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The sustainability of growth: history and prospects

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Over the past year, China's reform era has passed its quarter century mark. This period has been characterised by sustained rapid economic growth. Rapid expansion was broken only by a year or so of what the rest of the world would consider to be moderate growth, in 1989 and 1990 (Table 1.1).

This chapter discusses the origins of the reform era in China, and presents elements of the statistical record of economic growth and integration into the international economy over the past quarter century. It concludes with discussion of challenges to the continuation of strong economic performance in China and an assessment of the prospects for sustaining rapid growth.

THE ORIGINS OF REFORM IN CHINA

The reform era has now occupied almost half of the life of the People's Republic. The past quarter century is the longest period of political order and coherent national policymaking in China since the industrial revolution in Europe and North America began to exercise profound influence over Chinese life, from about 1840. The beginning of the era of Chinese disorder and incoherence that has recently receded into history is marked by the eclipse of China by the United Kingdom as the world's largest economy, and by the coincident First Opium War and colonisation of Hong Kong. Its end is marked with even greater clarity by Deng Xiaoping's ascendancy at the third plenary meeting of the Chinese Communist Party's eleventh Central Committee, in December 1978.

Table 1.1 Output growth and inflation performance in China, 1979–2003

	Gross domestic product	Retail price index	Consumer price index
1979	7.6	2.0	1.9
1980	7.8	6.0	7.5
1981	5.2	2.4	2.5
1982	9.1	1.9	2.0
1983	10.9	1.5	2.0
1984	15.2	2.8	2.7
1985	13.5	8.8	9.3
1986	8.8	6.0	6.5
1987	11.6	7.3	7.3
1988	11.3	18.5	18.8
1989	4.1	17.8	18.0
1990	3.8	2.1	3.1
1991	9.2	2.9	3.4
1992	14.2	5.4	6.4
1993	13.5	13.2	14.7
1994	12.6	21.7	24.1
1995	10.5	14.8	17.1
1996	9.6	6.1	8.3
1997	8.8	0.8	2.8
1998	7.8	−2.6	−0.8
1999	7.1	−3.0	−1.4
2000	8.0	−1.5	0.4
2001	7.3	−0.8	0.7
2002	8.3	−1.3	−0.8
2003	8.5	−0.4	0.4
Average 1979–2003	9.372	5.296	6.276
Average 1979–1996	9.917	7.844	8.644
Average 1997–2003	7.970	−1.257	0.186
Variance 1969–1996	11.239	42.412	48.007
Variance 1997–2003	0.386	1.680	1.941
t-statistic for difference in the means of 1979–96 and 1997–2003	2.362	5.649	4.930

Source: State Statistical Bureau, various years. *Zhongguo Tongji Nianjian* [China Statistical Yearbook], Zhongguo Tongji Chubanshe, Beijing.

The beginning and the end of China's period of disorder and economic underperformance are both linked to profound changes in China's relations with what are now the advanced economies. This reality is a reminder that the gains from deeper integration into an international community are not automatic. The gains depend on China's internal capacity to utilise international opportunity effectively. They are immense when the conditions are present for effective international integration.

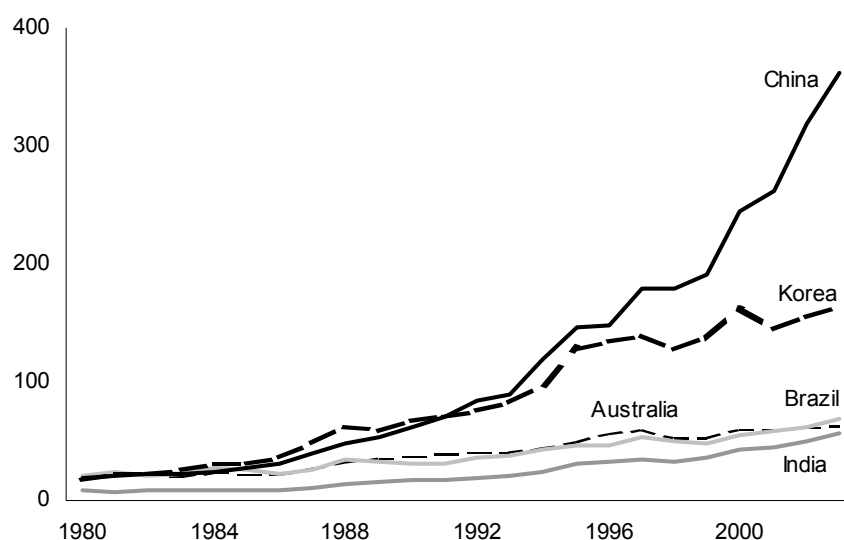
The coherence and order of the past quarter century, around increasingly ambitious economic reform and opening to the outside world, has had remarkable consequences. Amongst much else, China is rapidly increasing its share of world trade, investment and production, with the 400 million people in its Coastal provinces moving swiftly towards the frontiers of global productivity and incomes. Chinese living standards and life expectancy have increased beyond recognition. While the remaining poverty is a problem requiring an early solution, China has moved from having more people living in poverty than any other country, to having by far the most people to have recently emerged from poverty.

The volume of goods and services produced in China has increased by over seven times (Table 1.1), and the volume of international trade over ten times (Figures 1.1 and 1.2). From being one of the most closed economies in the world, China moved in two decades to receiving the largest annual volume of foreign direct investment ever to a single economy. Trade is expanding in 2004 at rates well above the average of the past quarter century, foreign direct investment at a higher rate than in most recent years, and output at about the average of the reform era.

