substantially enhanced, as a result. By the end of 2010, when China is supposed to complete its transition to a socialist market economy, its economy may be the trendsetter for the global economy, side by side with that of the USA's. Back in 1978, when economic reform had been launched, China was seeking rapid integration with the global economy. By the end of the Tenth Plan (2000–05), China was very well integrated with the global economy, with a strong inter-dependence with rest of the world, simply because of its galloping trade, foreign direct investment (FDI) inflows and a huge pile of foreign exchange reserves. But if China continues to expand its economy by way of accelerated growth, it is likely to keep the rest of the world engaged in its developments.

Reality is on China's side. Its growth machines are infallible and are not showing any signs of cooling off. At the start of the Eleventh Plan, the government had anticipated the real GDP to grow at the rate of 7.5 per cent. This anticipation was borne more out of a wish that the economy should begin to cool down, rather than any conscious planning. The possibility of any immediate declaration of growth is remote. During the course of the Eleventh Plan, we are likely to witness a more orderly and balanced economy, with visible signs of harmonious prosperity and broad-based development. The growth pattern too may witness significant structural changes, but perhaps without any moderation of growth. On the contrary, the economy may gain an additional growth momentum.

The overall economy, it appears, may continue to retain, if not add to, its current growth rate. An important point to note here is that the economy, or rather its growth rate, is beyond the control of the government in Beijing. To be specific, the Central government in China can do little to contain the growth rate. While it may wish the economy to cool down, it cannot do much, without the co-operation of the local governments and the booming private sector, which seem to have taken full control of the economy. For

instance, the pace of investment is determined largely by the local governments. Similarly, the local governments and the private enterprises decide on the direction of investments. Extreme de-centralisation, based on a clear division of labour between the Centre and the provinces, has considerably eroded the role of the Central Government in economic management. This vital aspect of the impact of de-centralisation on economic management has been ignored in the perspective for the Eleventh Plan. In several respects, there are also significant disconnects between the thinking of the Central government and those of the provincial governments. The latter continue to remain focused on rapid growth, and are not too keen on the imperative of *thought adjustments*.

Given this situation, China may continue to remain engaged in managing the issues that accompany a high growth economy. If the economy continues to grow at its current rate, or at a still higher rate, then the strategies for *balanced, sustainable economic and social development*, as outlined for the Eleventh Plan period may fall short of the requirements. The strategic parameters, as outlined in Table 7.1, are all based on an anticipated annual GDP growth of 7.5 per cent and may even go awry. Take the case of resource efficiency, that is, the imperative of greater efficiency in the consumption of resources per unit of economic output. The consumption of raw materials per unit of output, no doubt, depends on technical-cum-technological inputs, but the extent and/or absolute level of consumption is ultimately determined by the growth level. Even with the most efficient technological coefficients, higher output growth implies the higher consumption of raw materials and inputs. A situation of continued high growth may, thus, nullify the initiatives for the conservation of resources, considered so essential for environmental sustainability. There is, however, a larger issue that we shall discuss in some detail in the next chapter. This is about the implications of continued high growth for China's external economic relations and the world economy.

Eight

Trade, Globalisation and External Relations

The priorities of the Eleventh Plan mostly concern China's domestic economic disorder that needed urgent re-adjustments for parities in development. While the guidelines and principles cover all the aspects of concern for the imperative of harmonious development, there is one serious lacuna in the plan. The leadership has addressed the issues confronting its domestic economy in isolation from its international context. The economy has reached a stage in development and achieved a level of globalisation, wherein any planning for future development would have to take into account the possible ramifications of its policies for rest of the world. Much of China's economy is primarily about its external economy and globalisation.

Apart from rapid globalisation following sustained high growth in exports and massive capital inflows, China has, perhaps, developed the strongest inter-dependence with the global economy, so much so that it is now set to re-define international economic and geo-political relations, that is, the world economic order, so to say. This chapter is devoted to an understanding of the ramifications of China's high-growth economy for the world economy, especially for the traditional economic superpowers and the countries in the Asian region. We begin with a brief recapitulation of what has already been said in the preceding chapters.

Almost right from the beginning of economic transition, China had decided to open up its economy, mainly with a view to make itself acceptable to the world outside, and especially to the Western world. The Chinese Communist Party (CCP) leadership had two primary objectives at that time, namely, (i) it was desperately seeking foreign capital and wanted foreign investors to come and stay invested for China's development, and (ii) it wanted institutional supports, by way of technical and financial assistance.

Equally important was the imperative of ending years of economic isolation and building international economic relationships to facilitate its integration with the global economy.

At least initially, there was no conscious party decision in favour of export-led growth strategy. In this respect, China, it can be said, did not take any leaf from the experiences of its East Asian neighbours, nor did it seek any guidance from outside. The importance of exports was recognised primarily for the purpose of financing imports, which were considered essential for faster growth and modernisation of the economy. The focus of the leadership under Deng Xiaoping was on attraction of foreign capital and ending isolation.

The establishment of two special economic zones (SEZs) and four open cities in 1979 were initial experimental steps towards testing the attractiveness of China to the potential foreign investors. However, the thrust on building a friendly relationship with the West was equally significant. Seeking membership of the World Bank/International Monetary Fund (IMF) on one hand, and that of the World Trade Organization (WTO) on the other hand, were very significant steps in economic diplomacy during the initial years of reform in China. In addition, China was encouraging its young people to study abroad, especially in the USA. This was intended to serve a dual purpose, namely, (i) to learn the working and experiences of market economies, and (ii) to spread the message of China's commitment to change and opening up.

These were some of the elements of China's immediate post-Mao strategy for integration with the world economy. During the period 1979–81, international economic environment was very grim, in view of several crises confronting the economies of the developed world. All the advanced industrial economies were in deep recession, and needed costly structural adjustments. Besides causing severe global financial turmoil, the Latin American debt crisis had added further to the woes of the advanced economies. Given this situation, the Western world's response to the opening up of the economy in China was lukewarm and cautious. But for the prompt response from the ethnic Chinese from Hong Kong and Taiwan, the SEZs and the open cities would have taken a long time to take off. It was they who had responded to China's initial

opening up and utilised low-cost manpower for the purpose of their own ambitious forays into the global markets.

This, however, was the beginning of China's emergence as the hub for outsourcing and exports, besides the globalisation of its economy. But China had to wait till the mid-1990s before external trade and capital inflows could gather high momentum. Throughout the 1980s, China's open door policy, as also its export policy, were executed with caution, and the approach to globalisation itself was experimental in nature. The strategy was concretised during the period 1992–94, after Deng Xiaoping's famous 'tour of the south'¹. The second half of the 1990s witnessed the real liberalisation of trade and exchange rate policies. During the early 1990s, several steps were, however, taken to promote confidence in the minds of the foreign investors.

It was only by 1995 that the stage was ready for rapid globalisation of the domestic economy, and the external economy was ready to lead the overall growth. It is since then that the Chinese economy has been globalising at an accelerated pace. In 2006, China's two-way trade at USD 1,752.1 billion (estimated) was about two-thirds of her Gross Domestic Product (GDP). This is too high a ratio for an economy like that of China, which has a vast and growing domestic market. The comparable ratios for the USA and Japan are around 19 per cent. During the decade 1995–2005, while the GDP increased at the compound annual rate of 9.8 per cent, exports grew at the rate of 17.7 per cent, implying that for an increase of every one percentage point in the GDP, exports were increasing by about 1.8 per cent. During this period, China's share of world merchandise exports increased from 2.8 per cent to 7.3 per cent, while its share in Asia's merchandise exports increased from 10.3 per cent to almost 25 per cent. By 2003, China was Asia's largest exporting country, and in 2005, it was the world's third single largest, after the USA and Germany.

What is significant to mention here is the acceleration in the rate of export growth ever since China's entry into the WTO in 2001 (see Table 8.1). The average annual export growth during the period 2002–06 was 29 per cent, as against 12.4 per cent during the period 1997–2001². The membership of WTO has apparently given China significant mileage with respect to access to global markets.

Table 8.1
Annual Export Growth of China: 1996–2006

<i>Years (Pre-WTO)</i>	<i>Growth (%)</i>	<i>Years (Post-WTO)</i>	<i>Growth (%)</i>
1997	21.0	2002	22.3
1998*	0.5	2003	34.6
1999*	6.1	2004	35.4
2000	27.8	2005	28.4
2001	6.8	2006	26.0

Source: International Trade Statistics, 2006, WTO, Geneva.

*Note:** These two were years of the global economic crisis, following the Asian financial crisis and also due to the dot com bubble in the USA.

A few points about China's foray into the global market for goods may be mentioned here. One, contrary to popular perception, China is no longer a mere exporter of low-value labour-intensive goods. In 2005, while manufactured goods accounted for about 92 per cent of China's total merchandise exports, the export of office and telecom equipments accounted for about one-third of the total manufactured exports, and about 30 per cent of the total merchandise exports. Besides, fast-moving items of consumption such as personal and household goods and a large variety of other items, which undergo fast changes in terms of fashion, design, etc., were also emerging as major items of exports. Two, the currently fastest moving items of China's exports are mostly technology-intensive items. The single largest item of export from China is telecom equipment, not clothing, nor textiles. Further, it is the technology-intensive items that are primary contributors to China's bulging trade surplus (see Table 8.2). As can be seen, the country's export basket is indeed large and highly diversified.

Three, as can be seen from Table 8.2, China's product-wise trade balance has an interesting mix of positives and negatives. In 2005, while trade in agricultural products, raw materials and semi-finished products had a combined deficit of about USD 164 billion, the trade in final finished products had a surplus of about USD 221 billion. Further, certain semi-processed items also generated a sizeable surplus of about USD 42 billion. Textiles and clothing accounted for the bulk of the surplus of trade in manufactures (47.3 per cent), while O&T equipments accounted for 32 per cent.

Table 8.2
Product Group-wise Trade Balances: 2005

(Unit: USD billion)

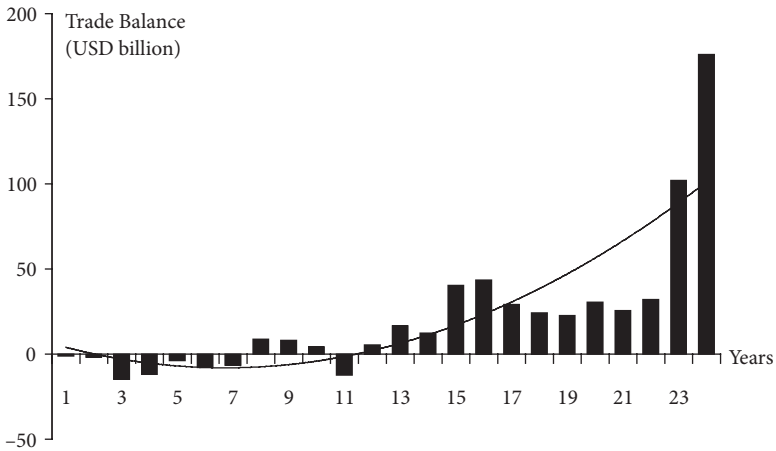
<i>Product Groups</i>	<i>Exports</i>	<i>Imports</i>	<i>Trade Balance</i>
Agri-products	28.7	45.2	(-) 16.5
<i>of which</i>			
Raw materials	4.1	23.7	(-) 19.6
Ores and minerals	2.7	38.6	(-) 35.9
Fuels	17.6	63.9	(-) 56.3
Non-ferrous metals	10.9	17.1	(-) 6.2
Manufactures	700.3	493.1	(+) 207.2
<i>of which</i>			
Iron and steel	19.3	26.3	(-) 7.0
Chemicals	35.8	77.7	(-) 41.9
Other intermediates	57.8	22.2	(+) 35.6
M&T Equipments	352.2	290.5	(+) 61.7
<i>of which</i>			
O&T Equipments	225.9	160.5	(+) 65.4
Textiles	41.1	15.5	(+) 25.6
Clothings	74.2	1.6	(+) 72.6
Other Manufactures	120.0	59.2	(+) 60.8
Total	761.9	659.9	(+) 102.0

Source: International Trade Statistics, 2006, WTO, Geneva.

Note: M&T = Machinery and Transport, O&T = Office and Telecom Equipments.

It may not have been consciously designed that way, but apparently the strategy was quite manifest, that was, import raw materials and semi-finished products and export finished goods, that is, import low-value and export value-added products. Such a strategy was implicitly a strategy for surplus in trade. China's trade balance has been consistently in surplus since 1994 (see Figure 8.1), with an average annual of about USD 26 billion during the decade beginning 1994. Beginning with 2005, the country's trade surplus has been growing at a galloping pace. It increased from USD 32 billion in 2004 to USD 102 billion in 2005, was almost USD 169 billion in 2006, and exceed USD 262 billion in 2007.

Figure 8.1
China's Trade Balance (1978–2006)



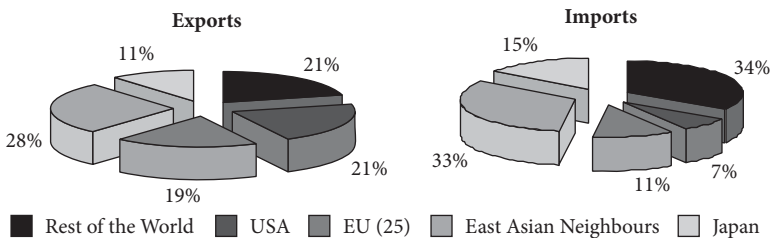
Source: Prepared from Direction of Trade Statistics 2007, IMF, Washington.

How did this happen? The answer is simple: a favourable world economic environment provided significant boost to China's exports, which more than doubled between the years 2003 and 2006. At the same time, import growth did not show a matching spurt. In fact, in recent years, China has been a bit calculative about imports, in view of the rising commodity prices in the world market. The average gap between export and import growth during the years 2005 and 2006 was as high as 8.5 per cent. Even the increase in oil prices did not have any significant effect on import growth, the reason being that the domestic production of oil increased substantially in the aftermath of the increase in oil prices. Both in 2005 and 2006, the nominal (overall) import growth was under considerable control. It declined from 39.9 per cent in 2003, to 36 per cent in 2004, and to 17.6 per cent in 2005 and 20 per cent in 2006. The decline in the nominal (overall) import growth is explained by the strategic management of imports, as was necessitated by the developments in oil price and appreciation of the domestic currency.

Another interesting aspect of China's external trade is the direction of trade, which is heavily biased against its rival Western countries, namely USA and the European Union (EU). Let us look at the

scenario for 2005, when China had a surplus trade of USD 102 billion. What is interesting is the distribution of the overall surplus trade vis-à-vis China's major trading partners. Before we explain this, a few words about the regional distribution of the export-import trade may be useful. In 2005, USA accounted for over 21 per cent of China's total exports, followed by the EU (over 19 per cent) and Japan, with a little over 11 per cent. China's East Asian neighbours, other than Japan, accounted for about 28 per cent. On the import side, the USA's share was less than 7.5 cent, the EU's a little over 11 per cent, Japan's about 15.2 per cent and the share of China's East Asian neighbours was about 32.5 per cent (see Figure 8.2).

Figure 8.2
Direction of China's Trade: 2005



Source: Director of Trade Statistics, IMF, 2005.

If we now consider China's trade surplus, which is by now huge and growing rapidly, it should be obvious that China had been getting its entire trade surplus from its trade with USA and the EU, while it had deficit trade vis-à-vis Japan and its East Asian neighbours. To be more specific, in 2005, vis-à-vis USA, China's trade surplus was about USD 114.5 billion, that is, for every dollar of US exports to China, the latter exported almost USD 5 worth of goods to USA. Similarly, during the same year, China's trade surplus vis-à-vis that of the EU, was USD 70.2 billion. In other words, in 2005, China earned a surplus of USD 184.7 billion vis-à-vis its trade with USA and the EU. It is obvious that China has heavily exploited the Western country markets (see Table 8.3).

