

of modern market economies improves the short-term tradeoff between growth and inflation.

This paper is organised as follows. Part 2 presents the case for economic restructuring. Part 3 analyses the macroeconomic record. Part 4 evaluates the post-1997 reflation package. Part 5 takes up the question of the susceptibility of China to the type of financial crisis that had hit Asia in 1997–98. Part 6 examines the issue of under-consumption and the need for financial restructuring, especially in the rural sector, if China's high growth is to be prolonged. Part 7 discusses the issue of enterprise restructuring. Part 8 contains brief concluding remarks.

2. THE RESTRUCTURING IMPERATIVE

The successful completion of the bilateral US-China negotiations in November 1999 over the conditions of China's entry into the World Trade Organisation (WTO) marks a watershed on many fronts for China. First and foremost, China's admission into WTO marks an important improvement in the economic security of China. Trade and foreign investment have constituted an important engine of growth since 1978. The requirement for annual renewal by the U.S. Congress of China's normal trading relationship with the United States made China's economic growth vulnerable to the vagaries of American domestic politics. Through WTO membership, this engine of growth could no longer be unilaterally shut off by the United States without the action being a major violation of international law.

WTO membership also marks a watershed in China's public recognition about the primary source of its impressive growth in the last two decades. The WTO is an international economic organisation that specifies and enforces broadly similar economic policy regimes on its membership. China's willingness to join such an institution reflects more than a desire to protect itself from potential blackmail by the United States, it also reflects China's realisation that the active ingredient in Deng Xiaoping's recipe for conjuring up growth was the convergence of China's economic institutions to the economic institutions of modern capitalist economies, particularly of East Asian capitalist economies.

At the early stages of China's reform when most of the intelligentsia did not know the full extent of the economic achievements of their capitalist neighbours, and when most of the top leaders were ideologically committed to Stalinist-style communism, it was important for the survival of the reformist faction of that time that the changes to China's economic institutions were comfortably gradual, conveniently located in areas far from Beijing, and cloaked in the chauvinistic rhetoric of experimentation to discover new institutional forms that are optimal for China's socialist system and particular economic circumstances. After twenty years of evolution in economic institutions, of rotation in political leadership, and of tectonic change in the political fortune of the communist parties in Eastern Europe and the former Soviet Union, the only organised opposition today to the continued convergence of China's economic institutions to international forms comes from a small group of sentimental Stalinists like Deng Liqun.¹ The social and political landscape in China has changed so much that the political leadership now incurs only minimal ideological liability when they introduce more capitalist incentives (e.g. differentiated pay, leveraged buy-out, stock options for managers) and capitalist tools (e.g. joint-stock company, bankruptcy law, unemployment insurance). The leadership is hence confident that its explicit embrace of capitalist institutions under WTO auspices would be seen by the general Chinese public (and the Chinese elite) as a step forward in the reform process rather than as surrender of China's sovereignty in economic experimentation.²

It must be underscored that WTO membership will involve considerable costs to China. China has agreed to reduce its industrial

¹ For recent warnings from this faction against perceived suicide by the Communist WParty, see "Elder warns on economic change," *South China Morning Post*, January 13, 2000, and "Leftists make late bid to slow reforms," *South China Morning Post*, February 10, 2000.

² This de facto public recognition by the government that the *deus ex machina* of China's impressive growth since 1978 is the convergence of its economic institutions to those of market economies will unfortunately not end the academic debate on this issue. Many China specialists have waxed eloquently about how China's experimentation has created economic institutions that are optimally suited for transition economies in general; see Sachs and Woo (forthcoming) for a survey of this debate.

tariffs from an average of 24.6 percent to 9.4 percent by 2005, and its agricultural tariffs from an average of 31.5 percent to 14.5 percent by 2004. China has also agreed to liberalise trade in many services, including telecommunications, insurance and banking. Compliance with WTO rules will create substantial dislocation in China, albeit for the sake of a better future. China is a natural food-importer and a natural factory-oriented society given its low land-man ratio. The agricultural sector employs over 320 million people, which is over two-third of the rural labour force. The bulk of China's state-owned sector, which employs over 40 percent of the urban labour force, survives only because of various forms of subsidies and import barriers, both of which contravene WTO regulations. The agricultural sector and the state sector together employed 47 percent of the total labour force in 1998. Conservatively, a fifth of China's workers may have to change jobs, and this could be a politically destabilising process if not handled adeptly, and if external shocks were to slow down economic growth.