The changes in foreign trade are at the centre of the Chinese transformation. Deep integration into the international economy has removed what had been tight constraints of resources and technology on Chinese economic development. China's abundant labour became an asset rather than a liability for economic growth when it could be traded for scarce capital-intensive and technology-intensive products (Figure 1.2). China's initial comparative advantage in labour-intensive goods at the beginning of reform ensured that the benefits of faster economic growth and deeper integration into the international economy were experienced to a considerable extent as increased demand for labour, thus spreading widely the benefits of growth and helping to entrench popular support for the new economic strategy (Figure 1.3).

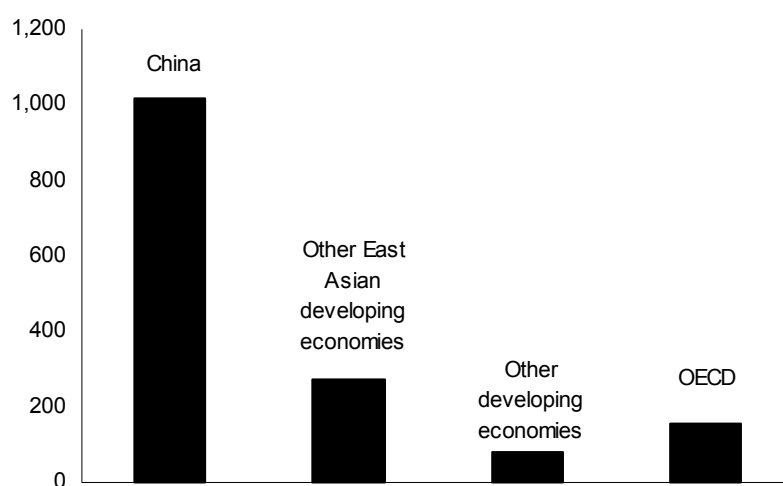
The Chinese reform era is not only a transition from socialist central planning, as reform may seem to be in Russia or Poland. The change is deeper than that. In

Figure 1.1 Exports of large developing countries and Australia, 1980–2003 (US\$ billion)



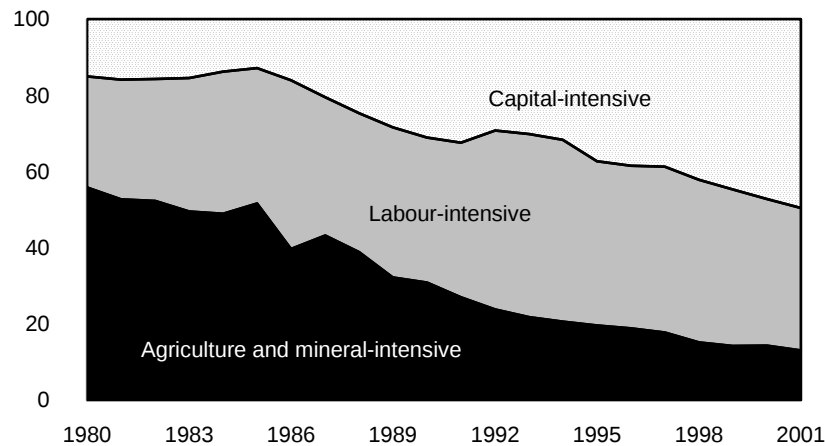
Source: International Economic Databank, The Australian National University, Canberra.

Figure 1.2 Proportionate growth of exports (constant prices), 1980–2003 (per cent)



Source: International Economic Databank, The Australian National University, Canberra.

Figure 1.3 Change in composition of exports, 1980–2001 (per cent)



Source: International Economic Databank, The Australian National University, Canberra.

the last quarter century, China has linked itself productively and comfortably to the modern, global economy and society that began to force revolutionary change in all aspects of life in the North Atlantic two centuries ago.

Seen in this perspective, Chinese reform since 1978 is not mainly a retreat from a dead-end in economic strategy that began with central planning in the 1950s. It is not mainly the unwinding of policies and institutions that were tried by the early People's Republic for a while and turned out to be mistakes. It is also and much more the expression of a new Chinese commitment to interaction with the modern world. It has emerged from the restoration of Chinese political order, alongside the transformation of many ancient Chinese institutions.

SO WHAT WERE THE CAUSES OF THIS HISTORIC RESTORATION AND TRANSFORMATION?

It helps in the search for an answer if we stop thinking of sustained rapid growth as some sort of economic miracle. The departure from the natural order of global economic life was apparent more in Chinese under-performance for one and a half centuries than in the so far incomplete recovery of lost ground in the past quarter

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century. From this perspective, strong growth since 1978 is simply the beginning of a natural catching up with economies that had for a while moved ahead.

But there was nothing inevitable about the catching up. For several decades after the Meiji restoration in Japan in the mid-nineteenth century, when China's large neighbour to the East found and applied successfully a formula for rapid absorption of superior economic methods from the North Atlantic, innovative Chinese tried to emulate that achievement in their own country. They were defeated by the weight of institutions that were deeply resistant to necessary change, and retained legitimacy from a time when they were successful beyond any others on earth. There were elements of success in applying the productive new ways of the West in the decades after the destruction of the imperial order in 1911. These remained isolated efforts as their extension outside the treaty ports was overwhelmed by political disorder, civil war and then war with Japan. The Chinese Communist Party after its success in 1949 contained a large modernising element, whose efforts were distorted by adoption of a model developed in the modernising West: the Soviet Union's embodiment of a Marxist ideal in central planning, that was later to be recognised as a failure in the countries from which China had drawn inspiration.