A matter of particular interest in this context is China's trade with USA, which is widely perceived as the most unequal trading relationship. During the decade beginning 1995, USA's exports

Table 8.3
Distribution of China's Trade Surplus: 2005

	<i>USD billion</i>		
	<i>Exports</i>	<i>Imports</i>	<i>Trade Balance</i>
USA	163.2	48.7	114.5
EU	193.8	73.6	70.2
Japan	84.0	100.4	-16.4
East Asian Neighbours	211.2	214.3	-3.1
Rest of the World	159.8	223.8	-63.2

Source: International Trade Statistics, 2006, WTO, Geneva.

(of goods) to the world increased from USD 584.7 billion to USD 904.4 billion (symbolising an average annual growth rate of 4.4 per cent), but during the same period, its trade deficit grew from about USD 186 billion to almost USD 828 billion, symbolising a growth rate of over 16 per cent a year, that is, almost the same rate of growth as that of China's exports during this period. USA enjoyed surplus in its trade in commercial services, but that was far from adequate, when related to its deficit of trade in goods. USA's combined (goods and services) trade deficit in 2005 was USD 753 billion (or 6 per cent of the GDP) up from USD 69 billion in 1995. The extent of the trade deficit of a country is an indicator of not only the extent of market access that the country provides to products from other countries, but also of the country's competitive weakness when the deficit is too large.

During the period, China emerged as the third single largest exporting nation (after Germany and the USA), and replaced Japan as Asia's largest exporter, but importantly, USA's share in China's global exports increased from 16.6 per cent to 21.4 per cent (with China's exports to USA growing annually at the rate of about 21 per cent). In 2005, USA's merchandise imports from China were worth about USD 260 billion, that is, 15 per cent of the total imports, but over 20 per cent of the import of manufactured goods. What is important to note here is the growing dependence of USA's domestic market on China as a source of supply, which is distinctly obvious from Table 8.4. In 2005, China supplied over one-fifth of USA's requirements of manufactured goods and import from China was growing annually at the rate of 19 per cent.

Table 8.4
Merchandise Imports of USA, EU and Japan from China

	<i>Total Imports in 2005</i>			<i>Shares in Total Imports (%)</i>					
	<i>USA</i>	<i>EU</i>	<i>Japan</i>	<i>USA</i>		<i>EU</i>		<i>Japan</i>	
				2000	2005	2000	2005	2000	2005
All Products	259.8	195.8	108.4	8.6	15.0	2.7	4.7	14.5	21.1
Manufacturers	250.1	187.6	93.0	10.7	20.2	3.3	6.2	20.9	33.2
O&T	80.2	61.2	24.9	10.5	34.4	4.2	13.8	10.5	37.1
Equipment									
EDP	43.2	31.6	14.3	12.1	43.1	5.0	16.2	11.0	51.5
Equipment									
Tele	35.5	26.7	8.9	14.4	33.1	5.5	14.8	20.8	49.2
Equipment									
Clothing	21.1	23.0	18.2	13.3	26.4	10.3	17.9	74.7	80.9
Other	79.8	44.8	18.6	31.4	41.5	8.7	12.0	26.1	37.5
Manufacturers									

Source: International Trade Statistics, 2006, WTO, Geneva.

Note: In rows (3), (4) and (5), O&T implies Office and Telecom, EDP = Electronic Data Processing.

Interestingly, the dependence of other countries on China is growing rapidly, particularly for technology-intensive products like office and telecom equipments, integrated circuits, Electronic Data Processing (EDP) equipments, etc. At the same time, the penetration of the US market by Chinese goods has been equally significant for a variety of low value items like textiles, clothing, personal and household goods, etc. Apparently, the US has been unable to retain competitiveness in advanced technology products (ATPs) vis-à-vis China. Beginning with 1995, China has had surplus trade in ATP, and the size of its surplus trade exceeded USD 50 billion in 2005, when China accounted for USA's entire deficit trade in ATP products.

As Compared to the US, the EU has been less vulnerable to China's export might, perhaps on account of the insulating effect of the single market³. However, the penetration of the EU market has been substantial, and exports from China grew at the rate of 24 per cent during the period 2000–05. Also, as has been the case with USA, China has been steadily expanding its shares of the EU

market for ATP products as well. As far as Japan is concerned, China had deficit trade, but in 2005, its share in Japan's total import bill was over 21 per cent (with about a 34 per cent share in the import of manufactures). Also, China had the highest penetration of the Japanese market for ATP products. With respect to clothing, in 2005, over 80 per cent of Japan's imports were from China.

The rise of China in the world market has been like re-defining global trading relationships in many ways. The pattern of China's trade has not been very different from what its East Asian neighbours were pursuing during the 1970s and 1980s, namely, that of an aggressive export drive in the markets of the advanced economies of the West. China is, seemingly, in the process of the total capture of Western country markets. Where China has acted differently from its East Asian neighbours is in its broad-based engagements with the rest of the world market as well, enabling many developing countries to increase their exports to China. Further, China has been at the vanguard of the Asianisation of global trade, and has been contributing significantly to the growing intra-Asian trade. For instance, during the period 2000–05, the share of Asia in China's total imports increased from 63.6 per cent to 73.8 per cent, which helped in increasing Asia's share of the world trade from about 27 per cent to over 31 per cent, and intra-Asia trade from 45.4 per cent to 47.2 per cent. A look at the pattern of China's trade suggests that China tends to buy regionally and sell globally. While China imports most from Asia, it is Asia where almost half of China's exports are headed. However, China's exports to the developing country markets of Latin America and Africa, and the markets of the Middle East and Latin America countries are also steadily gaining in shares.

From the point of view of the world economy, a matter of much greater import is not China's high GDP growth, but the high growth in exports, which has, of late, been growing at over 25 per cent a year, more than two and a half times the growth in world exports and China's own GDP growth. With subdued growth in imports, though high in terms of the standard of the world average, the continuation of high export growth will only ensure the steady accumulation of trade surplus and foreign exchange reserves. The latter is another feature of China's globalisation process. Being fuelled by the surplus in trade as well as by the large capital

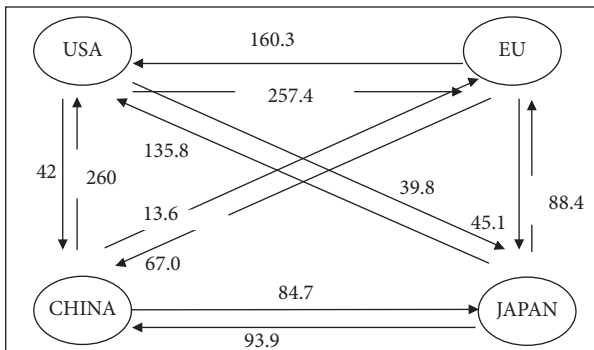
inflow by way of FDI, China's foreign exchange reserves have been growing at the same rate as that of its export growth. China has surpassed Japan as the single largest country in terms of the size of reserves. Needless to mention, with a large trade surplus, strong currency and growing reserves, China is a global economic power, and, in due course, slated to become the largest economy. More significantly, with the growing might of its external economy, China has already tilted the traditional balance of power.

In this context, let us look at the quadrilateral trade relations involving USA, EU, Japan and China, who together accounted for 60 per cent of the global trade in 2005. Figure 8.3 shows the extent of bilateral trade flows among the four partners in 2005. As can be seen, USA, the second single largest exporting nation, has the worst deficit scenario, and both USA and the EU are highly vulnerable to the export might of China and Japan. There is, however, a different way of looking at USA's position. USA has been providing the maximum market access to the other three countries, and particularly to China. The latter has the highest trade surplus vis-à-vis the former.

Undoubtedly, the competitive prowess of China is tilting the existing balance in global trade in favour of itself and Asia. A soaring trade surplus, largest foreign exchange reserves, strong currency, large inflow of foreign investments, etc., on one hand, and unstoppable high growth, large domestic investments, large

Figure 8.3
Quadrilateral Trade Flows in Manufactures: 2005

(Figures are in USD billion)



Source: Prepared from International Trade Statistics, 2006, WTO.

domestic savings, etc, on the other hand, make China the strongest economy of the world. It really does not matter if China's GDP is one-seventh of the USA's. The reality is that China is penetrating the global market with all its competitive strengths. The concern, however, is about the impact of China on the global economy. A question that comes to mind is whether China's high growth will result in global economic disorder. Alternatively, will China help in establishing an equitable world economic order?

A major concern in this context is about the US-China trade relationship, which may be called the most unequal trade relation in the world. Some aspects of this relationship have already been explained, and it has been observed how much USA is losing on account of its trade deficits. All the 50 States of USA and every item of merchandise from USA suffer from growing deficits vis-à-vis trade with China. The US-China trade relations have turned particularly adverse for USA ever since China's entry into WTO. It was USA who believed that China's entry into the WTO would open up huge opportunities for the access of US goods and services into China. This has not happened. USA's exports to China have undoubtedly increased since 2001 (the year of China's entry into WTO), but not the way it had expected. As has been already mentioned, in 2005, USA's exports to China, at about USD 42 billion, constituted only 4.6 per cent of its global exports, whereas imports from China constituted 15 per cent of the total imports. China's entry into the WTO has turned out to be a nightmare for the US economy.

It has been impacting the US economy adversely, and causing intense trade frictions between the two countries. Faced with a situation of galloping deficits, USA had been relentless in its efforts to persuade China for a one-time substantial appreciation of the yuan, tighter implementation of the IPR regime (primarily with respect to copyrights protection) and more market access for US-made goods. There is a growing concern in the US industry and government about the shifting of jobs to China and the closure of plants in USA, resulting in the increasing clamour for protection of the domestic industry against competition from cheaper Chinese goods. The phenomenon of loss of manufacturing jobs has been very well studied by trade analysts in USA. Among others, Robert E. Scott of the Economic Policy Institute (USA) has succinctly

presented the impact of China's trade on jobs and industries in USA. Some extracts from this Report are reproduced below:

The rise in the United States' trade deficit with China between 1989 and 2003 caused the displacement of production that supported 1.5 million US jobs. Some of those jobs were related to production or services that ceased or moved elsewhere; others are jobs in supplying industries. These jobs reflect the effect on labour demand—in lost job opportunities—in an economy with a worsening balance between exports and imports. Most of these lost opportunities were in the high-wage and job-haemorrhaging manufacturing sector. The number of job opportunities lost each year grew rapidly during the 1990s, and accelerated after China entered the World Trade Organisation (WTO) in 2001. The loss of these potential jobs is just the most visible tip of China's impact on the US economy.... Where the largest impact was once felt in labour-intensive, lower-tech manufacturing industries such as apparel and shoes, the fastest growth in job displacement is now occurring in highly skilled and advanced technology areas once considered relatively immune, such as electronics, computers, and communications equipment....

China's entry into the WTO was supposed to provide openings for sufficiently rapid growth in US exports to reduce the trade deficit with China. While the export growth rate has increased since 2001 (from a very small base), the value of those exports has been swamped by a rapidly rising tide of imports....

US exports increased from USD 5.8 billion in 1989 to USD 26.1 billion in 2003, a four-fold increase. Imports rose from USD 11.9 billion to USD 151.7 billion in the same period, a twelve-fold increase on top of a base that was already twice as large as exports. As a result, the US-China trade deficit increased [by] USD 119.5 billion, a twenty-fold increase.

USA's next big concern is regarding the growing menace of piracy and counterfeiting, which it feels is unacceptably high and calls for action to prevent further losses to the US companies and workers. For instance, according to the Motion Pictures Association, the percentage of the potential market for US movies lost to piracy in China in 2005 was as much as 90 per cent. While the piracy of US movies is rampant everywhere, it is highest in China, followed by Russia and Thailand with 79 per cent each. Of course, Beijing readily admits the problem to be a serious one and is keen to check the problem as a matter of strategic policy⁴. The government has stepped up the enforcement of laws against piracy, and

preventive actions have been increasing, but perhaps not enough is happening on the ground to generate much confidence.

According to a study conducted by the International Data Corp. (Wall Street Journal, Asia, 16 May 2007), an estimated 82 per cent of the software used in China in 2006 was pirated, as against the global average of 35 per cent. The enforcement of law was mildly effective in a way that in 2003 the piracy rate was 92 per cent. The extent of revenue loss suffered due to software piracy can be understood from the fact that due to this reduction in the piracy rate between 2003 and 2006, the losses that could be avoided were worth USD 864 million.

The other aspect of USA's uneasiness vis-à-vis China is the exchange rate of the yuan, which is undervalued. For USA, this is a prime market access issue. Substantial one-time appreciation, they argue, would facilitate the larger sale of US-made goods in the Chinese market. For China, however, this is an issue of much greater import for its domestic economy, especially in the context of the unemployment problem. It simply cannot oblige the US, appreciates the latter's concern. China would like to approach the issue of appreciation of currency in accordance with the situation, and would not like to be pushed too much. The currency has been, of course, appreciating, but at its own pace.

Objectively speaking, China is currently focused on the real issue of foreign exchange reserves, the size as well as growth of which is a matter of concern. Given the absence of currency convertibility and the plethora of controls on the use of foreign exchange, the inflow-outflow of foreign exchange reserves is highly imbalanced. Even the import regime is managed and regulated, and far from free. The problem with the currency value lies in the restricted exchange control regime. Official tinkering with currency value is not likely to help. What is required is greater external liberalisation and more opening up, especially in the financial sector.

The unusual distortions in US-China trade relations has to be seen in the right context, and not to be seen as an exceptional case. In our view, it has a lot to do with the working of globalisation. In an integrated global economy, countries with better competitive advantages tend to gain the most. Globalisation works best in the competitive economies. In the case of China, opening up had started at a time when global investors, that is, the multinational

corporations (MNCs) were desperately scouting for low-cost, hassle-free and favourable investment opportunities. China had the unique advantage of having a large stock of low-cost labour, of both the skilled as well as unskilled varieties. This, coupled with Beijing's commitment to faster economic development, helped project China as the most competitive investment destination, not to speak of the additional lure of a potentially huge domestic market. As already mentioned, beginning with the mid-1990s, investors from the US and West Europe started crowding in for investing in China, with many even shifting their home country operations lock, stock and barrel to locations in China.

It was a case of a competitive race for a berth in China's fast-growing economy. Subsequently, the MNCs from the US and major EU countries began using China as an export hub, wherein they could exploit the advantage of low-cost manufacturing and compete in the global markets, including especially their own home country markets. The genesis of China's growing trade surplus vis-à-vis the US and the EU lies in this development. In a way, this has created a unique clash of interests between the MNCs and their home country governments, making it difficult for the latter to get effectively engaged in any trade dialogues for remedial measures. The scale is heavily tilted on the side of China.

It is virtually impossible for the US and the EU to pressurise China to agree to what they want. Thanks largely to the presence of the MNCs and their engagements there, China has acquired considerable immunity against the consequences of trade frictions. More importantly, the authorities in China have gained control over the negotiating issues. For instance, on the vexing issue of appreciation of the yuan, the Chinese authorities are now urging the US 'to show courage and vision to stick with a longer-term approach to resolving the bilateral trade disputes, rather than fixating on the currency' (Wall Street Journal, Asia, 16 May 2007), and are asking the US to lift the ban on certain high-technology exports to China and grant the latter the status of a market economy. This last issue, that is, the absence of market economy status, is an irritation for China, which has been negotiating for it with its major trading partners and yet not getting it in spite of its clout in the global market. The world's third largest economy is not acknowledged as a market economy. The Chinese cannot digest this.

