China’s Great Economic Transformation

Thirty years of change have modernized China’s economy

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China’s massive, protracted, and unexpected economic upsurge began in the late 1970s and continues nearly 30 years later. China’s extended boom began at remarkably low levels of income and consumption. Its growth spurt is remarkable for its geographic spread as well as its speed and longevity. While coastal regions have led the upward march of output, exports, and income, China’s central and western regions have recorded enormous gains as well.

Rapid advance in output per capita has elevated hundreds of millions from absolute poverty. Using an early official poverty indicator, the share of impoverished villagers drops from 40.7 percent in 1980 to 10.6 percent in 1990 and 4.8 percent in 2001. A second indicator shows higher proportions living in absolute poverty, but indicates a comparable trend (75.7 percent impoverished in 1980 and 12.5 percent in 2001).

China’s economy has abandoned its former isolation in favor of deep engagement with world markets. The trade ratio, which measures the combined value of exports and imports as a share of gross domestic product (GDP), jumped from under 10 percent prior to reform to 22.9 percent in 1985, 38.7 percent in 1995, and 63.9 percent in 2005—a level far higher than comparable figures for any other large and populous nation. China has also become a major player in the global market for foreign
direct investment, receiving annual inflows in the neighborhood of $70 billion during 2004–06 and generating moderate, but rapidly increasing, outflows of direct overseas investment ($16.1 billion in 2006).

China’s economic ascent rests on a series of gradual, often discontinuous, and continuing transitions. A massive exodus from the villages has reduced the farm sector’s share of overall employment from 69 to 32 percent between 1978 and 2004, while the farm sector’s GDP share fell by more than half.

The slow retreat of planning has cumulated in a dominant role for market outcomes. Price determination, formerly concentrated in official hands, now reflects shifts in supply and demand. Data for 2000–03 indicate an 87 percent share of market pricing (as opposed to prices that are fixed or guided by government) for “means of production”; comparable figures for farm products and consumer goods exceed 90 percent.

Following a quarter century of liberalization, markets for products, labor, and materials are well developed and increasingly competitive. While investment decisions, capital markets, and transfer of ownership rights still bear the imprint of official preferences, the overall impact of market forces continues to deepen. Despite the dominance of state ownership in finance, telecommunications, steel, petroleum, tobacco, and other important sectors of the economy, private entrepreneurs continue to push into sectors formerly reserved for public enterprise. The Organization for Economic Co-operation and Development’s estimates show the private sector, which scarcely existed at the start of reform, accounting for 59.2 percent of China’s GDP for 2003. Thus, China’s reforms brought these momentous shifts, from poverty to growing prosperity, from village to city, from plan to market, from public toward private ownership, and from isolation to global engagement.

Key factors in China’s reform success

China’s pre-reform plan system saddled the economy with costly defects that constrained its economy to a path that delivered modest gains at best and indubitably failed to satisfy Chinese ambitions. In economic terms, Chinese socialism held the economy far below its production frontier while severely restraining the frontier’s outward movement.

In China, partial measures affecting incentives, prices, mobility, and competition—what might be termed “big reforms”—created powerful momentum, which easily dominated the friction and drag arising from a host of “smaller” inefficiencies associated with price distortions, imperfect markets, institutional shortcomings, and other defects that retarded growth and increased its cost but never threatened to stall the ongoing boom.

Rural reform

Early initiatives in the farm sector illustrate the impact of limited reforms affecting incentives and mobility. The shift to household cultivation meant that farmers could claim the fruits of extra effort for themselves. The restoration of household farming immediately reinstated the link between effort and reward throughout rural China. Substantial increases in official purchase prices, especially for grain, added to the rewards from extra effort. With new incentives spurring work effort, farm output jumped quickly, even though the post-reform rural environment retained important elements of the planned economy.

The response to early rural reforms quickly spread beyond the farm sector. Following the revival of agriculture, rural industry, now fortified by greater access to the cities, rising incomes among potential rural customers, increased supplies of agricultural inputs, and throngs of eager job seekers, bounded ahead with renewed vigor. The resulting shift of employment from farming toward rural industry began the continuing exodus from farming—an important component of economy-wide productivity change during the early reform years.