WHAT WAS DIFFERENT ABOUT THE NEW EFFORTS IN MODERNISATION UNDER THE DENG ASCENDANCY FROM 1978?

The political order under the reformist leadership of the Chinese Communist Party stands out as the first of the important things that were different. But after the continued dislocation of the first 29 years of the People's Republic—the Great Leap Forward, the Cultural Revolution, and the destabilising shifts of strategy before and between—this itself seems to have required an element of good fortune. It depended first of all on the surviving status of old leaders who, in the times of war and revolution, had played major roles that could create heroes, and second on the disillusionment of these grand leaders with the outcomes of the early decades of Communist Party rule. The Communist Party's judgment of Mao Zedong's historical contribution was that he had been 70 per cent right. The successful launching of reform depended on the historical legacy of order under the Communist Party, and just as much on the clear identification of the '30 per cent' that was wrong. The change of development strategy was supported by widespread unhappiness amongst Chinese with the dislocation and economic instability and underperformance of the decade which had preceded the death of Mao.

The ascendancy of the reformers, like the Duke of Wellington's description of the victory over Napoleon in the Battle of Waterloo, was a 'close-run thing'. It followed several years of what Deng Xiaoping once described to me as 'indecisive policy', after the death of Mao in 1976. It seemed inevitable only in retrospect.

The ascendancy of a new leadership was only the first of several demanding necessary conditions. China was 'in the right place at the right time' to launch a new approach to economic development. And its leaders stumbled upon a combination of reform policies that was able to accelerate growth for a while, and so establish a base for the identification of the more complex policies that could maintain the momentum of growth.

East Asia, with Japan's postwar expansion reaching maturity and the internationally oriented growth of what were called the newly industrialised economies (NIEs) reaching its height, was 'the right place and the right time'.

It was the right place because geography matters to trade and investment flows and to the international transmission of ideas about economic development strategy and policy. Throughout the period of deepening integration with the international economy, transactions with East Asia have been disproportionately large, and have grown more rapidly than those with the rest of the world until the Japanese stagnation in the 1990s. It has helped that these have been times of strong expansion in the rest of East Asia's international trade and investment, especially with the structural adjustment out of labour-intensive exports in Japan from the early 1970s and the newly industrialised economies from the mid 1980s. The easing of political tensions with Taiwan and Korea expanded China's East Asian trade and investment world from the late 1980s. Structural change continued to generate reasonably strong growth in imports into, and direct investment from, Japan, even through the Japanese macroeconomic stagnation after the early 1990s.

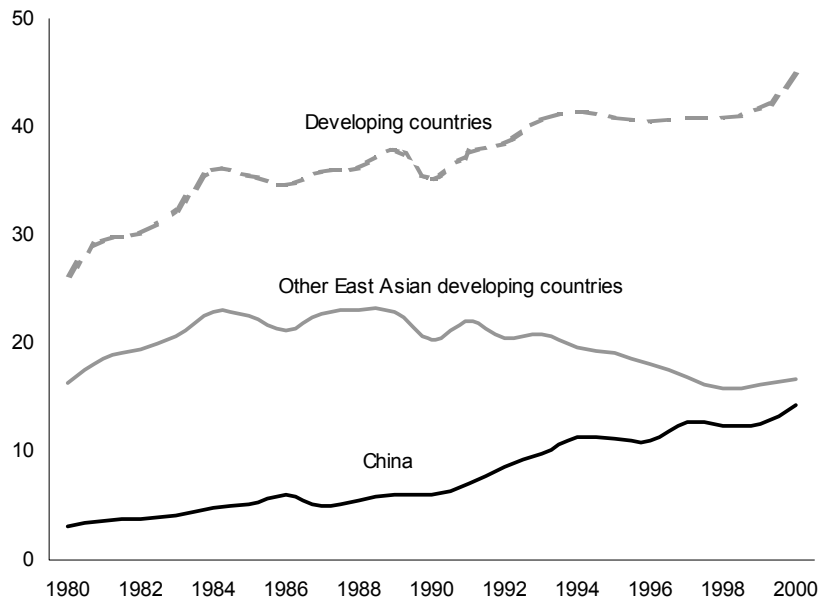
It was the right place and time because a prosperous Chinese business community in East Asia outside the People's Republic was ready to respond on an immense scale to the new opportunities in China's opening to the international community. The proximity of the Chinese business diaspora in Hong Kong, Taiwan and Southeast Asia facilitated the response.

It was the right time as well because smaller East Asian economies had pushed their way as exporters of labour-intensive manufactures to the rest of the developed world. Japan, Hong Kong, Taiwan, Korea and the first of the Southeast Asian economies had done this at a time when Cold War strategic imperatives helped contain protectionist reactions to the rise of newly competitive suppliers. Over the first decade of China's open policies, Japan and the NIEs' economic success

was causing them to vacate international markets for newly competitive suppliers, with China first amongst them. The expansion of China's labour-intensive exports could therefore proceed mainly by taking over the shares of other East Asian suppliers (Figure 1.4). Without the geo-strategic support that had accompanied the rise of Japan and the NIEs, it would have been difficult for China to force its way as a pioneer large-scale exporter of labour-intensive goods.