In the context of China's external economic relations, there have been several other developments of far-reaching implications for the world economy, and especially for the developing economies. One such development, arising out of the imperative of feeding its high growth, is the relentless search for raw materials and energy sources. This is what is defining and/or re-shaping China's relations with the non-OECD (middle/low-income) developing economies, which see their exports to China rising and are apparently happy with their closer economic and political relationship with the former.

Given its high growth and rising level of prosperity, China has a strong feeling of insecurity with respect to the supplies of energy resources, particularly oil and gas. Take the case of oil. Prior to 1993, China was a net oil exporter, but has been a net importer since then, due to the rapid increase in demand. Domestic consumption has been currently increasing at the rate of 5,00,000 barrels per day (bpd). In 2005, China's domestic production of crude was 181 million tonnes and the imports were worth 127 million tonnes. If the GDP continues to grow at more than 10 per cent a year, as it is growing currently, import-dependence is likely to go up substantially. In 2006, oil consumption was estimated to be 7.4 million bpd, and is projected to go up to 14.2 million bpd by 2025 (Douglas, Nelson and Schwartz, 2006). Further, about 70 per cent of this consumption is likely to be met through imports. Obviously, China would be keen to secure the sources of supply.

One of the important components of the strategy for oil security pursued by China has been diversification of the sources of supply, by way of forging strategic arrangements with the countries of the Middle East and Africa, or for that matter, any country that produces oil. The state-owned Chinese companies are going all out to make strategic investments in the major oil-producing countries in the Asia–Africa region and beyond. The initiative had started in a small way in 1993, when for the first time, operating rights were purchased for the Banya block in Thailand and investment was made for having offshore production assets in Indonesia. The first acquisition of significant oil production assets (with a 60.3 per cent stake) in Kazakhstan had taken place in 1997. The China National Petroleum Corporation (CNPC) now owns a 92 per cent stake in the existing production assets in Kazakhstan, with a production

of about 1,16,000 bpd, yielding equity oil of about 1,07,000 bpd (Eurasia Group, 2006). Similarly, during the same year, CNPC had acquired a 40 per cent stake in the Greater Nile Petroleum Operating Company (GNPOC). The momentum for acquisition of production assets abroad received a significant boost in 1998, when China re-organised its oil and gas industry to create three major oil companies: CNPC (Petrochina), China Petrochemical Corp (Sinopec) and the China National Offshore Oil Company (CNOOC).

These are monolithic companies, with clearly defined roles for themselves, and spearheading the drive for enhanced energy security. All of them have invested significantly in the Middle East, Africa and beyond. The key countries with which China has strategic relations for the purpose of energy security are listed below.

Middle East	:	Iran, Iraq, Oman, Yemen and Syria
North Africa	:	Algeria and Libya
Russia and Eurasia	:	Russia, Kazakhstan and Turkmenistan
South-east Asia/Australia	:	Indonesia and Thailand
The Americas	:	Venezuela, Ecuador, Peru, Colombia, Bolivia and Canada
Sub-Saharan Africa	:	Sudan, Angola, Nigeria, Congo Republic, Gabon and Madagascar

This is very much in tune with the country's declared policy, 'consolidate the Middle East, develop the surrounding regions, expand in Africa, and explore the Americas' (Douglas, Nelson and Schwartz, 2006). For several reasons, however, China's quest for energy security is a matter of concern for the rest of the world. First, there is a concern for geo-political stability. Several of the countries with which China has arrangements, have considerable geo-political sensitivities. Particularly, this has serious implications for US-China relations. It poses a serious challenge for both USA and China, as both need to co-operate to maintain a harmonious geo-political order in the energy belts of the world. Will the two have a growing clash of foreign policy interests, or will this lead to greater bilateral co-operation? Second, many of the countries mentioned in

the list above tend to view China as an economic powerhouse that can end US dominance. They are very eager to forge a relationship with China that would suit their geo-political interests in their respective regions. Faced with the prospect of energy insecurity, China, on her part, has been using her foreign policy tools in various ways, but there is need for greater pragmatism. For China, there is a great opportunity to project its role as a responsible economic powerhouse. For instance, China can use its foreign exchange reserves for increasing Chinese investments in energy-rich developing economies and help in their development process. China has already been doing this, especially in Africa, where there are some 900 Chinese investment projects. China-Africa trade has also been growing steadily and reached a record USD 39.7 billion in 2005, signifying a nearly four-fold increase from the 2001 level. However, China is expected to play a much more active role. As the country's investments in the energy-rich developing economies of Africa and elsewhere increase, it is in China's interest to ensure security of investments. The third question is about the energy security interests of other energy-scarce developing economies. For such economies, the concern is regarding their ability to access supply sources at reasonable costs, and without jeopardising their balance of payments positions. Most of these economies cannot sustain their growth in a situation of high oil prices, nor can they easily opt for alternative sources of supply.

As far as non-energy resources, that is, industrial raw materials are concerned, large-scale imports by China have mixed implications for developing countries. The growing demand for basic raw materials such as coal, iron ore, bauxite, copper ore, etc., has already been lifting global commodity prices out of prolonged depression, and in the process, increasing the export prospects for several commodity exporting countries, where economic growth depends, to a large extent, on the unit price realisation. Further, the growing requirement of raw materials is also making China invest in many of these countries, thereby opening up further growth opportunities. In this sense, China's high growth has been having considerable growth-inducing effects on many developing economies, through trade and investments.

On the other side of the picture, an increase in the international prices of primary commodities (including oil) may put many

developing economies into difficulties, in view of the rising cost of imports and the consequent increased cost of production. For China, an increase in the international prices of commodities is likely to hurt its interests as well. Beyond a limit, increased prices are likely to hurt competitiveness. However, being a large buyer, China has certain leverages that other developing countries do not enjoy. China has already earned a very significant clout in the global commodity markets. The prices are linked to how much China buys. Objectively speaking, on account of sustained high growth, while the linkage between China and the developing economies has increased significantly, the latter are mostly at the receiving end. It is China that influences the price that the latter can receive for their exportables, but the latter find it difficult to access the Chinese market for their finished products.

China's extended economic relationship with the developing economies is not so much a matter of strategic decision. It has evolved out of the necessity to procure raw materials and energy resources, and is structurally lopsided in terms of the composition of the trade basket. From the developing countries, China imports raw materials (a unique case is that of the China-India trade wherein iron ores account for bulk of India's exports). But it usually exports low-priced finished goods to the developing countries. The developing country exporters cannot compete with the low-cost domestic producers of China, whose cost structure and competitive practices lack transparency, and are difficult to comprehend. This is a usual complaint of exporters from the developing countries. So far, China has not expressed its views clearly on the issue, nor has it made any significant policy statement.

For China, there are three broad categories of trade partners. First, there are the Western countries, namely, the US and the EU. Partnering with the US and the EU is important for the purpose of market access and for garnering a trade surplus. The second category is concerned with partnering with the neighbouring countries in East and South-east Asia, for the purpose of materials, market and technology. Besides, China banks heavily on the ethnic Chinese spread across East Asia, for trade as well as investments. In view of the ASEAN-China Free Trade Agreement (FTA) and mutual appreciation of the imperative of closer intra-regional integration, China would like to have greater regional engagements.

Needless to say, it is with its East Asian neighbours that China has the maximum engagements. With the rest of the world, China's interest is largely for the purpose of establishing a presence in the market and for the procurement of raw materials.

In recent years, there has been a noticeable shift in favour of a phenomenon of import substitution, which is happening due to a number of factors, and should be a cause for concern for several developing countries. According to a recent Deutsche Bank (DB) report (Global Market Research, 7 June 2007), 'Although import substitution—Chinese products substituting imports in the domestic market—is not officially labelled as a government-led strategy, the actual pace of import substitution has accelerated significantly in recent years. The dependence of China's export production on imported components fell from 44 per cent in 2004 to the current 31 per cent.' Essentially, it is about China's domestic producers offering competition to exporters from abroad. China's domestic market is likely to get fortified by its own domestic enterprises.

This development, it must be mentioned, is, perhaps, not an indication of the emergence of a protectionist tendency. On the contrary, it speaks of the rapid growth of competitive domestic enterprises, which, by virtue of their growing competitiveness, are now able to compete with foreign suppliers. Further, this apparent import substitution is taking place mostly in the industries using middle-end technologies, usually prevalent in the components segments. If imports are getting substituted in export production, it speaks of the technological progress that is taking place in the Chinese industry. According to the DB report, 'This progress has been made possible by: (i) the rapid development in China's access to technologies, (ii) productivity growth which magnifies its comparative advantages of low-cost labour, and (iii) government support, including tax incentives, grants for R&D and favourable procurement policy.' In other words, the phenomenon of substitution of imports by local producers speaks of the growing competitiveness of China's domestic industry.

For many developing countries, however, this should be a matter of concern. The increasing competitiveness of China's domestic producers has two implications. One, developing country exporters would find it difficult to compete in China's domestic market. Two, they would find it difficult to compete against China in

international markets, and may even be edged out. For them, China presents certain inherent comparative advantages that they cannot have. Between 2000 and 2005, while world exports increased by USD 3,979 billion, China had accounted for 13 per cent of the incremental exports. The distribution of the rest was as follows: USA—3.1 per cent, the EU (25)—39.3 per cent, Africa—3.8 per cent, Japan—2.9 per cent and Asia (without China and Japan)—14.7 per cent, respectively.

Going back to the question that was raised at the beginning of this chapter regarding the impact of China's growth on the world economy, the following points may be highlighted:

1. China's sustained export-led growth has helped expand world merchandise trade, besides contributing significantly to increasing the share of developing countries in global trade and restoring some order in the unequal pattern of world trade.
2. More particularly, China's high growth, and the rapid globalisation of its economy have restored dynamism in the Asian, especially the East Asian, economies. It has re-kindled the prospect of the Asian century, or may be the Chinese century. Especially, the emergence of China's economy has revived the growth prospect of East Asia as a monolithic economic block. There is talk of an East Asian FTA, in which China is likely to play a leading role. Whenever it is formed, the proposed FTA is likely to be the most powerful of all economic-cum-trading blocks. It is a different matter that ASEAN may lose complete relevance as a result.
3. The relationship between China and Japan, however, becomes a critical issue in this context. Will China and Japan act in co-operation with each other for ensuring greater Asian economic prosperity? This is a question on which both China and Japan will have to decide. A lot depends on how the two will bury the past and how Japan would respond to China's *numero uno* status in Asia. If they fail to co-operate with each other, Asia runs the risk of polarisation. The question in that case would be about the prospect of Asian integrity.

4. On the other end, China's unstoppable expanding trade surplus vis-à-vis USA and the EU runs the risk of an East-West economic conflict on one hand, and a widening North-South conflict, on the other. It is unlikely that the West would be a mute observer of the emergence of an Asian century or a Chinese century, for that matter. Of particular concern, in this context, is the evolving US-China trade and economic relations, which, incidentally, is intimately linked to geo-political equations between the two.
5. In the same context, China's strategy for energy security is also a matter of concern in view of its implications for US-China bilateral strategic relationships. It is a severe test for China's policy of peaceful development as the credo of a foreign policy.
6. At the moment, the major tensions in the existing world economic order can be traced to a variety of economic and geo-political issues, involving two major trade relations in the world, namely, the US-China and the US-Japan relations.
7. In the quadrangular formation of the world economy, the EU is almost a stand-alone case, having its own concerns on China's East. However, here again, EU-Russia and Russia-China relations have their own implications for the world economy. Much is centred around energy security, in which Russia and China play a significant part.
8. For the rest of the world economy, the emergence of China as an economic powerhouse has mixed implications, and what matters is the overall balance of the positives and the negatives. However, there is an issue that needs to be considered here. China's economic might may as well affect the intra-south economic and political relationship in a big way, besides generating geo-political tensions throughout the south.

NOTES

1. In the face of the growing criticism of the liberal economic policy in the aftermath of over-heating of the economy, Deng Xiaoping had toured the southern coastal

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cities to find out the effect of the working of the open door policy. Back in Beijing, he had reported on the success of the policy.

2. The export growth during this period (1997–2001) was low, largely because of the slowdown in the world economy due to the Asian financial crisis and the burst of the dot.com bubble in the US economy.
3. Single market can be said to have taken place when two or more countries agree to eliminate all tariff and non-tariff (mainly technical) barriers to trade between/among them. The EU had agreed in 1992 to establish a single market of all its member countries.
4. Recently, China has put in place an effective anti-piracy drive not only by enforcing appropriate legislative measures but also through strict monitoring and implementation.

Nine

Concluding Observations

China's high growth story has not come to an end. On the contrary, the momentum of growth has apparently received an additional boost in the objectives and visions for the Eleventh Plan. Having registered near 10 per cent growth during the period 1978–2005, the economy is now achieving an accelerated growth of about 10.5 per cent on an average quarterly basis. With more broad-basing of investments across the regions and economic sectors and rising per capita household consumption expenditure, the momentum of growth is likely to be sustained for long, well beyond the Eleventh Plan (2006–2010) period. There can be little doubt that China is destined to be Asia's largest economy very soon. It needs no projection to justify this. Instead, there are some aspects of China's economy that may be highlighted.

First, China's modern economy is a young economy—only 30 years old, and has tremendous untapped potential. So far, growth has come largely from a few provinces. While the better-off provinces, especially the coastal provinces, are likely to sustain their respective growth momentum, the laggard ones are now getting poised to register high growth, taking the lead from their better-off counterparts. All the provinces are following the same growth pattern. What one can expect to see, therefore, is a broad-based high rate of growth, as opposed to the current pattern of inequitable growth. Similarly, while all these years, growth has been driven primarily by the industrial sector, China's services sector, still relatively undeveloped and semi-organised, is likely to emerge as the complementary driver of growth. Liberalisation that is underway, as a fulfilment of the country's WTO commitments, is now likely to spur the growth momentum in this sector.

Second, it is the state that is at the helm of affairs in the Chinese economy. China's is a state-driven, state-managed market economy.

The state, which is the Chinese Communist Party (CCP) for all practical purposes, is determined to push the economy towards a unique model of the socialist market economy, and is totally preoccupied with the task of building a prosperous developed economy. It is difficult to find any other country, where the government is as deeply committed to economic development as in China. Throughout the process of economic transition, the CCP has demonstrated its unique ability to manage various challenges entirely on its own. Its able management of the crisis of overheating of the economy in the late 1980s and early 1990s spoke eloquently of its ability to manage transition. In more recent years, its apt handling of international pressure for appreciation of the yuan in the face of a rising trade surplus vis-à-vis the US and the EU speaks of the maturity and confidence of the CCP leadership. It is not entirely a joke that the CCP works like a large chamber of commerce. Much of the credit for high economic growth and successful globalisation of the economy naturally goes to the party.

This, however, should not make us overlook the role played by the people of China. In the aftermath of the initial agricultural reform in 1978, it was the people, primarily ordinary peasants, who had taken up the cudgels, and begun to walk the tough road to prosperity. They did not wait for the government to help them. As pointed out earlier, the proliferation of Township and Village Enterprises (TVEs) was a demonstration of people's initiatives. In no time, China had seen the emergence of a huge number of small and medium entrepreneurs. What has driven the Chinese people into inherent entrepreneurship is a subject matter of a separate study by itself and cannot be covered in this work. However, it can be said that the average Chinese, because of long periods of suffering and deprivation behind them, are now intolerant of poverty and would not depend on the government to take them out of it. Given the freedom to do so, they would like to do things themselves and work for a better living. This is what makes China different from many developing countries, wherein people depend heavily on the government for their material well-being.