The tradeoff between stability and restructuring that is so starkly brought to the forefront by China's admission into WTO is not a new tradeoff. China's WTO membership has really accentuated an existing dilemma and not introduced a new one. The government has always realised that the soft budget constraint of the inefficient state-owned enterprise (SOE) sector is a constant threat to price stability, and the diversion of resources to keep this sector afloat is a drag on economic growth. But serious restructuring of SOEs means much more than facing higher urban unemployment, it also means confronting the politically powerful industrial-military complex and the industrial-bureaucratic complex. Economic rents now pose a bigger obstacle to restructuring than ideological sentimentality, and, unlike the latter, it is not something that the mere passing of time will resolve.

Luckily for China, the job of restructuring had been made easier because China's economic structure in the early years of the reform could allow growth to occur without much restructuring. This is because China in 1978 was still an undeveloped economy dominated by self-subsistence peasant agriculture, unlike the urbanised Central European and Russian economies in 1989 which had an overabundance of heavy

industries. This meant that the introduction of market forces caused economic development in China but economic restructuring in Poland and Russia, which translated, respectively, into output growth and output decline.³

The movement of Chinese labour from low-productivity agriculture to higher-productivity industry, and from the poor inland provinces to the richer coastal provinces produced an average annual growth rate of 10 percent in the 1978–95 period. The Chinese state sector certainly did not wither away in this period; it employed 18.6 percent of the workforce in 1978 and 18.0 percent in 1995, and there were 38 million more state workers in 1995 than in 1978.⁴ There was reallocation of labour from agriculture to industry but not reallocation of labour from state to non-state enterprises. China in 1978 was thence very different from Russia in 1991; extensive growth was still possible in China whereas it had run its course in Russia.⁵

Since China was in the fortunate situation of being able to postpone most of the pain of restructuring, it was quite understandable that China did so. The result is that after two decades of “reform and opening,” the job of economic restructuring is far from done. Among the many daunting tasks left are:

- a government sector that is still too large (despite a recent cut in the size of the central bureaucracy), too intrusive, and susceptible to corruption;

³ This argument is developed in Sachs and Woo (1994).

⁴ The 18.0 percent for 1995 is calculated from the *China Statistical Yearbook 1996* because the total workforce data from 1990 onward was revised upward in the *China Statistical Yearbook* of the succeeding years by increasing the size of the rural workforce. The revised data is inconsistent across time, the growth in labour force between 1989 and 1990 is now 15.5 percent (!), while the old data shows an increase of 2.5 percent. Using the revised data, the SOEs employed 17 percent of total labour force in 1995.

⁵ Easterley and Fischer (1994) showed that extensive growth came to a quicker end in Russia than would be in capitalist market economies because the elasticity of substitution between capital and labour in Russia was much lower.

- a state-owned enterprise (SOE) system that has proved itself resistant to numerous efforts to increase its efficiency and profitability;
- a state-dominated financial system where the banks lack the ability to assess the economic merits of proposed projects, and, worse, have shied away from lending to non-state enterprises, the most dynamic component of the economy; and
- inadequate institutional infrastructure to allow smooth running of a market economy; for example, an efficient commercial court system, speedy bankruptcy procedures, independent mechanisms to mediate labour conflict, uniform accounting standards, and social safety nets are really not yet in place.

It was only after the ascent of Zhu Rongji to the prime ministership in early 1998 that a decisive program of restructuring was implemented. The size of the central government was cut by a third, and the process of privatising many small and medium enterprises was speeded up. Twenty million workers left the payroll of state-owned units in 1998, compared to two million in 1997. This represented an 18 percent reduction in state employment in one year!⁶

Now that China is entering WTO, it can no longer postpone the required restructuring of the inefficient components of its economy. However, the restructuring job was made more difficult in the last two and a half years because of negative external shocks. The Asian financial crisis caused Chinese exports to East and Southeast Asia to decline tremendously, and Chinese exports to North America and Western Europe to face increased competition from the Asia countries whose currencies had fallen in value against the Renminbi (RMB). Foreign direct investments amounted to \$40 billion in 1999, down from \$45 million in 1998. The result was a GDP growth rate of 7.8 percent in 1998 and 7.1 percent in 1999, despite the government's vigorous attempts to reflate the economy since mid-1998.

⁶ This is such a large shift that it raises the discomfoting thought that some of the shift may be a mere change in employment classification without change in work conditions; an issue that we cannot go into here.