It was the right time for all of these reasons, and also because China was open to new approaches to economic strategy at a time when success of internationally-oriented policies elsewhere in East Asia had become evident for all to see. The contrast between the economic dynamism of Japan and the NIEs and economic instability and underperformance in China generated pressure for change in China. More importantly, the success of internationally oriented growth elsewhere in East Asia provided a model for development that was at once broadly appropriate and demonstrably practical.

Figure 1.4 Developing economy shares of world exports in labour-intensive manufactures, 1980–2000 (per cent)



Source: International Economic Databank, The Australian National University, Canberra.

I can say with some confidence that Chinese leaders 'stumbled' upon a successful growth strategy, because that is more or less what they said themselves. There was no 'blueprint' for China's economic reform and internationalisation—even less than there had been in Taiwan and Korea at the beginning of their sustained economic growth one and a half decades earlier.

But after the 1978 Plenum, there was acceptance that domestic and international exchange through markets was a necessary and acceptable component of a national development strategy. There was pragmatic acceptance that a wide range of institutions and policies that raised national economic output had a legitimate place in China—summed up in Deng's rehabilitation of an earlier Maoist exhortation to seek truth from facts. These strands were drawn together in the 1987 Party Congress' acceptance of General Secretary Zhao Ziyang's definition of China as a backward country in the 'primary stage of socialism', in which the first national objective had to be the strengthening of the national economy.

After 1978, foreign trade, foreign direct investment and the utilisation of external technology and capital in all forms became acceptable components of national policy. Local experiments with new forms of agricultural production were given legitimacy, leading within a few years to the virtually complete replacement of the people's communes with the immensely more productive household responsibility system. Markets became important for exchange for the rapidly expanding agricultural output.

The absence of a comprehensive reform strategy, the eclecticism of economic policy and the gradualism of change have been criticised by foreign observers from time to time over the past quarter century. But the absence of a blueprint was an inevitability of China's circumstances, and in practice a virtue.

It was an inevitability because in 1978 there was no conceptual basis for a market economy in China. A few leaders, and a few intellectuals around the edges of policy, had absorbed some of the elements of internationally oriented growth elsewhere in East Asia. The main understanding grew out of the new patterns of development themselves, supported at crucial times by insights from the wider East Asian experience.

The absence of a model was a virtue, because any theoretical model of reform of the centrally planned economy in China after 1978 would have been deeply flawed. The rapid unwinding of the institutions of a centrally planned economy, dominated by state-owned enterprises in the cities and communes in the countryside, is fraught with risk. We understand this reality more clearly since the unhappy experience in the former Soviet Union a decade or so after the

commencement of Chinese reform. Some of the great strengths of the Chinese economy in the era of reform came as surprises to Chinese and foreign observers alike, and would have been given an inadequate place in a program built upon received theory and the experience of others as it appeared in 1978. After the initial success of the household responsibility system, the outstanding surprise was the extraordinary dynamism of industrial production in the township and village enterprises that grew out of the disintegrating people's communes.

The surprises in institutional transformation have continued over the past five years with the extraordinary pace of development of private businesses, including through swift movement of most small and medium-sized state-owned firms and township and village enterprises into private ownership (Garnaut et al. 2001; Garnaut and Song 2004). The designers of a reform blueprint would have held up progress dangerously if they had seen the imperfections of the township and village enterprises as barriers that had to be corrected by planned privatisation at an early stage of reform.

So China's reforms succeeded partly because leaders who had confidence in some general directions of movement were bold enough to make a start before many features of the path ahead were clear. Chinese reform subsequently required transformations in ideology, in ideas about economic development strategy and policy, in law and regulatory systems, and in economic institutions. Above all, it required the accumulation of new knowledge and wisdom in a billion Chinese minds, as the Chinese people learned to do new things in an economic and social world that was changing fundamentally.

THE DOMESTIC AND INTERNATIONAL ECONOMIC CHALLENGES AHEAD

These transformations in ideology, ideas, strategy, policy, law, institutions, knowledge and experience have occurred alongside each other, reinforcing each other. For all the problems of reform and movement towards a market economy, almost all Chinese have experienced significant increases in their material standard of living, and substantial expansion in personal freedoms. This has strengthened the political base for reform and the market economy, and made a retreat into central planning and a less open economy impossible. The political tensions surrounding reform—and there are many—are of a different kind. They derive from pressures for different distribution of the benefits of economic growth.

The further the changes have gone, the closer they have taken the emerging Chinese reality to that of advanced economies and societies, and of China's East

Asian neighbours, which have lived for longer in an internationally-oriented society and economy. The further the changes have gone, the more immediately relevant have been the insights from modern economics in the advanced industrial economies.

From the profession of economics, the insights that were most relevant in the early stages of reform were relatively simple, although nevertheless crucial—the more essential because some of the most important of them were counter-intuitive to humanity everywhere. The counter-intuitive insights included the idea that markets allocate resources more efficiently and promote growth in economic output more effectively than wise people armed with large amounts of information and great power. Most counter-intuitive of all was the central insight that an economy becomes richer if it removes barriers to imports from other countries and accepts the relative contraction of some industries that inevitably follows.

The emergence of a market economy in China has made more sophisticated insights from economics more directly applicable to policy, at the same time as the modern economics profession has taken root in China, and as its practitioners have become increasingly influential in discussion of economic strategy and policy.