Hard work is apparently an in-built quality of an average Chinese—male and female alike. Driven by self-confidence, they believe that they can make a difference in their lives, if only they are allowed the scope to do so. Apart from individual initiatives,

community spirits, developed during the era of Mao's socialism, had also been very much at work. One thing that the Chinese always respect is the value of education, especially technical education. The Chinese believe that becoming rich depends on techniques. 'Never miss the chance to send your children to school' was a popular saying among the Chinese, especially the Chinese farmers. Technicians are considered financial gods, and, post-reform, farmers had frequently been turning to them for help in new skills and knowledge.

In view of the tenacity of purpose shown by the Chinese people and the inherent quality of the hard work undertaken by them, it can be reasonably argued that inequality of income and disparities in levels of well-being may actually motivate the people to work harder, thus impacting the economy in a positive way. What we see as potential sources of social instability may actually be lubricating the growth machine and sustaining the growth momentum. We can be sure about it, as far as the Chinese people are concerned. Millions of Chinese (estimated at over 100 million), who have left their families and children in the villages to toil for 15–18 hours a day in the unorganised, and often illegal, mines and factories in urban areas, are not really fighting poverty and starvation, but seeking prosperity for themselves and their children. This is one way of looking at the development, which is often projected by many observers as an adverse fallout of China's growth.

The Chinese, as far as I have understood, are habitually paranoid, and their paranoia is about financial insecurity, which they dread the most. This is not difficult to understand, if we recall how the Chinese people have suffered acute penury and deprivation for generations. They always tend to work for a secured future. This is what explains the very high propensity to save seen among Chinese households. This propensity is likely to stay for many more years. The paranoia about possible financial insecurity in the future is observed not only among the resident Chinese, but also among the non-resident ones. It is largely out of this paranoia that the non-resident Chinese (from Taiwan, Macao and Hong Kong) are keen to strengthen their bases in the homelands that they had left. Large-scale investment in China by the non-resident Chinese from East Asia is, to a large extent, on account of this paranoia. The paranoid nature of the Chinese people has

been an important invisible factor behind China's high growth. It has worked in a positive way, by motivating people to work hard for long hours, shun profligacy and save for the future.

To reiterate the point, it is paranoia that is driving the Chinese people to secure their future; it is not known though how much of prosperity makes the future secure. At the same time, they would not live frugally but opt for the best lifestyles, the standards for which are, as of now, being set by the consumers in the Western world. Thus, with rising income, China has emerged as the fastest growing market for consumer goods of all sorts. Needless to say, China would continue to remain a booming market for consumer goods for many years, making China a *high saving, high spending* economy. Let me explain this part a little further.

As has been mentioned, the country is likely to stay on a high growth path. Given this, at a fixed propensity to save, with rising income, both savings and consumption tend to grow. If the Chinese people maintain their propensity to save at its current level (which generates a savings ratio of around 47 per cent), they will continue to save a lot, and yet spend a lot, and the country would graduate into the above-mentioned category. If the government succeeds in building a harmonious socialist economy (as is objective of the Eleventh Plan), then bulk of the population can afford to be less concerned about savings and display an increased propensity to consume, giving further impetus to growth in consumption in the process.

As such, with rising income and high economic growth, the propensity for savings tends to decline and so does the savings ratio. This principle is likely to work in the case of the Chinese economy as well. A question that is relevant to ask in connection with the economy is as to how long it will take for China's current savings ratio to come down to East Asia's current level of the savings ratio (of around 36 per cent). I am not attempting to find an answer to this question, but have raised this issue to make yet another point in connection with the economy. This is about the composition of domestic savings in China (talked about in passing in Chapter 5).

Domestic savings in China are undergoing a very significant shift in composition. While during the initial years of transition, household savings were the main drivers of gross domestic savings and constituted bulk of the latter, in recent years, the enterprises

have emerged as the major component. It is the enterprises, and particularly the domestic private enterprises, that account for bulk of bank deposits. With continued high growth, increasing profitability of the enterprises is getting translated into enterprise savings, implying growing financial soundness, and therefore growing competitiveness, of the industry.

This development is significant in that, as of now, much of the enterprise savings are deployed in greenfield investments, creating additional capacities and raising production volumes in almost every sector. Typically, the enterprises also usually tend to invest within the sectors that they operate in. Cross-sectoral investments by the enterprises are observed mostly in the case of related and inter-dependent sectors. In other words, the enterprises are highly focussed in their investments. High savings are also seen to be used for the purpose of increased R&D activities by the enterprises, all with a view to improve product quality and facilitate product innovation. The phenomenon of increased focused on R&D is observed in practically all segments of industry. The point that needs acknowledgement is that the Chinese firms have been undergoing a transition from mass producers to producers of mass quality goods, as also from producers of low-technology products to those of high-technology products. It is not surprising, therefore, that even in respect to technology-intensive products, China's trade is in surplus and is growing rapidly.

It is not enough to acknowledge China as the world's manufacturing hub. China is steadily acquiring technological prowess in manufacturing. What is least recognised is that, besides its high growth, China has reached a stage in the development of its manufacturing industry, wherein it is constantly renewing itself, as it is growing in terms of the scale of production. Technology levels are improving alongside new capacities. Growing savings are facilitating the process of technology up-scaling by financing the indigenous R&D activities of domestic enterprises. These, and several other factors, are not only lubricating China's high growth, but also helping the economy gain increasing competitive strengths.

A few words about globalisation and the Chinese economy. It was right at the beginning of the reform process that China decided to ride on the back of the global economy, which had all

that the country needed, that is, capital, technology and market. It was an intelligent strategy for the transformation of a disorganised socialist economy into a market economy. It must be said that China has successfully used globalisation to its advantage. Unlike most developing countries, China laid greater emphasis on foreign investments rather than on foreign aid. In place of foreign aid, the focus was on accessing foreign capital, which was solicited by way of investments as well as multilateral assistance (for example, soft World Bank loans). Foreign investments were used to obtain access to both foreign markets and technology.

Today, China is the second largest destination of foreign capital, and has trade surplus, which is not only rising steadily but is larger than the total export turnover of neighbouring India, another fast moving exporting nation. We have explained why its export growth, like its GDP growth, is not likely to slow down in the near future. By 2010, China may be the largest exporter of merchandise, on one hand, and the fastest expanding domestic market, on the other hand. Even as growth in imports is well short of the growth in exports, the domestic market is opening up. Add the large amount of foreign capital during every year and the rate of addition to reserves, and one can get an idea of full dimension of globalisation of the Chinese Economy and believe that the economy with the largest reserve would have considerable clout in the affairs of the global economy. By early 2007, China had surpassed Japan as the largest holder of foreign exchange reserves.

Let us take the size of foreign exchange reserves as an indicator of the influence that an economy can exert on the financially integrated global economy. It will not be difficult to understand the economic might of China with over USD 1.2 trillion in reserves. Further, the quality of reserves (in terms of the factors contributing to reserve growth) is such that it is significantly insulated against normal turbulences in the global financial market. The increasing size of foreign exchange reserve in China may be seen as an emerging phenomenon of the shifting of global capital in Asia, the emergence of Asia as the financial epicentre of the world, and perhaps the emergence of some Asian currencies as reserve currencies of the future.

This last aspect would, however, depend on the exchange rate policies of the major Asian economies, particularly of China and

Japan. This is where one comes across a significant conservative approach in Asia with respect to the currency policy. Even as the economies are undergoing rapid globalisation, Asian countries, including China, tend to manage the exchange rate with a classical understanding of its role. China, with its robust external economy and growing reserves, is destined to overhaul the global economic order in a big way, but what is not clear is how. What role is China likely to play? There are several relevant issues about China's economic policies in the coming years, and especially about its view of the world economy and the country's role in it. As of now, there is little indication of how China would like to mould the global economy to fulfil its vision of a 'strong Chinese economy', as was perceived in 1978. When this vision was perceived, the world was only a few trillion dollar economy and China was nowhere in it. In 2007, it was over a 50 trillion dollar economy, with China accounting for around 3 per cent of it in size and creating tensions in every corner of the global economy. It would be worth watching China and the world economy developing together in the coming years.

The emergence of China as a major economic powerhouse means one thing for the Western economies and another thing for the fast moving developing economies like that of India. For the latter, there are, perhaps, several lessons to learn. The most significant lesson, however, is that, when it comes to economic development, it does not really matter what constraints are there in the way of development. What matters is how determined a nation is about its development. Commitment to economic development is all that one needs. For countries like India and other emerging market economies, China's high growth may pose considerable challenges on many fronts, namely access to global markets, rising prices of commodities, difficulty in access to scarce resources such as energy, etc. For the developing economies, there is perhaps one implication of China's high growth. If they too do not focus on matching growth, they may be feeling the weight of the Chinese economy on their domestic economies.

For the outside world, there is no point in criticising the existing pattern of development in China, particularly income inequality, regional disparities, environmental pollution, etc. Given that the Chinese themselves are worried about the issues confronting them

and the government is committed to establishing a harmonious development, these problems would be addressed. But there is a lesson here too: take growth to a level where it becomes easier to address issues relating to social dimensions of growth. When the level of development is low, one has to perhaps give growth a priority over equality. In China, everyone suffered and everyone shared extreme poverty not only during the communist regime but also for thousands of years before that. Now, there is inequality but hardly any poverty. Tomorrow, there may be very little to comment upon.

We are not talking about the nature of administration. On this point, perhaps, there is much room for progress. Much is said about the state of human rights in China, lack of democracy, menace of corruption, lack of transparency, and so on. On the state of the investment climate and competitiveness ranking, the annual World Competitiveness Reports of the World Economic Forum tell us that China is way behind the city state of Singapore in Asia or Finland in the Nordic. There is no denying that China suffers from many shortcomings. What, however, we fail to notice is that on the part of the Chinese administration, there is always a humble acknowledgement of their shortcomings. To the international community, they always say two things: (i) we are a developing economy, and (ii) we are a learning society. These speak a lot about how they think of their future.

Issues like human rights and the state of democracy, that is, broadly the quality of politics and the social lives of the average Chinese, are not subject matters of this book. A lot has been written and said by several scholars, and the readers themselves have their own opinions. As has been mentioned at the beginning of this book, there is a lot of knowledge about China. On my part, I shall only make a few general observations, which deserve in-depth research.

First, while the world outside, especially the Western world, thinks that there is no democracy in China, this perception is based on their own understanding of what a democracy is. The Chinese, however, believe that there is democracy in China, and everything in China is democratic. One cannot make a nation, especially when it is a vast one, to think differently from what they think of themselves; nor should one do that. It is an undemocratic

thought. The Chinese think that democracy is a nation-specific idea. There is no harm, if we respect that thought.

According to a 2005 White Paper on Political Democracy (*China.org.cn*). *'The socialist political democracy of China ... grew out of experience of the CPC and the Chinese people in their great practice of striving for national independence, liberation of the people and prosperity of the country. It is the apt choice suited to China's conditions and meeting the requirement of social progress'* (emphasis added). In other words, there is a Chinese version of democracy—a socialist democracy, just as there is a Chinese version of market economy. The focus of the China style democracy is also clear: the prosperity of the people and the country, under conditions that are suitable for China. Also, the adjective 'socialist' is paramount, be it the economy or politics. The White Paper was categorical that *'we are against the anarchic call for 'democracy for all' and against anybody placing his own will above that of the collective'*.

In the same manner, China has her own idea about the protection and promotion of human rights, which includes: (i) the people's right to subsistence and development, (ii) civil and political rights, (iii) legal guarantee for human rights, and (iv) economic, social and cultural rights, among other issues. It may be mentioned that since the Tenth National Party Congress (NPC) in 2004, China has adopted a number of measures that are meant to improve the human rights of the Chinese people, who exercise their power through the local level congresses. For instance, in 2004, the NPC Standing Committee examined 33 draft laws relating to legal issues, the election system, etc., and adopted 25 of them, through amendment of the Constitution.

The following information from the State Council of the PRC (April, 2005) gives us an idea of how the government looks at the whole issue of human rights, and the progress achieved by it. The list, it may be added, is not comprehensive, but should help the readers understand China's concern for human rights, which is essentially about the promotion of human capital.

1. At the beginning of 2005, the Central Committee of the Chinese Party Congress (CPC) and the State Council promulgated 'Opinions on Several Policies on Further

Strengthening Agricultural Work and Enhancing the Comprehensive Agricultural Productive Capability', deciding to further intensify efforts in implementing the policies of cancellation of the special agricultural product tax, reduction or exemption of agricultural tax, provision of direct subsidies to grain-growing farmers, for quality seeds for four grain crops, and for those who buy large or medium-sized agricultural vehicles or equipment (abbreviated as 'two reductions and exemptions' and 'three subsidies') so as to further guarantee the rights and interests of the farmers.

2. Throughout the country, 150 million farmers no longer pay agricultural tax, while the rate of agricultural tax for 540 million farmers was reduced by three percentage points, and the agricultural tax rate was reduced by one percentage point for the rest of the farmers.
3. By the end of 2004, the low rent housing system for minimum-income families was established in 35 large and medium-sized cities. By the end of 2003, the per capita living space in cities and towns reached 23.7 sq. m, and 27.2 sq. m. in rural areas.
4. In 2004, the Central Government earmarked 12.2 billion yuan as funds to aid the poor. By adopting effective measures such as improving production and living conditions in the poor areas, and enhancing the comprehensive quality of poor rural farmers, the government has greatly reduced the number of poor farmers who lack adequate food and clothing throughout the country.
5. In 2004, the state promulgated one administrative law, 15 departmental regulations, 5 industrial standards on production safety and more than 70 regulatory documents to tackle the problem of industrial hazards.
6. In 2004, natural disasters caused great damage throughout China. The government helped evacuate and resettle 6.11 million disaster victims, and rebuilt more than 1.4 million houses that had been destroyed in the disasters. During the spring and winter of 2004, when crops were not harvested, some 90 million people received relief aid,

and their fundamental needs for food, clothing, lodging, water and medical treatment were met.

7. In 2004, China had 296,000 healthcare institutions, 3,047,000 hospital and clinic beds, 4,390,000 medical personnel, and 3,586 disease prevention and control centres (including anti-epidemic stations) with 160,000 medical personnel. Moreover, there were 1,279 healthcare supervision and examination institutions with 26,000 medical personnel, and 42,000 township clinics with 669,000 beds and 881,000 medical personnel. A new rural co-operative medical service system has been tried out in 333 cities across the country. It covers about 100 million rural residents so far, including 80.4 million farmers.
8. In 2004, the NPC Standing Committee examined the enforcement of six laws, including the 'Land Management Law', 'Law on Compulsory Education' and 'Trade Union Law'. It examined and deliberated 11 work reports of the State Council, the Supreme People's Court and the Supreme People's Procuratorate about the establishment and improvement of an emergency mechanism concerning public health contingencies and the building of courts and procuratorates at the grassroots level. Throughout the year, the NPC Standing Committee received more than 40,000 people seeking help from higher authorities for their problems, handled more than 60,000 petitions, and urged relevant departments and local governments to solve some of the problems that had caused great discontent among the masses, thus guaranteeing the citizens' right to appeal to higher authorities, file a charge and report an offence as provided for in the Constitution.
9. In 2004, the National Committee of the Chinese People's Political Consultative Conference (CPPCC) performed its functions of participating in the discussion and administration of state affairs, exercised its democratic rights and carried out democratic supervision through its regular work of making proposals, and inspections and investigations into specific issues, and reflecting public opinion.

10. In the previous year, the CPPCC National Committee received 4,478 bills submitted by its members and participating organisations. Of these, 4,263 were accepted for further deliberation. These bills covered topics such as the building of democracy and the legal system, increasing the farmers' incomes, safeguarding the legitimate rights and interests of migrant workers, establishment of a multi-layer social security system in the countryside, employment and re-employment, and welfare.
11. A democratic decision-making system mainly in the form of villagers' congresses and representative conferences, and a democratic supervision system based on making village affairs public and democratic evaluation were also established, thus considerably raising the level of villagers' self-government within the framework of the law.
12. By the end of September 2004, China had 1.02 million grassroots trade union organisations, 115,000 more than in the previous year, signifying an increase of 12.6 per cent. Non-public enterprises had 459,000 trade unions.
13. The number of trade union members nationwide was 137 million, 13.544 million more than in the previous year, signifying a growth of 11 per cent.
14. In 2004, the State Council promulgated China's first comprehensive administrative regulation on religious matters.
15. The above regulation clearly defines the rights of religious groups and adherents with regard to religious activities, establishment of religious colleges and schools, publishing of religious books and periodicals, management of religious properties and foreign religious exchanges.
16. From January to October 2004, the Chinese public security organs investigated and cracked 2.004 million criminal cases. The people's courts at all levels wound up 644,248 criminal cases of the first instance, in which 767,951 criminals were sentenced, effectively protecting the victims' legitimate rights and interests.
17. Since May 2004, the Supreme People's Procuratorate has carried out a special campaign to severely deal with criminal cases involving the government functionaries'

infringement upon human rights by misusing their powers, focusing on cases of illegal detention and search, extorting confessions by torture, gathering evidence with violence, abusing people in custody, disrupting elections as well as serious cases of dereliction of duty that cause heavy losses of life and property of the people. In total, 1,595 government functionaries suspected of carrying out criminal activities were investigated and prosecuted, thus effectively bringing under control offences of infringement on rights.

18. Up to June 2004, there were 114,500 lawyers in practice and 11,691 law firms in China.
19. The Chinese government attaches great importance to the protection of labourers' rights. The state has adopted many measures to promote employment and re-employment, including provision of re-employment aid, strengthened control over unemployment and regulation over staff cuts by enterprises. In 2004, there were 9.8 million new employees and 5.1 million re-employed laid-off workers in urban areas in China; the registered unemployment rate was 4.2 per cent in urban areas.
20. In 2004, the Central treasury put 146.5 billion yuan into social security, 18.1 per cent more than in the previous year. The standards of basic pensions for retirees from enterprises and the minimum living guarantee for urban residents in some areas have been raised. In 2004, basic pensions were duly and fully issued to all retirees from enterprises throughout China, totalling 303.1 billion yuan, with 52.2 billion yuan of subsidies from the Central treasury.
21. By the end of 2004, the number of people participating in basic pension insurance, unemployment insurance, medical insurance and industrial injury insurance in urban areas had reached 164 million, 106 million, 124 million and 68.45 million, respectively, 8.47 million, 2.11 million, 15.02 million and 22.70 million, respectively, more than at the end of the previous year.
22. At present, there are more than 70,000 private schools (educational establishments) at all levels and of various

kinds, with over 17 million students, and more than 10,000 training institutes.

23. In 2004, the enrolment of technical college students and undergraduate students throughout the country was 4.473 million, 0.65 million more than in 2003, and the enrolment of graduate students was 0.326 million, 0.057 million more than in 2003. At present, there are over 20 million students in institutions of higher learning in China, and the gross enrolment ratio for higher education has reached 19 per cent. Enrolment in secondary vocational education has reached 5.48 million, and there are now 13.68 million students in such schools. There are 5.957 million undergraduate students and technical college students in institutions of higher vocational education, 1 million more than in the previous year.
24. The overall population coverage rates of radio and TV broadcasting were 94.1 per cent and 95.3 per cent, respectively. In 2004, 212 feature films and 44 films on science and education, documentaries and animated cartoons were produced. During the same year, 25.77 billion copies of national and provincial newspapers, 2.69 billion copies of periodicals of various kinds and 6.44 billion copies of books were published. A relatively complete public cultural system had taken initial shape, and the people's basic cultural rights were protected.

Annexures

ANNEXURE I

SELECTED ECONOMIC INDICATORS OF CHINA 1978–2005

(Units \$ Billion)

Year	GDP Growth		Trade			FDI	Foreign	Ex-
	%	CPI%	Exports	Imports	Balance		Exchange	ternal
							Reserve	Debt
1978	11.7		9.8	10.9	-1.1		0.2	
1979	7.6		13.7	15.7	-2.0		0.8	
1980	7.8		18.1	20.0	-1.9		-1.3	
1981	5.2		22.0	22.0	0.0		2.7	
1982	9.1		22.3	19.3	3.0		7.0	
1983	10.9		22.2	21.4	0.8		8.9	
1984	15.2		26.1	27.4	-1.3	1.3	8.2	
1985	13.5	9.3	27.4	42.3	-14.9	1.7	2.6	15.8
1986	8.8	6.5	30.9	42.9	-12.0	1.9	2.1	21.5
1987	11.6	7.3	39.4	43.2	-3.8	2.3	2.9	30.2
1988	11.3	18.8	47.5	55.3	-7.8	3.2	3.4	40.0
1989	4.1	18	52.5	59.1	-6.6	3.4	5.6	41.3
1990	3.8	3.1	62.1	53.3	8.7	3.5	11.1	52.5
1991	9.2	3.4	71.8	63.8	8.1	4.4	21.7	60.6
1992	14.2	6.4	84.9	80.6	4.4	11.0	19.4	69.3
1993	14.0	14.7	91.7	104.0	-12.2	27.5	21.2	83.6
1994	13.1	24.1	121.0	115.6	5.4	33.8	51.6	92.8
1995	10.9	17.1	148.8	132.1	16.7	37.5	73.6	106.6
1996	10.0	8.3	151.0	138.8	12.2	41.7	105.0	116.3
1997	9.3	2.8	182.8	142.4	40.4	45.3	139.9	131.0
1998	7.8	-0.8	183.8	140.2	43.6	45.5	145.0	146.0
1999	7.6	-1.4	194.9	165.7	29.2	40.3	154.7	151.8
2000	8.4	0.4	249.2	225.1	24.1	40.7	165.6	145.7
2001	8.3	0.7	266.1	243.6	22.6	46.9	212.2	170.1
2002	9.1	-0.8	325.6	295.2	30.4	52.7	286.4	168.5
2003	10.0	1.2	438.2	412.8	25.5	53.5	403.3	193.6
2004	10.1	3.9	593.3	561.2	32.1	60.6	609.9	228.6
2005	9.9	1.8	762.0	660.1	101.9	60.3	818.9	

Data Source: World Bank China Office Research Paper No. 4, by Min Zhao, The World Bank Beijing Office.

ANNEXURE II

CHINA: GDP BY REGION 1999–2004

(RMB billion, at current prices)

	1999	2000	2001	2002	2003	2004
Beijing	217.0	247.5	284.5	321.0	378.0	428.0
Tianjin	145.0	163.5	184.0	205.0	253.0	293.0
Hebei	456.5	508.5	557.5	612.0	779.0	876.5
Shanxi	150.5	164.0	178.0	201.5	266.5	304.0
Inner Mongolia Autonomous Region	126.5	140.0	154.5	173.0	227.0	271.0
Liaoning	417.0	466.5	503.0	545.5	609.0	687.0
Jilin	166.0	182.0	203.0	224.5	263.5	295.5
Heilongjiang	289.5	325.0	356.0	388.0	474.5	530.0
Shanghai Municipality	403.5	455.0	495.0	540.5	655.5	745.0
Jiangsu	769.5	858.0	951.5	1,063.0	1,340.5	1,540.0
Zhejiang	536.5	603.5	674.5	779.5	983.5	1,124.0
Anhui	290.5	303.5	329.0	356.5	427.5	481.0
Fujian	355.0	392.0	425.0	468.0	539.5	605.0
Jiangxi	185.0	200.0	217.5	245.0	308.5	349.5
Shandong	766.0	854.0	943.5	1,055.0	1,343.5	1,549.0
Henan	457.5	513.5	564.0	616.5	775.0	881.5
Hubei	385.5	426.5	466.0	497.5	566.5	630.5
Hunan	332.5	369.0	398.0	434.0	501.0	561.0
Guangdong	846.0	966.0	1,064.5	1,176.5	1,404.5	1,603.5
Guangxi Zhuang Autonomous Region	195.0	205.0	223.0	245.5	296.5	332.0
Hainan	47.0	51.0	54.0	60.0	69.5	76.5
Chongqing Municipality	147.5	158.5	174.5	197.0	237.5	266.5
Sichuan	371.0	401.0	442.0	487.5	581.5	655.5
Guizhou	91.0	99.0	108.0	118.5	142.5	159.0

(Annexure II Contd.)

(Annexure II Contd.)

	1999	2000	2001	2002	2003	2004
Yunnan	185.5	195.5	207.0	223.0	265.0	295.5
Tibet Autonomous Region	10.5	11.5	13.5	16.0	18.5	21.0
Shaanxi	148.5	166.0	184.0	203.5	255.0	288.0
Gensu	93.0	98.0	107.0	116.0	140.5	155.5
Qinghai	23.5	26.0	30.0	34.0	41.0	46.5
Ningxia Hui Autonomous Region	24.0	26.5	29.5	32.5	41.0	46.0
Xinjiang Uygur Autonomous Region	116.5	136.0	148.5	15.5	198.0	220.0

Source: State Statistical Bureau.*Note:* Provinces are listed in Chinese order rather than according to size.

ANNEXURE III

PROVINCIAL ECONOMIES: SECTORAL BREAK-UPS OF GDP: 1999

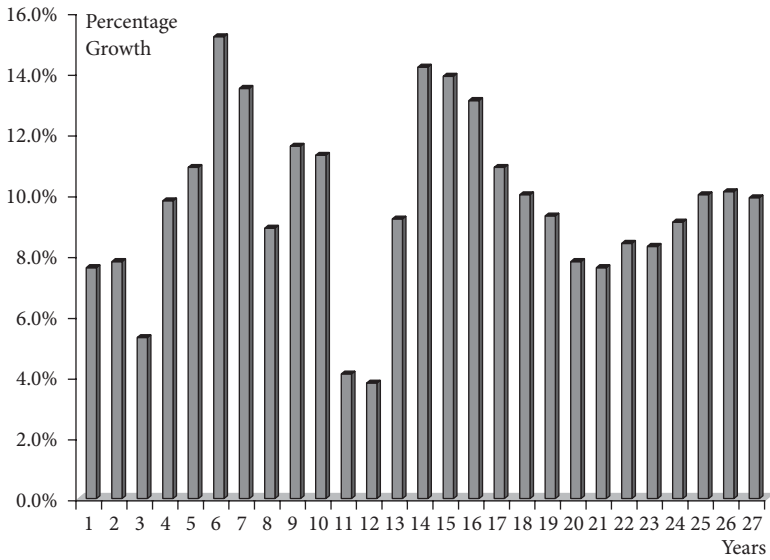
(in percentage)

Region	Primary Industry	Secondary Industry	Tertiary Industry	Region	Primary Industry	Secondary Industry	Tertiary Industry
Beijing	4.02	38.70	57.34	Hubei	16.95	48.93	34.10
Tianjin	4.89	49.10	46.00	Hunan	23.39	39.00	37.60
Hebei	17.64	49.10	33.26	Guangdong	12.06	50.38	37.55
Shanxi	10.62	50.48	38.89	Guangxi	28.39	35.62	35.99
Inner Mongolia	27.03	40.64	32.31	Hainan	37.44	20.15	42.41
Liaoning	12.48	47.97	39.54	Chongqing	19.21	40.84	39.94
Jilin	25.36	40.23	34.40	Sichuan	25.35	41.94	32.70
Heilongjiang	13.02	54.79	32.18	Guizhou	29.34	38.23	32.43
Shanghai	1.98	48.43	49.59	Yunnan	22.20	44.46	33.33
Jiangsu	13.04	50.92	36.10	Tibet	32.37	22.72	44.90
Zhejiang	11.78	54.11	34.10	Shaanxi	18.00	43.15	38.87
Anhui	25.48	43.97	30.55	Gansu	20.52	45.47	34.00
Fujian	17.70	42.46	39.83	Qinghai	17.00	41.06	41.90
Jiangxi	23.66	38.62	37.72	Ningxia	20.00	42.52	37.60
Shandong	15.93	48.36	35.70	Zinjiang	22.97	39.42	37.60
Henan	24.54	45.25	30.20				

Source: State Statistical Bureau.

ANNEXURE IV

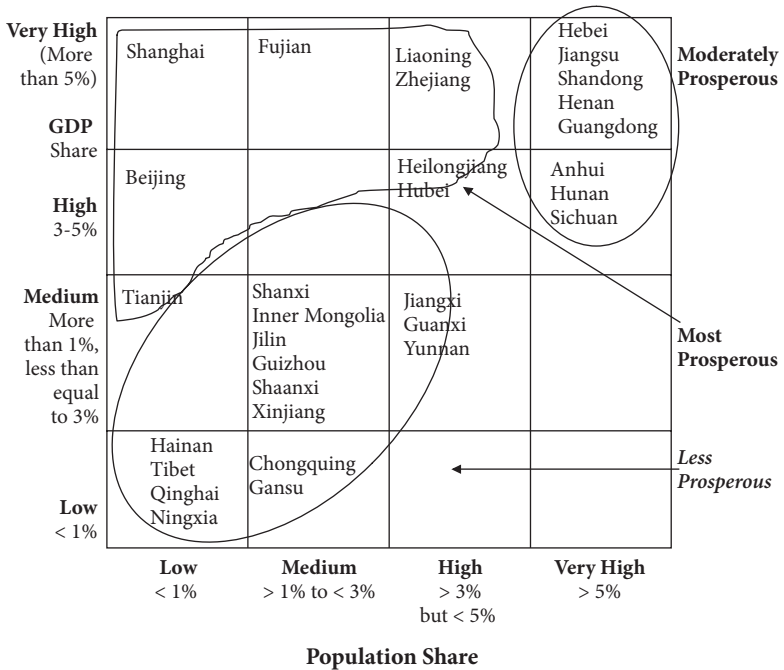
REAL GDP GROWTH RATE IN CHINA 1979–2005



Source: State Statistical Bureau.

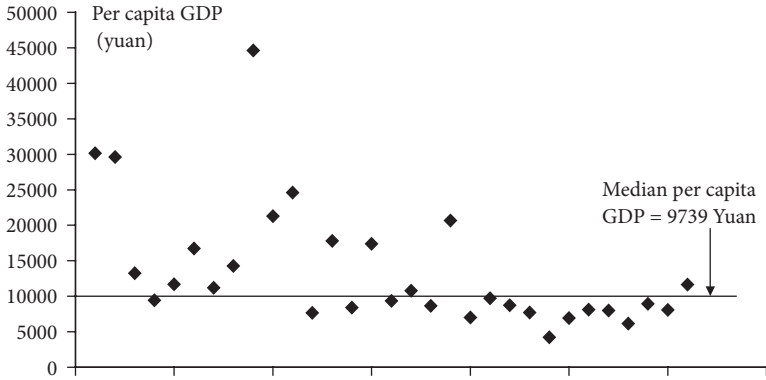
ANNEXURE V

GDP/POPULATION CLUSTER OF CHINA: 2004



Source: Prepared from China's National Accounts Statistics, 2004 by Shashwati Ghosh.