The increasing quality and influence of professional economic analysis make it more likely that timely solutions will be found for a number of large challenges of an economic kind to the sustainability of growth in China. I would list amongst the major challenges the weaknesses in the financial system, and the closely associated problem of disproportionate allocation of capital to an inefficient state-owned business sector; the uneven geographic dispersion of economic growth across China, with inland regions growing more slowly than the coastal provinces; the closely related issue of inefficiency in state regulation of agriculture and other aspects of the rural economy; the partly related question of growing dispersion in the interpersonal distribution of incomes; periodic macroeconomic instability, manifested in imbalances in external payments and fluctuations in the rate of change in domestic prices; and doubts about the capacity of international trading partners to continue to adjust to rising Chinese exports as China grows to occupy a larger and larger position in total global trade (see Figure 1.5 for the rising share of China in world exports).

All of these challenges are capable of solution, which can be facilitated by application of economic analysis. None in 2004 seems as daunting as did many other issues that seemed capable of blocking growth at earlier stages in the reform period. But each in itself will require a huge concentration of analysis and political will, any failure in which could have dangerous consequences. Each of the

challenges are on an unprecedented scale and, partly as a result, complexity, which increases the risks that chance events will intervene to upset the implementation of attempts at reform.

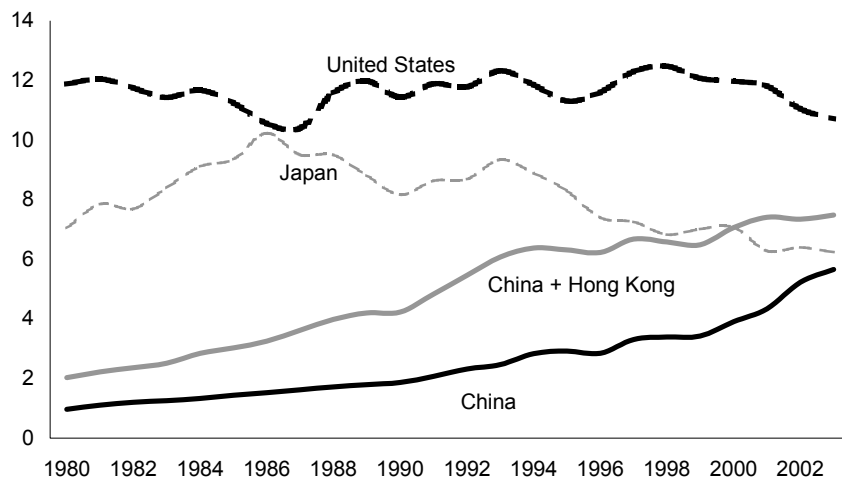
The history of overcoming barriers that in advance seemed extremely difficult over the past quarter century is a source of confidence for the future, but it provides no guarantee of success in tackling new problems, each of unprecedented magnitude for challenges of a similar kind elsewhere in the world.

A FLAWED FINANCIAL SYSTEM

The experience with financial crisis in developing East Asia in 1997 and 1998 has heightened awareness of the risks inherent in the flawed Chinese financial system.

The awareness itself improves the prospects for timely corrective action. Non-performing loans are large as a proportion of bank assets by any standards, and comparable with pre-crisis ratios in several East Asian economies that were damaged greatly in the financial crisis of the 1990s.

Figure 1.5 Share of world exports, 1980–2003 (per cent)



Source: International Economic Databank, The Australian National University, Canberra.

Some features of the Chinese loan problem are unusual. Fifty-eight per cent of assets in 2003 were held within just four major commercial banks, a ratio that has fallen quickly over recent years from 70 per cent in 1997 (this remains an unusually high concentration of assets in the top four banks, although exceeded by Singapore, Australia and Thailand amongst substantial economies in Asia and the Western Pacific). Non-performing loans ('unpaid loans' in the Chinese nomenclature) are overwhelmingly held by these four state-owned banks. In early 2004, they represented, officially, 21 per cent of the Industrial and Commercial Bank of China's assets, and 30 per cent of the Agricultural Bank of China's assets. The ratios of non-performing loans in the Bank of China and the China Construction Bank were lower (16 and 9 per cent, respectively) following the injection by the state of US\$45 billion to recapitalise them early in 2004. The cheap and easy credit, especially to state-owned enterprises in the investment boom of 2003 and continuing into early 2004, seems to have been creating excess capacity in some real estate and manufacturing and to be adding to future asset quality problems.¹

The non-performing loan ratio is considerably lower in other categories of banks, which are younger, and under less pressure to make 'policy loans' to state-owned enterprises.

The assets of the state-owned banks are supported by explicit or implicit state guarantees. There is no prospect of a banking crisis for as long as the state is willing and able to provide adequate fiscal support. The state's fiscal capacity is large compared with any foreseeable requirement to recapitalise the banking system, and expanding with growth in the economy.

The challenge of the flawed banking system to sustained growth is not its potential to precipitate financial crisis. It is of another kind. The commercial banks do not have the management capacity to assess risk adequately and to allocate capital efficiently to its most profitable uses. The banks are the main source of investment capital—more so than in most developing and developed countries. The ratio of bank loans to GDP in 2003 was close to the highest in Asia and the Western Pacific at 148 per cent. This was comparable with the other Chinese economies Taiwan (154 per cent) and Hong Kong (146 per cent), and much higher than others in Asia and the Western Pacific.

The banks have access to a high proportion of the extraordinarily large Chinese household savings. For the most part, they direct these savings to the least productive and profitable businesses in China—the large businesses that remain in state ownership. For the most part, they deny resources to the dynamic, productive domestic private sector, which continues rapidly to expand its share of economic activity despite unfavourable treatment in the allocation of capital and in other ways.