ANNEXURE VI

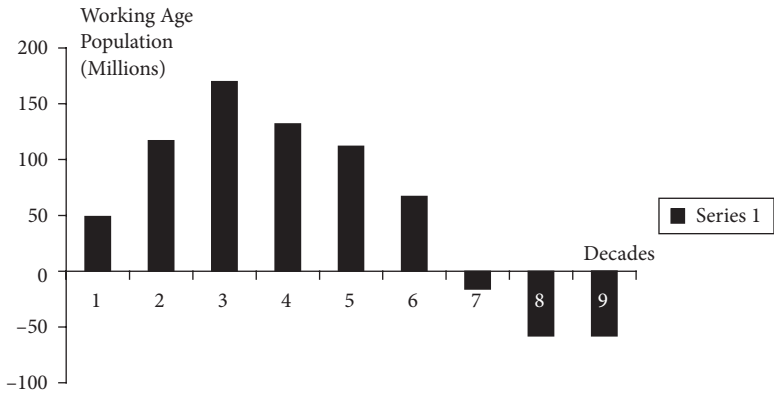
INTER-PROVINCIAL DIFFERENCES IN PER
CAPITA GDP: 2004

Source: NBS data, Government of PRC.

ANNEXURE VII

THE PRC'S WORKING AGE POPULATION (15-64)
WILL SOON PEAK AND THEN DECLINE

(Decades of 1955-65 to 2035-45)



Source: Jim Saxton (R-N), five challenges that China Must Overcome, Washington-DC (2006).

ANNEXURE VIII

HOW PRIVATE IS THE CHINESE ECONOMY?

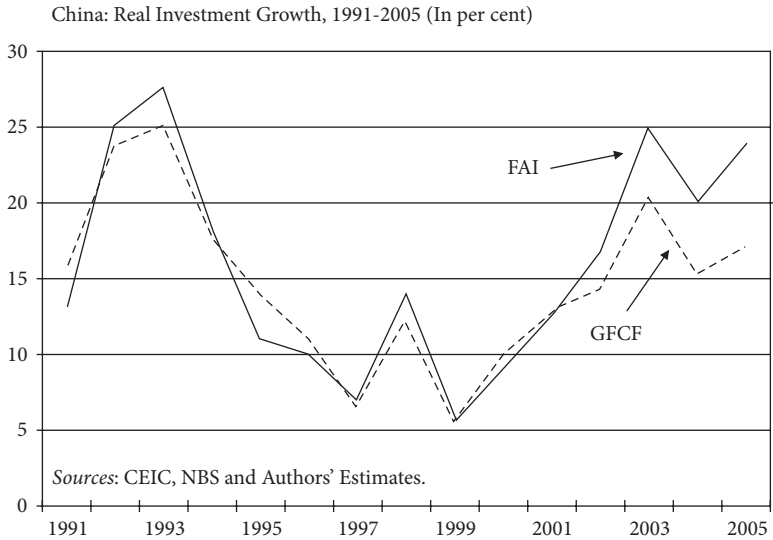
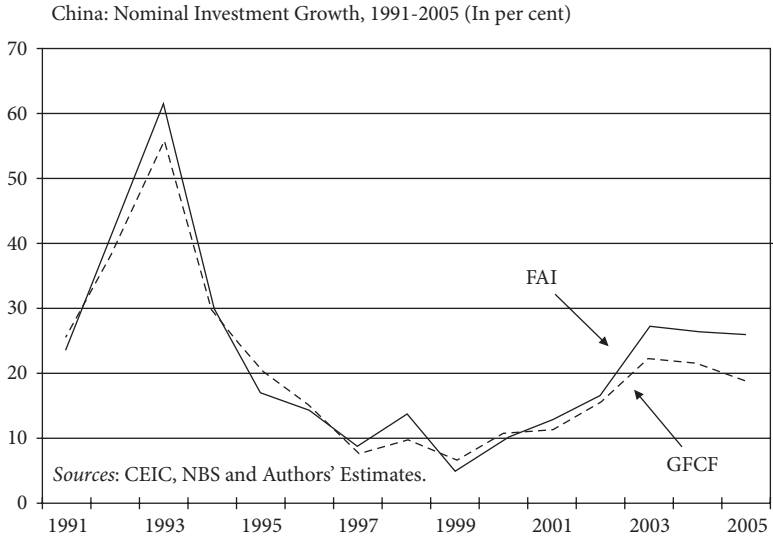
Share of SOEs in Industrial Sales Revenue: 2004

Liaoning	61	Central average	57
Jilin	76	Yunnan	71
Heilongjiang	81	Guizhou	68
North-east average	73	Guangxi	56
Beijing	54	Sichuan	48
Tianjin	39	Chongqing	52
Shandong	34	Hainan	43
Hebei	44	South-west average	56
Bohai average	43	Shanxi	56
Jiangsu	19	Shaanxi	81
Shanghai	40	Ningxia	60
Zhejiang	12	Neimengu	58
Fujian	22	Qinghai	86
Guangdong	20	Gansu	81
South-east average	23	Xinjiang	83
Anhui	59	North-west average	72
Henan	47		
Hunan	54		
Jiangxi	61		
Hubei	62		

Source: Governance, Investment Climate and Harmonious Society: Competitiveness Enhancements for 120 Cities in China (Document of the World Bank, Report No. 37759-CN).

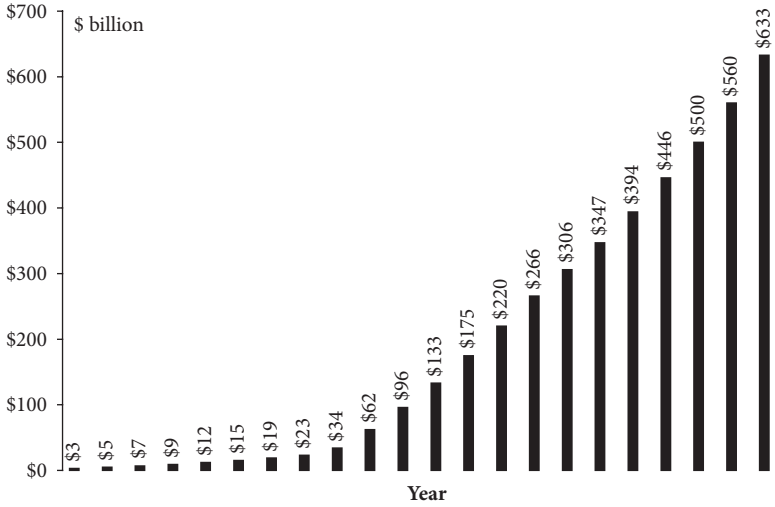
ANNEXURE IX

INVESTMENT GROWTH IN CHINA: 1991-2005



Source: Taken from Barnett and Brooks, 2006.

ANNEXURE X

CUMULATIVE FOREIGN DIRECT INVESTMENT (FDI)
IN CHINA (1982–2005)

Source: State Statistical Bureau.

ANNEXURE XI

REGION-WISE DISTRIBUTION OF CONTRIBUTIONS
TO FIXED ASSETS INVESTMENT: 2004

<i>Region</i>	<i>SOEs</i>	<i>Contributors to FAI</i>		
		<i>Foreign</i>	<i>Other Domestic</i>	<i>Rural</i>
		<i>Enterprises</i>		
Eastern Region	28.9	14.6	56.5	19.6
North-east	36.4	7.5	56.1	11.2
Central Region	38.7	5.1	56.2	16.0
Western Region	46.1	3.3	50.6	10.9

Source: State Statistical Bureau.

ANNEXURE XII

OUTPUT OF MAIN INDUSTRIAL PRODUCTS: 2004

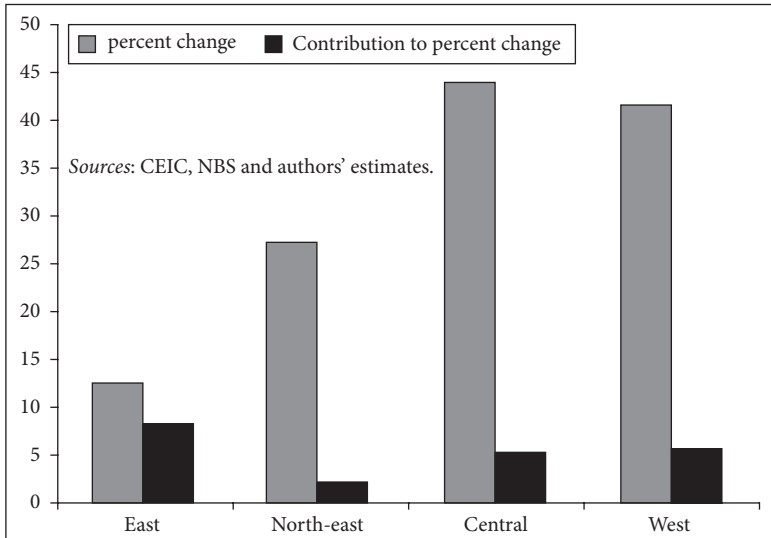
	<i>Units</i>	<i>Output</i>
Coal	10,000 tons	199,232.4
Crude petroleum	10,000 tons	17,587.3
Cigarettes	100 million cigarettes	18,736.3
Yarn	10,000 tons	1,291.3
Sulphuric acid (100% equivalent)	10,000 tons	3,928.9
Soda ash (100% equivalent)	10,000 tons	1,041.1
Caustic ash	10,000 tons	1,334.7
Ethene	10,000 tons	629.9
Chemical fertiliser (effective content equivalent)	10,000 tons	4,804.8
Cement	10,000 tons	96,682.0
Plate glass	10,000 weight cases	37,026.2
Steel	10,000 tons	28,291.1
Steel products	10,000 tons	31,975.7
Alumina	10,000 tons	697.9
Metal-cutting machine tools	10,000 units	48.7
Motor vehicles	10,000 units	509.1
Household refrigerators	10,000 units	3,007.6
Air conditioners	10,000 units	6,390.3
Programme control switchboards	10,000 lines	7,625.2
Computers	10,000 units	9.7
Microcomputers	10,000 units	5,974.9
Integrated circuits	100 million units	235.5
Colour TV sets	10,000 sets	7,431.8
Power generation	100 gigawatt hour	22,033.1

Source: Communiqué on major data of the first National Economic Census of China (No.2).

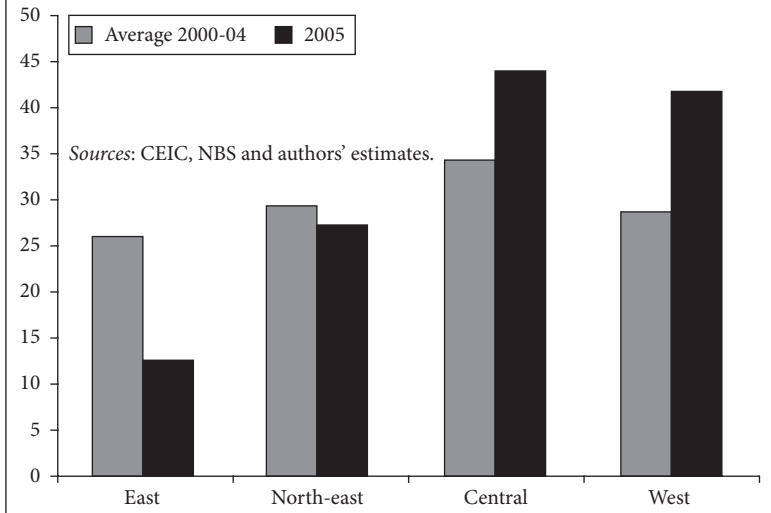
ANNEXURE XIII

RESIDENTIAL REAL ESTATE BY REGION

China: Residential Real Estate Investment by Region, 2005



China: Residential Real Estate Investment by Region (Change in percent)



Source: Taken from Barnett and Brooks, 2006.

ANNEXURE XIV

China: Financing Pattern of Urban and Rural Fixed Asset Investment

	1999	2000	2001	2002	2003	2004	2004	2005
							Urban 1/ Urban 1/	
	(In per cent of total)							
State budget	6.2	6.4	6.7	7.0	4.6	4.3	4.3	4.4
Domestic loans	19.2	20.3	19.1	19.7	20.5	18.3	20.4	18.8
Foreign capital	6.7	5.1	4.6	4.6	4.4	4.4	4.3	4.2
Self-raised	53.4	52.2	52.4	50.6	53.7	55.7	51.4	54.5
Other sources	14.4	16.0	17.3	18.0	16.8	17.2	19.6	18.1
	(In per cent of expenditure side GDP)							
Total Funding of Fixed Asset Investment	35.3	37.1	38.9	41.4	48.8	55.1	39.0	43.3
State budget	2.2	2.4	2.6	2.9	2.2	2.4	1.7	1.9
Domestic loans	6.8	7.5	7.4	8.1	10.0	10.1	8.0	8.1
Foreign capital	2.4	1.9	1.8	1.9	2.2	2.4	1.7	1.8
Self-raised	18.8	19.3	20.4	21.0	26.2	30.7	20.1	23.6
Other sources	5.1	5.9	6.7	7.5	8.2	9.5	7.6	7.8
Memo items								
Mortgage lending	1.6	2.3	2.3	2.4	2.9	3.1	3.1	1.3
Mortgage lending and domestic loans (as per cent of total funding)	23.8	26.4	24.9	25.6	26.6	23.9	...	21.8
Industrial enterprise profits	2.4	4.3	4.3	4.7	6.0	7.1	...	7.7
SOE profits	0.2	1.2	2.6	3.1	3.5	4.6	...	4.8
Depreciation 2/	...	15.4	15.7	...	15.9	14.9

Sources: CEIC and author's estimates.

1/ Full details of urban and rural FAI financing have not been published as yet for 2005. 2/ From regional analysis of GDP in NBS statistical yearbooks, as per cent of sum of regional GDP.

Source: Taken from Barnett and Brooks, 2006.

ANNEXURE XV
 PROVINCE-WISE SECTORAL DISTRIBUTION
 OF EMPLOYMENT

<i>Regions</i>	<i>Sectoral Shares (%)</i>		
	<i>Primary</i>	<i>Secondary</i>	<i>Tertiary</i>
Beijing	6.9	26.4	66.7
Tianjin	19.3	40.1	40.6
Hebei	47.1	28.9	24.0
Shanxi	43.8	25.4	30.8
Inner Mongolia	54.5	14.9	30.6
Liaoning	36.8	24.8	38.4
Jilin	46.5	18.6	34.9
Heilongjiang	49.1	20.4	30.5
Shanghai	8.3	39.5	52.2
Jiangsu	31.0	36.2	32.7
Zhejiang	26.9	39.7	33.4
Anhui	52.3	20.2	27.5
Fujian	40.3	29.4	30.3
Jiangxi	48.0	20.3	31.8
Shandong	44.4	27.6	28.0
Henan	58.1	20.4	21.5
Hubei	44.0	18.9	37.1
Hunan	55.2	15.9	28.8
Guangdong	35.7	29.1	35.2
Guangxi	57.8	10.8	31.3
Hainan	58.0	10.1	31.9
Chongqing	47.6	20.1	32.3
Sichuan	52.8	17.5	29.6
Guizhou	59.6	9.8	30.6
Yunnan	71.3	9.1	19.6
Tibet	63.7	9.4	26.9
Shaanxi	51.2	17.3	31.5
Gansu	58.5	13.8	27.7
Qinghai	51.2	16.5	32.3
Ningxia	49.9	21.4	28.7
Xinjiang	54.2	13.2	32.6
National Total	46.9	22.5	30.6

Source: NBS data, Government of PRC.

ANNEXURE XVI

A NOTE ON THE FISCAL SYSTEM IN CHINA

The fiscal system in China is characterised by the sharing of tax revenues between the Central Government and local governments. According to their respective responsibilities, the Central Government is responsible mainly for expenditures for national defence, foreign affairs and the operation of Central Government agencies, as well as expenditures for economic restructuring, development co-ordination among regions and macro-economic adjustment, and the local governments are mainly responsible for expenses on the operation of government agencies under their respective jurisdictions, as well as the expenditure for economic and social development in their regions. In accordance with the principle of matching responsibilities with revenues and some other principles, taxes are divided into Central Government taxes, local government taxes and taxes shared between the Central and local governments. Central taxes are those needed for protecting national interests and undertaking macro-economic regulation. Shared taxes are those directly related to economic development. Local taxes are those that are suitable for collection by local governments.