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Discrimination by the banks against the private sector is no longer a consequence of state policy. It is now a reflection of private prudence by officers of state-owned banks, with weak capacity for evaluation of business risk, and increasing responsibility for bad lending decisions. Bank officers know that it is far less personally damaging to make a loan to a large state business with the encouragement of high officials, and for that loan to fail to perform, than to make a loan that is not serviced according to contract to a smaller and especially to a privately owned firm.

The correction of this important weakness of the banking system must have many parts.

Reforms to financial legislation and regulation have given the official regulatory authorities more of the powers and roles enjoyed by their counterparts in advanced market economies. The building of a new legal framework has gone a long way. The development of the capacity for the regulatory authorities to conduct their new responsibilities effectively will take much longer. There are major tasks in the restructuring of the regulatory agencies. Around 300,000 officials are employed by the regulatory agencies relating to the financial sector, few of whom have the experience and training required for their new functions. The task of recruitment, training and removal of people who are not able to succeed in a difficult professional transition is immense. In the most favourable of circumstances, it will take a long time.

The task of restructuring the state-owned financial institutions, especially the banks and insurance companies, and recruiting and training staff for new functions and new approaches to work is even more formidable.

The task of reform has made significant headway over the past few years. It is now being supported by acceptance of foreign equity into many financial institutions—mainly in the last two years. Foreign equity participation is expanding rapidly, including from two Australian banks in 2004. This process will accelerate over the next few years as China implements its commitment to end non-prudential measures restricting ownership after 2006 under its agreement on entry into the World Trade Organization (WTO), and as the management advantages of foreign enterprises are recognised more clearly and utilised more effectively. It is probable that financial entities with majority foreign ownership will come to play major leavening roles in Chinese financial development.

The expanding roles of foreign entities have been preceded by the emergence of a range of domestic privately owned financial institutions of substantial size. Developments along these lines have already been important, but have been held

back by the combination of management weaknesses in private financial enterprises and the caution of inexperienced supervisory officials.

The continuation of rapid privatisation of state-owned businesses and, separately, the explosive growth of the private sector, is increasing the urgency of fundamental financial reform. But in the short-term, pending effective reform, it is tending to increase the privilege in access to capital of those enterprises, mostly large, which remain in majority state ownership.

The middle stages of financial reform may be associated with increasing risk of financial crisis, as entities that cannot rely on state support become more important in the system. This in itself will generate caution about the pace of change. The risks will be less the more China relies on international financial enterprises, the strength and geographic diversity of whose asset portfolios provides protection against domestic financial shocks. Recognition of this reality is likely to be more important in the expansion of the roles of foreign entities over the next several years than the formal requirements of the agreements on WTO entry.

GROWING REGIONAL AND INTERPERSONAL INEQUALITY

The rapidly expanding importance of the private market economy, to proportions that are now comparable to advanced industrial economies, and the concentration of opportunities for rapid economic development under the open policies in the coastal provinces, are together generating strong tendencies to wider dispersion in the distribution of incomes. These politically contentious issues are again a major focus of this year's China Update volume (Chapters 4,8,9 and 11).

Two sets of reforms are crucial to constraining the widening of income inequalities in ways that support rather than contradict the continuation of economic growth. One is the removal of artificial barriers to the movement of people, capital, goods and services within China. The other is the introduction of effective income taxation and social security systems.

The rate of increase in rural and especially farm incomes has been held back for most of the past decade by a retreat into state regulation of production and trade in farm products. This is now being unwound, generating another period of stronger growth in farm incomes (see Chapter 4 and Rozelle et al. 2004). Rozelle et al. (2004) present data indicating that the reduction of internal transport and transaction costs on movements of goods has reduced these impediments to rural incomes growth to levels comparable to advanced industrial economies. This is an achievement of high historic importance. There has been much less progress in reduction of the even more important barriers to movement of people,

and on the necessary improvement of education in inland rural locations, to prepare young people for productive lives outside poor rural areas.

There is at least growing realisation that the household registration system, which excludes migrants from rural areas from a wide range of urban services, is an impediment to reduction of the most egregious inequalities in contemporary China. There is as yet little evidence of the national political will that would be required for comprehensive reform.

Progress on taxation and social security reform is being built on increasingly sophisticated analysis of the issues. Reform is being driven by realisation of the politically explosive nature of continuing unemployment amongst people retrenched from the restructuring of state-owned enterprises. In contrast to reform of the household registration system, here the slow progress reflects the sheer complexity and scale of the task more than resistance by established interests.

MACROECONOMIC INSTABILITY

Last year's China Update volume (Garnaut and Song 2003), written at the height of international excitement at China's economic growth, warned that the febrile macroeconomic environment, fuelled by state expenditure, would require early correction if China's rapid growth was to be sustained (Garnaut 2003). At a time of zero inflation and of substantial trade and current account surpluses, it foreshadowed the early emergence of inflationary pressures and of external deficits. The necessary response was a reduction in the expansion of direct public expenditure and lending by the state banks to other state-owned enterprises.

The turn around in macroeconomic conditions became apparent late in 2003, with import growth exceeding that of exports by a wide margin and removing most of the trade and current account surpluses. Consumer prices, led by food, began to rise at an annual rate of about 5 per cent after a long period of deflation or price stability (see Chapter 2, this volume, for the detail).