The details are as follows: Central tax revenues: customs duties; import-related VAT and consumption tax collected by the customs; consumption tax; Enterprises. Income tax which is collected from railway and transportation and paid by China's Post, Industrial and Commercial Bank of China, Agricultural Bank of China, Bank of China, Construction Bank of China, Development Bank of China, Agricultural Development Bank of China, Import and Export Bank of China, Offshore Petroleum and Natural Gas Corp., PetroChina Company Limited and China Petroleum and Chemical Corporation; Operation tax, profits and city maintenance tax paid by the railway departments, various banks and various insurance companies; profits handed over by Central enterprises and the vessel tonnage tax and vehicle purchase tax for the income with special purposes.

Local tax revenues: Operation tax (excluding the part paid by the railway department, various banks and various insurance

companies); profits handed over by local enterprises; city and township land use tax; fixed assets investment orientation regulation tax; city maintenance tax (excluding the part paid by the railway department, various banks and various insurance companies); house property tax; farmland occupation tax; land appreciation tax; urban real estate tax; vehicle and vessel usage tax; vehicle and vessel usage licence plate tax; deed tax; stamp tax; agriculture tax and animal husbandry tax (including agriculture, speciality tax) and state-owned land use tax.

Tax revenues shared between the Central and local governments: Domestic VAT: 75 per cent for Central Government and 25 per cent for local governments. Income Tax: 60 per cent for Central Government and 40 per cent for local governments. Resource Tax: tax paid by offshore oil enterprises goes to the Central Government, and the rest goes to the local governments. Stamp tax revenue collected on stock transactions: 97 per cent goes to the Central Government; the remaining 3 per cent goes to local governments. State tax agencies and local tax agencies have been established separately. In principle, state taxes and shared taxes are collected by State tax agencies while local taxes are collected by local tax agencies.

The Central Government returns part of its tax revenue to local governments based on the growth in local government value-added taxes and consumption tax. The Central Government provides assistance in the form of fiscal transfers to less developed regions and the regions inhabited by ethnic minorities.

The budget year corresponds with the calendar year, starting on January 1 and ending on December 31. The Chinese budgets are managed separately by governments at different levels. There are five levels of budget management. The national budget is composed of the Central Government budget and local government budgets. As stipulated by the Budget Law of the People's Republic of China (PRC), the budget draft and budget implementation of the Central and local governments must be reviewed and approved by the National People's Congress (NPC) and local people's congresses, respectively. The Central and local budget adjustment plans and final accounts must be reviewed and approved by the Standing Committee of the NPC and local congresses.

Source: <http://english.gov.cn/official/workreports.htm>.

ANNEXURE XVII

CHRONOLOGY OF EXTERNAL LIBERALISATION AND EXCHANGE REFORM

1979-1987: Early stage of opening up

[December 1978] Third plenum of the Central Committee of the Communist Party makes a decisive break with the legacy of the Cultural Revolution and resolves to focus the Party's work on economic development in order to achieve substantial, sustained gains in outputs. In order to achieve this objective, it is decided that market-oriented reforms and opening up of the economy will be adopted.

Financial Liberalisation

<i>Banking System</i>	<i>Capital Market</i>	<i>Exchange Rate Regime</i>	<i>Restriction on Current Account Transactions</i>
1979 Bank of China (BOC) is the only bank that is allowed to conduct business in foreign currency. The Bank of Tokyo, the first foreign bank, is approved to set up a representative office in China.		1980 An experimental trading system is established by the BOC in a few cities, where domestic enterprises are permitted to sell retained foreign exchange to other domestic enterprises at the internal settlement rate. The BOC acts as broker.	1979 To promote exports, the national monopoly of trade is broken. FFEs are allowed to conduct trade of specified goods. SEZs and Guangdong and Fujian provinces are allowed to set up FTCs with Central Government approval. International transactions are based on a foreign exchange plan, prepared by various ministries. BOC is responsible for implementing the plan, and all transactions are performed in accordance

(Continued)

(Continued)

Financial Liberalisation

<i>Banking System</i>	<i>Capital Market</i>	<i>Exchange Rate Regime</i>	<i>Restriction on Current Account Transactions</i>
1982 Foreign financial institutions are allowed to set up branches in SEZs, but are not allowed to conduct business in RMB. The first foreign bank starts to operate.		1981 A dual exchange rate regime is established. An internal settlement rate, calculated as the exporters' average break-even point multiplied by 1.1, applies to goods exports and imports. The official rate, peg to a basket of currencies but adjusted occasionally, is used for non-trade related transactions.	with it. Local governments and firms are allowed to retain part of their foreign exchange proceeds from trade and non-trade activities, but approval is required to use the retained foreign exchange and quota. The non-retainable foreign exchange should be sold to BOC.
1986 All domestic banks can conduct business in foreign currency.		1982 BOC starts extending foreign exchange credit to exporters. 1983 The license of foreign trade is granted to some big SOEs. 1984 MOFTEC releases a list of commodities forbidden from import. Approval is no longer required for FTCs to import non-forbidden commodities. BOC and CBIC start to extend loans to importers. 1985 Firms are allowed to freely use up to 50% of their retained earnings. The State Council grants the Guangdong and Fujian provinces with the authority to approve the set-up of FTCs.	

<i>Direct Investment</i>		<i>External Debt, Guarantee and Derivatives</i>		<i>Cross-border Transfer</i>	
<i>Inward</i>	<i>Outwards</i>				
1979	Four SEZs (Shenzhen, Zhuhai, Shantou and Xiamen) are set up.	1980	Domestic entities to borrow external debt are required to fill in the annual external debt plan and be approved by the State Council. SAFE and SDPC are responsible for compiling the external debt plan.	1980	Transfer across the border must be implemented through an FEDB. Carry-in foreign bank note, valuable minerals or financial instruments are not restricted, but carry-out of these items is generally not allowed.
1980	FDI is allowed with the Central Government's approval. FFEs are required to deposit all foreign exchange proceeds in BOC. Profits can be remitted out of the country, but repatriated profits are subject to 10% tax. FFEs are required to keep foreign exchange balance.	1980	Outward direct investment is permitted only after examination of the source of the foreign exchange funds, approval of the authorities concerned with foreign direct investment, and completion of offshore investment foreign exchange registration. Profits from overseas investment should be repatriated home and surrendered to BOC.		
1984	Fourteen coastal cities are opened for FDI. Shanghai city government is granted with authority to approve FDI up to US\$ 10 million. FFEs in open cities are exempted from profit tax in the first two years and granted 50% reduction in the following three years.				

(Continued)

(Continued)

<i>Direct Investment</i>		<i>External Debt, Guarantee and Derivatives</i>	<i>Cross-border Transfer</i>
<i>Inward</i>	<i>Outwards</i>		
FFEs in open cities are free from import duties when importing equipment, raw material, parts and components. Profit repatriation of FFEs in open cities is no longer subject to tax.			1985 Domestic residents are allowed to retain all proceeds from overseas remittances and deposit them in BOC.
1985 Foreign investors can invest in port construction. Four regions are opened to foreign investment. Restriction on setting up joint venture in Shanghai is relaxed. Foreign investors can invest in oil and gas exploitation projects in 10 provinces.			
1986 JVEs can pay in foreign currency for purchase from firms outside of SEZs and ETDZs.			

1987–1991: Setting up foreign exchange controlling and monitoring system

[Early 1988] In the wake of a bout of inflationary pressures, a stabilisation programme is introduced (the “rectification programme”), in which structural reforms are given lower priority than stabilisation and administrative measures are used to supplement nascent indirect instruments of macro-economic control. China reinforces exchange control system, and at the same time, sticks to reform and opening up policies.

Financial Liberalisation

<i>Banking System</i>	<i>Capital Market</i>	<i>Exchange Rate Regime</i>	<i>Restriction on Current Account Transactions</i>
	1987 Domestic entities are allowed to issue bonds in the international market with the State Council's approval.	1988 Part of FERQs from export proceedings are made available to domestic exporters. By October 1988, 80 swap centers have been established. Bank of China is allowed to agent spot and forward foreign exchange trade. The swap rate is allowed to float. Governments are allowed to sell self-owned FERQs in swap market. All firms are allowed to trade retained foreign exchange and FERQs in swap market for specified use.	1988 The State Council decides to propel the trade responsibility system nationwide and further accelerate and deepen external trade system reform. The authority to approve the set-up of FTCs is assigned to provincial governments.

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Financial Liberalisation

<i>Banking System</i>	<i>Capital Market</i>	<i>Exchange Rate Regime</i>	<i>Restriction on Current Account Transactions</i>
1990 Shanghai, the first city outside of SEZs, is opened for foreign financial institutions.	1990 The Shanghai Securities Exchange is officially recognised. The PBC regulates inter-bank market rates and promulgates new measures to regulate inter-bank markets.	1988-89 Official rate is applied for the foreign exchange plan, the surrender of proceeds in foreign currency, and purchases associated with FERQs. 1991 The official exchange rate is changed from one of pegging to a basket to a system of managed floating. Individuals are allowed to buy foreign exchange in swap markets to pay for overseas tourism, overseas study and emigrants with the approval of SAEC. But the ceiling on the purchase is low.	1991 Export receipts verification system is implemented. The State no longer provides subsidies to support exports.

<i>Direct Investment</i>		<i>External Debt, Guarantee and Derivatives</i>	<i>Cross-border Transfer</i>
<i>Inward</i>	<i>Outwards</i>		
1989 FFE's are allowed to earn foreign exchange from sales to firms in SEZs, EDZs or other FFEs, or from sales of products that substitute imports to domestic enterprises.	1989 Notification on overseas direct investment is released by SAFE. Domestic investors are required to deposit 5% of investment amount in a special account with a FEDB for profit repatriation. Domestic firms are not allowed to provide guarantee to overseas investment firms.	1987 Financial institutions with licence and non-financial institutions with foreign exchange earnings are allowed to be engaged in foreign exchange guarantees.	
	1989 Upper bound is imposed on the outstanding short-term external debt. PBC sets the national upper bound and SAFE sets the upper bound for each financial institutions. Short-term debt is forbidden to be invested in long-term project. Issuing international bonds is included in the nation's foreign capital utilisation plan. The external debt registration and monitoring system is further improved. Both direct external debt and on-lend debt are to be registered with SAFE.		

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<i>Direct Investment</i>		<i>External Debt, Guarantee and Derivatives</i>	<i>Cross-border Transfer</i>
<i>Inward</i>	<i>Outwards</i>		
1990 The administrative procedures for setting up a FFE is streamlined. Pudong (Shanghai) sets up EDZs. Foreign investors are allowed to invest in land and real estate development projects.	1990 Only enterprises that have own foreign exchange can invest overseas. The profits from overseas investment should be repatriated home and surrendered. The investing enterprises can retain FERQs up to 100% of the repatriated profits in 5 years and 80% afterwards.	The qualification for engaging in external guarantee is raised. Government departments and administrative units are forbidden from providing external guarantee.	
1991 Profit Tax Code for FFEs is enacted; 10% tax on FFEs' profit repatriation is repealed.		1990 Non-financial enterprises (non FFEs) are allowed to borrow from foreign banks or jointly owned banks in China with SAFE's approval.	
		1991 Enterprises in pivot industries can buy foreign exchange to repay external debt.	

1992-1996 accelerating liberalisation

[November 1993] Third Plenum of the Fourteenth Central Committee outlines and approves comprehensive reform strategy in which foreign exchange management reforms are mentioned as a key element for a market-oriented economy. A market-based unified floating exchange regime and current account convertibility are targets of the reform.

Financial Liberalisation

<i>Banking System</i>	<i>Capital Market</i>	<i>Exchange Rate Regime</i>	<i>Restriction on Current Account Transactions</i>
1992 The rectification programme ends. The authorities announce their intention to accelerate the reform process. Gradually, more commercial banks, mostly of regional scope, are licensed. Seven more coastal cities are opened to foreign banks.	1992 B-share market is launched. July 15, 1993 The first Chinese firm, Qingdao Beer, lists in Hong Kong Stock Exchange.	1992 Part of the FERQs made available to the state are purchased at a premium equal to the monthly weighted average of the rate in the swap market. The PBC starts selling the quotas that it has bought at the market rate to importers through the swap market at the prevailing swap market rate.	1992 Some inland cities and border regions are opened for border trade and investment. Import adjustment tax is nullified. Some qualified big SOEs are allowed to conduct foreign trade in specified products. Part of the FERQs from non-trade proceedings are made available to firms.
1993 Shanghai, as a pilot city, is opened to foreign insurance companies. The first foreign insurance company is in operation in September 1992.		1993 Research institutes and state owned commercial corporate can conduct foreign trade in specified products.	
		1993 The State Council decides that the SAFE should function under the guidance of the PBC. The SAFE issues regulation on licensing, capital, operation, control, and risk limits for financial institutions' foreign exchange operations.	

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Financial Liberalisation

<i>Banking System</i>	<i>Capital Market</i>	<i>Exchange Rate Regime</i>	<i>Restriction on Current Account Transactions</i>
1995 Twenty-four cities are opened to foreign banks. The first joint venture investment bank is established.	1996 Except for buying B-share, non-residents should not buy, sell or issue any note and bonds in monetary market. Financial institutions can issue bonds denominated in foreign currency in international market with the State Council's approval.	1994 The official and swap market exchange rates are unified at the prevailing swap market exchange rate. The unified exchange rate regime is a managed floating system. The CFETS becomes operational, creating an integrated system of foreign exchange trading centralized in Shanghai. A two-tier trading system is established.	1994 Most exchange restrictions on current account transactions are removed. The foreign exchange retention quota system is repealed. The foreign exchange plan is nullified. A foreign exchange surrender and purchase system is applied to all proceeds and expenditure under current account transactions. An import payment verification system is launched.
1996 Foreign banks are allowed to be foreign exchange designated banks, and trade foreign currency with FFEs. The first non-state owned bank—Mingshen Bank is established. Domestic banks can extend loans in foreign currency and issue credit card in foreign currency. Inter-bank foreign currency market is in operation.	The foreign exchange proceeds from overseas IPO or bond issuance are not allowed to be converted in RMB nor be used to invest in foreign bonds or other financial instruments.	1996 China announces achieving current account convertibility. Imports of equipment for export processing are no longer free from import duties. Foreign investors are allowed to set up joint owned foreign trade corporate in Shanghai and Shenzhen.	FTCs are not required to surrender profits to the authorities but pay profit tax instead.

<i>Direct Investment</i>		<i>External Debt, Guarantee and Derivatives</i>	<i>Cross-border Transfer</i>
<i>Inward</i>	<i>Outwards</i>		
1992	Retail and distribution services industries are opened to foreign investment with ownership restriction. More regions are opened to foreign investment, and ownership requirement for FDI in most industries is relaxed. Imports of FFEs that are free from import tariff are up to the amount of total investment.	1993	FFEs, private enterprises and individuals are allowed to trade futures. SOEs and JVs are allowed to trade futures for hedge purpose only.
1995	SOEs and collective owned enterprises are allowed to be converted as FFEs through selling equity to foreigners, issuing B-shares or acquiring foreign investment with foreign ownership no less than 25%.	1995	Domestic financial institutions are not allowed to trade derivatives in overseas market. Government entities are forbidden from providing external guarantees. Only qualified financial institutions and enterprises are allowed to provide external guarantee with SAFE's approval. FEDBs are allowed to trade RMB forward with firms.
		1995	1996
			Foreign exchange account holder can remit foreign exchange in the account abroad. Individuals can carry up to US\$ 4000 foreign banknote out of the border.