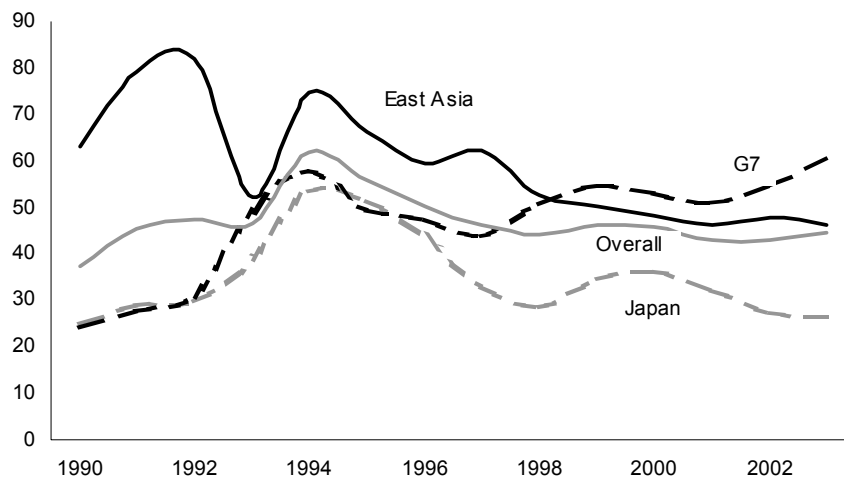
The inflation has some interesting features, not present earlier in China. Rising food prices were part of the response to the running down of much of the huge grain surpluses accumulated in the late nineties in response to inefficient agricultural regulation. Higher farm prices reduced the supply of labour from rural areas, at a time when labour demand was increasing rapidly and tending to push up wages in the rapidly expanding coastal provinces, where the boom in foreign trade and investment has been concentrated.

So part of the new inflation reflects structural changes that are likely to be continuing features of the Chinese economy. Coastal China has commenced the

structural transformation that is an inevitable consequence of successful economic growth in the East Asian pattern. Increasingly, with rising costs of labour, the accumulation of capital in all forms, including in the skills of the labour force, the coastal province's comparative advantage is shifting towards more sophisticated and capital-intensive production. This is already evident in the rising shares of capital-intensive products in China's exports (see Figure 1.3). It will go much further.

The policy response came in February 2004, most importantly as restrictions on investment in heavy industry by state-owned enterprises. This sent a shudder through global commodity and financial markets, amidst speculation about whether there would be a 'soft landing', and about whether more disruptive intervention would be seen as being necessary to complete the correction. In September 2004 there are signs of substantial reduction in investment in heavy industry, and the temperature in markets for industrial inputs has fallen. So far so good. However, continuing downward pressure on lending to state enterprises over a long period is required if the imbalances discussed last year are to be removed.

Figure 1.6 China in the East Asian crisis, competitiveness index, 1990–2003 (1990=100)



Source: International Economic Databank, The Australian National University, Canberra.

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The process of rising wages and structural transformation towards more sophisticated patterns of production can be slowed but not stopped by continued large-scale migration from the inland provinces. This provides opportunities for accelerated development in inland China through emigration, transfers of income, and through the shift of production capacity in labour-intensive production.

The size and heterogeneity of the Chinese economy introduces some special challenges into macroeconomic policymaking. The rise in real costs and associated structural change in coastal China over a long period could occur through inflation (as it mostly did in Japan before the currency adjustments of the early 1970s and in Korea and Taiwan before the exchange rate adjustments of the mid 1980s), or through nominal exchange rate appreciation (as in Japan in the mid and late 1970s, Korea and Taiwan from 1985, and Singapore throughout the period of its structural transformation).

The special complication in China is that non-inflationary increases in real costs in coastal China through currency appreciation would generate falling prices—all the disadvantages to development of deflation—in the Chinese inland. For this reason, there are advantages in China adopting over a long period of time a combination of exchange rate and monetary policies that secure price stability in the inland alongside moderate inflation in the coastal provinces that are experiencing real cost adjustment and rapid structural change.

These considerations in choice of exchange rate regime have not yet entered the main policy discussion.

More generally on the exchange rate regime, further exchange control and trade liberalisation, the increase in domestic demand and imports and inflation have removed the substantial basis for concern about exchange rate undervaluation that excited international interest in 2003. The case for changes in the exchange rate regime does not at the present time include chronic undervaluation. There are large advantages for China and its international partners in maintaining focus on exchange control and trade liberalisation as instruments for continued external adjustment in the period immediately ahead. The choice of exchange rate regime is discussed further in Chapter 5.

PROBLEMS IN THE INTERNATIONAL TRADING SYSTEM

China's early rapid expansion of labour-intensive exports through the 1980s was facilitated by two features of the international institutional and economic environment at that time. First, the multilateral trading system enjoyed the strong support of major countries including the United States. Despite costly exceptions for agricultural

products and textiles, it was generally supportive of newly competitive suppliers to international markets. Second, structural change in other East Asian economies was providing considerable access for labour-intensive exports in the markets of the advanced economies on the back of declining shares for established suppliers.

By the end of the 1980s, China's exports of the main labour-intensive products, textiles clothing and footwear, were being more tightly constrained in North American and European markets by country quotas under the Multifibres Arrangement. Other export commodities were being harassed in many markets by anti-dumping and other contingent protection measures. The tensions in trade relations with the main Western countries intensified with the cooling of political relations after the Beijing massacre in 1989.

Nevertheless, China's rapid export expansion continued with barely a pause. Several factors worked to ease market access. The establishment of bilateral trade with Taiwan and especially Korea opened substantial new opportunity. The enthusiastic extension of internationally oriented growth after 1992, spurred by Deng Xiaoping's exhortations on his last visit to southern China, saw a huge expansion of foreign direct investment reducing transactions costs in international trade and raising productivity in the export industries.