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<i>Direct Investment</i>		<i>External Debt, Guarantee and Derivatives</i>	<i>Cross-border Transfer</i>
<i>Inward</i>	<i>Outwards</i>		
1996 As of July 1996, the foreign exchange surrender and purchase system is extended to FFEs. FFEs may open foreign exchange account in bank. SAFE sets the ceiling on these foreign exchange accounts. The foreign exchange proceeds from capital account transactions are not allowed to be converted in RMB, unless SAFE approves. Foreign exchange balance requirement for FFEs is repealed.	1996 When domestic entities make overseas investment, SAFE checks the source of foreign exchange earnings. The foreign exchange proceeds from capital account transactions are not allowed to be converted in RMB unless being approved by the SAFE.	1996 FFEs' providing guarantee for a domestic entity is subject to SDPC's guiding plan and is required to be registered as external debt. Foreign exchange proceeds from external debt are not allowed to be converted in RMB. International leasing of plane is subject to national external debt plan.	

1997–2000: Strengthening supervision on outward flows

In December 1996 China becomes a member of IMF's Article 8 of Articles of Agreement, achieving current account convertibility. The breakout of Asian financial crisis makes China be cautious about financial liberalisation. The monitoring system over external transactions is significantly strengthened.

Financial Liberalisation

<i>Banking System</i>	<i>Capital Market</i>	<i>Exchange Rate Regime</i>	<i>Restriction on Current Account Transactions</i>
1997 Reserve requirement is extended to the foreign exchange deposits of foreign banks. Foreign bank should allocate non-performing asset reserve. Eighteen cities are opened for foreign banks to do business in RMB. Foreign banks outside of SEZs no longer enjoy the profit tax exemption and reduction. The foreign financial institutions in SEZs are not free from exemption of business tax (8%) after five years preferential period.	1997 Financial institutions are allowed to issue bonds in international market with SAFE approval. February 1999 The first private firm is listed abroad.	December 1998 The swap centres are shut down. FFEs can trade foreign exchange with FEDBs.	1997 Non-manufacturing firms in SEZs can be engaged in foreign trade. Domestic entities should repatriate foreign exchange proceeds from current account transactions home, and surrender them to a bank or deposit them in a FEDB if being approved.

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<i>Financial Liberalisation</i>		
<i>Banking System</i>	<i>Capital Market</i>	<i>Exchange Rate Regime</i>
Domestic financial and insurance companies' business tax is raised from 5% to 8%. Banks are allowed to do off-shore business with SAFE's approval. Foreign investors can invest in domestic banks.	2000 Qualified institutions are allowed to issue bonds in overseas market. SDPC, PBC and other departments evaluate the institutions' qualification and the State Council approval is required.	1998 Individuals purchasing foreign exchange below the ceiling no longer requires SAFE approval. Citizens can deposit in banks or convert in RMB their foreign exchange proceeds from current account transactions or overseas remittance.
1999 The geographic restriction on foreign banks is repealed.		1999 Private firms can do foreign trade.
2000 Effective May 2001, foreign financial institutions in SEZs no longer enjoy the preferential business tax. The business tax rates of domestic and foreign financial firms are unified to 8%, and will be reduced to 5%, one percentage point a year from 2001 to 2003.		

<i>Direct Investment</i>		<i>External Debt, Guarantee and Derivatives</i>	<i>Cross-border Transfer</i>
<i>Inward</i>	<i>Outwards</i>		
1997 The industrial guidance for foreign direct investment is relaxed. Seven ministries start to exercise a joint annual examination over foreign funded enterprises.	1998 Residents can deposit or convert in RMB their foreign exchange proceeds from capital account transactions with SAFE's approval.	1997 Only qualified financial institutions and enterprises can provide external guarantees with SAFE's approval.	
January 1998 FEEs in encouraged category are free from tariff, consumption tax and VAT for imports of equipment.		1998 Domestic FEDBs should not issue long-term letter of credit not related to trade. Banks issuing letter of credit with maturity more than one year requires prior approval from the SAFE. Domestic FEDBs extending RMB loans to domestic entities should not accept guarantees in foreign currency issued by foreign banks or overseas entities (including standby letter of credit) as collateral.	

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<i>Direct Investment</i>		<i>External Debt, Guarantee and Derivatives</i>	<i>Cross-border Transfer</i>
<i>Inward</i>	<i>Outwards</i>		
1999	The preferential policies are extended to FDI in energy, transportation and infrastructure industries. The authorities encourage foreign investment in western region. FFEs in western region can enjoy a lower profit tax rate, 15% in the first three years. The restriction on FFEs borrowing in RMB is relaxed.	1999 Major exporters and importers can trade futures of specified commodities at abroad.	
2000	Foreign enterprises should buy insurance products from domestic insurance company. Railway, water transportation and gasoline mining are opened for foreign investment. Medical care is opened for foreign investment, but ownership restriction remains.		

2001: Accelerating financial liberalisation in context of accession to WTO

China accedes to WTO as of December 2001, committing to liberalising its service industries including banking, securities, insurance among others.

<i>Financial Liberalisation</i>		
<i>Banking System</i>	<i>Capital Market</i>	<i>Exchange Rate Regime</i>
<p>2001 Foreign banks are allowed to provide foreign exchange services to all firms and individuals. Four cities are opened for foreign banks to do RMB businesses. In December 2001 foreign insurance companies are allowed to operate in China. Seven are approved.</p> <p>2002 Opening security industry to foreign investment. The first jointly owned fund company is approved. The first jointly owned life insurance company is in operation.</p>	<p>2001 Domestic residents can invest in B-share with self-owned foreign exchange.</p> <p>2002 Foreign financial institutions can invest in domestic capital market within specified quota after being approved by the authorities.</p>	<p>2001 On July 21 2005 RMB exchange rate regime changes from a de facto peg to US dollar to a managed floating system with a reference to a basket of currencies. Non-financial institutions are allowed to participate in inter-bank spot foreign exchange market. RMB forward and swap are allowed to trade. Foreign banks are allowed to do forward trade.</p> <p>2002 Current account foreign exchange settlement account and specified account are combined as current account. The ceiling of current account is raised to 20% of foreign exchange proceeds from current account transactions in previous year. Individuals are allowed to purchase up to US\$20,000 for overseas study per year.</p>

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Financial Liberalisation

<i>Banking System</i>	<i>Capital Market</i>	<i>Exchange Rate Regime</i>	<i>Restriction on Current Account Transactions</i>
2003 Foreign owned insurance companies are allowed to participate in foreign exchange inter-bank market. The foreign ownership restriction in future corporate is repealed. Foreign investors can buy equity of domestic banks. But the foreign ownership cannot exceed 25% of total equity or 20% for any single foreign investor.	2004 Insurance companies can use their own foreign exchange to invest in international capital market. 2005 The first foreign company is listed in Shanghai Stock Exchange.		2003 RMB, hard currency or currency of neighboring countries are allowed to be used in border trade. The maximum amount that individual can purchase for tourism is raised to USD 3000 per transaction, or USD 5000 if staying overseas for more than six months. 2004 The ceiling of foreign exchange current account is significantly raised. The procedures for firms to buy foreign exchange are simplified. The Law of External Trade is revised. No approval is required for firm or individual to do external trade.
2003 Four more cities are opened to foreign banks to do RMB businesses. Foreign banks are allowed to provide RMB service to domestic firms in open cities.	Effective February 2005, the deadline for repatriation for foreign exchange proceeds raised by resident shareholders from overseas IPO is extended to six months after the funds are collected.		

2004

PBC provides settlement service for Hong Kong banks that are engaged in RMB deposits, currency exchange, credit card and remittance businesses.

Financial Liberalisation

Banking System

Capital Market

Exchange Rate Regime

Restriction on Current Account Transactions

2005

2005

The geographic restriction and ownership restriction to foreign insurance companies are repealed. Foreign insurance companies are allowed to provide health insurance, group insurance, pension and annuity services.

Seven more cities are opened for foreign banks to do RMB business. The total number of open cities reaches 25. The required reserve ratio for foreign exchange deposits are unified to 3%. Before that, it is 2% for China funded financial institutions, 5% for deposits up to three months maturity in foreign financial institutions, 3% for deposits more than three months maturity in foreign financial institutions.

Enterprises in export processing zones can use foreign exchange to settle trade with enterprises in the zones. SAFE significantly raises the ceiling on the current account again. Firms can surrender their foreign exchange proceeds at their own discretion. The ceiling of individual purchase of foreign exchange for tourism or overseas study is raised again. Individuals are allowed to buy foreign exchange to pay for overseas expenditures paid via credit card.

<i>Direct Investment</i>		<i>External Debt, Guarantee and Derivatives</i>		<i>Cross-border Transfer</i>
<i>Inward</i>	<i>Outwards</i>			
2001 The business tax rate that finance and insurance companies pay is lowered from 8% to 5% in three years, one percentage point a year.	2001 The restriction on purchasing foreign exchange for overseas investment is relaxed. Firms are allowed to purchase foreign exchange to repay debt before it matures.	2001 The restrictions on purchasing foreign exchange to repay domestic debt denominated in foreign currency is repealed. The restrictions on purchasing foreign exchange to repay the external debt or domestic debt in foreign currency before the debt matures are relaxed. All firms that are engaged in foreign trade can trade futures and other hedge instruments in overseas market.	2001 Individuals, residents or non residents, are allowed to carry up to US\$10,000 cash across the border. There is no limit on other financial instruments denominated in foreign currency.	2003
2002 A new four-tier classification system is introduced, defining activities in which foreign investment is encouraged, permitted, restricted, or banned. FDI in encouraging category can enjoy duty exemption of imports of equipments. Many industries, that are previously closed to foreign investment, particularly in public utilities and services industries such as insurance, banking, commerce, tourism, accounting,	2002 A pilot programme is carried out in six provinces to grant local SAFE authority to approve the purchase of foreign exchange for overseas investment.	2002 Restrictions on buying foreign exchange to repay the debt in foreign exchange are repealed. Big SOEs are encouraged to repay external debt before the maturity date.	2004 The maximum amount of RMB banknote that is allowed to be carried across border is raised from RMB6000 to 20,000. Mainland residents are allowed to use RMB bank card for overseas tourism. SAFE imposes strict screening process on non-residents purchase and sales of foreign exchange. The restriction on transferring assets overseas is further relaxed.	

<i>Direct Investment</i>	<i>External Debt, Guarantee and Derivatives</i>	<i>Cross-border Transfer</i>
<i>Inward</i>	<i>Outwards</i>	
<p>telecommunication, transport, accounting, legal service are opened. The sub-sectors in restricted category are reduced from 112 to 75.</p>	<p>2003 The requirements of foreign exchange risk examination and profit repatriation deposit for overseas investment are repealed. The joint annual examination of overseas invested companies is launched.</p>	<p>2003 The provisional regulation on external debt is issued. The long-term external debt quota is extended to foreign banks in China. Domestic entities are forbidden from issuing guarantee to non-operational overseas entities. Government departments and other quasi-government entities are not allowed to borrow external debt or provide external guarantee without the approval from the State Council.</p>
<p>2003 Foreign investors are allowed to open foreign exchange account in China to facilitate their M&A activities.</p>	<p>2004 Firms investing overseas is no longer required to get approval from authorities.</p>	<p>2004 External debt quota management system is extended to foreign owned banks. A ceiling is imposed on the foreign banks' outstanding short-term external debt. Foreign banks in China issuing guarantee to non residents are subject to external debt regulation.</p>
<p>2004 Multinational corporate, ir-respective domestic owned or foreign owned, are allowed to lend to their overseas affiliates or subsidiaries.</p>		

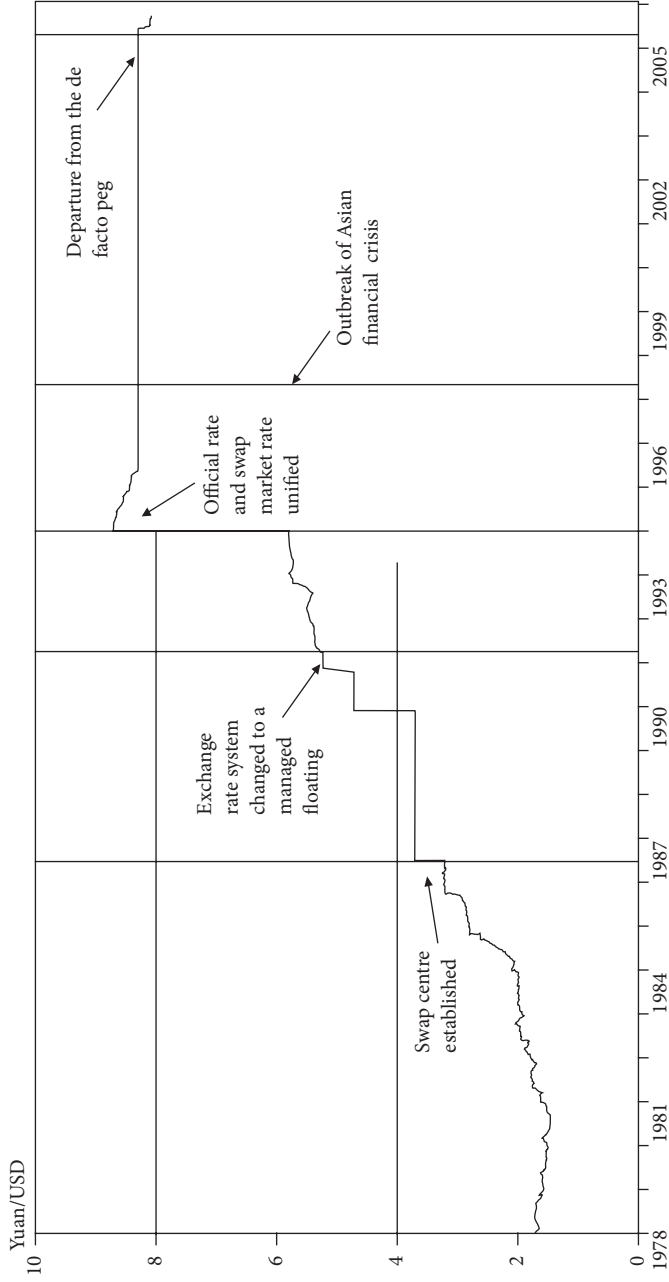
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<i>Direct Investment</i>		<i>External Debt, Guarantee and Derivatives</i>	<i>Cross-border Transfer</i>
<i>Inward</i>	<i>Outwards</i>		
2005 Domestic residents are allowed to set up companies at abroad to facilitate round tripping investment or overseas financing (issuing bonds and stocks). The industrial guidance to foreign direct investment is revised.	2005 Authorities over some capital account transactions are assigned to local SAFE bureaus. The pilot project to allow selected provincial and regional SAFE to authorise purchase of foreign exchange for outward investment is rolled out nationwide, with the total volume being raised from US\$3.3 billion to 5 billion.	2005 Domestic entities issuing guarantee for residents to foreign banks in China are subject to domestic guarantee regulation.	2005 The approval procedures for individual assets transfer is simplified.
	2005 The due import payments with maturity over 6 months and more than US\$200 thousand is required to be registered as external debt. Ceilings are imposed on the scale of the external debt of foreign investment companies. Supervision over the domestic banks' guarantee to overseas companies is changed from approval by transaction to annual outstanding balance management.		

ANNEXURE XVIII

RMB Official Exchange Rate, End of Period



Source: World Bank China Office Research No. 4 by Min Zhao, The World Bank, Beijing Office.

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