These factors helped to maintain some momentum in export expansion even through the Asian financial crisis and the associated appreciation of the real exchange rate (see Figure 1.4). The restoration of growth and real appreciation elsewhere in Asia underpinned the subsequent export boom that continues today.

The international trading environment for China reached a new high point with entry to the World Trade Organisation in 2001. The gains to China from WTO membership are continuing to expand and will do so until the transition is complete late in the current decade. The gains of WTO membership are coming from China's own liberalisation, constraints against arbitrary denial of most-favoured-nation treatment, removal of the restrictive country quotas in European and North American textiles markets with the end of the Multifibres Arrangement from the beginning of 2005, and access to the WTO disputes settlement machinery. The gains were to be restricted for some time by transitional arrangements that allowed treatment of China as a non-market economy for anti-dumping purposes.

Despite its recent success within the multilateral trading system, China over the past two years has participated enthusiastically in the Asia Pacific region's new-found commitment to bilateral and discriminatory trading agreements. This is partly defensive, in response to other countries' negotiation of preferential trading arrangements, but as in other countries also reflects weakness in policy analysis.

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China's first 'Free Trade Agreement' (FTA), with ASEAN, was begun with the removal of restrictions on bilateral trade in fruit and vegetables from 1 January 2004. Bilateral liberalisation in other sectors remains under discussion. When Australia sought a bilateral FTA in mid 2003, China made the granting of market economy status a condition of entering negotiations. This has become a politically contentious issue in Australia that must be resolved before progress can be made. Meanwhile, ASEAN and New Zealand have moved ahead of Australia in the FTA queue by granting market economy status.

It is not clear where this headlong descent into preferential trade will leave the Asia Pacific and global trading systems. It seems at first sight that China will lose less than others from these developments, as it is able to use the bargaining weight offered by its size as a market to secure favourable bilateral arrangements, including on matters away from the centre of conventional trade policy.

China has also been active in seeking to secure its interests in the multilateral trading system, including through taking positions supportive of liberalisation in discussions on the WTO Doha Round of multilateral negotiations. It threw its weight behind the 'G20' group of developing economies that emerged as a force for liberalisation of trade in goods in Cancun, albeit with a strong developing country bias, but since then has made it clear that its efforts will not be confined to this group. China's emerging role in the international trading system is discussed further in Chapters 6 and 13.

A closer examination raises larger questions about whether the exceptional export growth of recent years, and the resulting structural change, would be sustainable in a world in which the multilateral trading arrangements were seriously compromised. China needs access to global markets for continued rapid growth in its trade to be acceptable to its partners. Preferential trading arrangements concentrate adjustment to the growth of China disproportionately in China's preferential partners. Ultimately this complicates the continuation of access to export markets on the scale that China requires, even if China is able to secure special concessions from particular partners through bilateral negotiations. These realities are bound to make China a major player in systemic development in the period ahead.

THE DOMESTIC AND INTERNATIONAL POLITICAL CHALLENGE

The economic challenges to sustained growth discussed in this chapter are large. A failure in any one of them could set back the rise in productivity and the growth in living standards as well as China's role in the international economy for several

years. But, in each case, Chinese leaders and technocrats are mindful of the issues, have access to sound advice on the reform agenda, and face no insurmountable domestic barriers in implementing promising strategies. Now more than at any time in the past quarter century, it seems unlikely that failure of economic reform and policy responses to mainly economic challenges will end prematurely the completion of the restoration of China's historic position near the frontiers of world economic activity.

The larger doubts about the sustainability of rapid economic growth in China arise from uncertainty about the domestic and international political transitions that must accompany economic change on the immense scale of the Chinese restoration. These political challenges are not the subject of the present book, but we are wise to keep them in mind.

The Chinese political order of the past quarter century has been built on the continuing hegemony and to some extent legitimacy of the Chinese Communist Party, albeit a Party that has undergone fundamental change in its guiding doctrines. The Party has undergone transformation in its internal governance over the reform period, reflected recently in the completion of the orderly transfer of state, Party and military power from Jiang Zemin to Hu Jintao. There has been substantial democratisation of leadership selection and control at lower levels of government.

It is inevitable that continued expansion of the market economy, improving education, the extension of modern information technologies into all corners of China, the expansion of domestic and international travel and communications and the personal self confidence that comes with growing scarcity of labour and higher and more secure labour incomes will generate pressures for wider participation in selection and control of national executive government.

This is not an urgent matter for this year or next. But major accommodating change will have to be led by China's leaders, at some time long before the graduation of China as one of the world's high income countries. The alternative will be loss of the internal cohesion and order that was the starting point of the new departures in economic policy and strategy a quarter of a century ago.

The other large threat to sustaining rapid growth over a long period in China is a breakdown of productive relations and in the worst case war with the world's one superpower, the United States. Mismanagement of the Taiwan issue in Beijing, Washington and Taipei could lead to the worst of outcomes. For the time being, the dangers have been substantially diminished by US preoccupation with the terrorism threat, in the management of which China has given the United States considerable support, including through participation in the UN-led military intervention in Afghanistan.

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NOTES

¹ These and other data on the Chinese banking system are drawn from a recent unpublished paper by Ping Xinqiao, Fan Ying, Hao Chaoyan and Mao Lian, presented to the Tenth Anniversary Conference of the China Center of Economic Research, 15 September 2004.

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