Freeing the market

Encouraged by the explosive response to partial reform of the rural economy, officials pressed ahead with urban reform efforts focused on improving the performance of state-owned industry. Early urban reforms achieved only limited progress toward their main objective of “enlivening” state-owned enterprises (SOEs). They did, however, contribute to the expansion of rural industry and urban collective enterprises by opening new markets as well as new sources of materials, subcontracting opportunities, and technical expertise.

A unique policy innovation was instrumental in spurring the development of urban and rural collective industry as well as increasing market awareness and efficiency within the state sector. Rather than eliminate plan allocations at official prices, China’s reformers created a dual price system that split transactions for most commodities into plan and market components. Once producers had satisfied plan requirements, they could distribute after-plan residuals at increasingly flexible prices. This initiative thrust market forces into the economic lives of all Chinese households and businesses. Furthermore, this
landmark change avoided the economic or political earthquakes associated with privatization or full liberalization of prices. The arrival of dual pricing instantly recast the plan system as a vast array of taxes and subsidies.

This novel arrangement reversed two central shortcomings of the plan system: rigid prices and neglect of innovation. Participants in China's economy—including the large SOEs at the core of the plan system—now faced a new world in which market prices governed the outcome of marginal decisions to sell above-plan output or purchase materials and equipment.

By the turn of the century, notwithstanding significant exceptions associated with the pricing of credit, risk, and foreign exchange, supply and demand had emerged as the main arbiters of prices throughout the Chinese economy. Expanded, but still incomplete, price flexibility also facilitated the process of whittling away at barriers to mobility, which had restricted the transfer of labor, capital, commodities, and ideas across administrative boundaries under the plan system.

The hukou system of residential permits offered the largest hindrance to mobility, curtailing productivity-enhancing transfer of workers out of agriculture and stunting the growth of urban service occupations. Additional restrictions arose from campaigns promoting local and regional “self-reliance,” which rolled back regional economic specialization, forcing many localities to abandon specialty crops in favor of low-productivity subsistence farming. Dual pricing enlarged markets that provided opportunities for entrepreneurs to purchase materials and equipment, manufacture products newly in demand or neglected by the plan system, and sell them profitably. The same markets allowed rural migrants to pursue employment opportunities, first in nearby towns and later in distant cities, where they could now use cash to purchase food and other essentials formerly available only to holders of location-specific ration coupons.

Although reform did not eliminate price distortions or barriers to the mobility of people and goods, the beneficial consequences of allowing people to respond to price signals were enormous. Villagers needed no precise calculation to see that they could raise their incomes by taking up non-farm occupations; several hundred million recognized the opportunity and made the choice. Erosion of long-standing prohibitions against development of the tertiary sector produced an explosion of new activity involving restaurants, retail outlets, private schools, and a vast array of other activities.

Opening to the world

As the influence of markets, price flexibility, and mobility expanded within the domestic economy, a separate strand of reform began to move China's isolated system toward greater participation in international trade and investment. During the late 1970s, an abortive plan to expand imports revealed huge latent demand for foreign equipment and technology. In the ensuing debates, China's leaders agreed to establish four tiny "special economic zones" in Guangdong and Fujian. Initial operations in these zones seemed directionless and inconsequential, but the arrival of ethnic Chinese entrepreneurs, mostly from Hong Kong and Taiwan, turned the zones into drivers of regional and eventually national growth.

China's progression from near-isolation to extensive openness to international trade and investment added a new dimension to economic growth. Access to commodities, information, and trade opportunities linked to international markets expanded steadily from the tiny initial base as the number of special zones and open cities rose and as the scope of permissible activity stretched to encompass direct foreign investment along with import-export trade. Rapid expansion of overseas study, international travel, and publication of information from abroad (including abundant translations) multiplied the points of contact between the domestic and global economies, as did the easy interchange with overseas Chinese entrepreneurs, tourists, and kinfolk.

The emergence of foreign-linked joint ventures, and eventually of wholly owned foreign firms, as major elements of China's economy brought millions of Chinese workers, engineers, and managers into direct contact with the technical standards, engineering processes, and management practices needed to compete in global markets. The expansion of supply networks linked to export production or to foreign-owned businesses connected increasing numbers of purely domestic operators with international standards and practices. Growing foreign presence has consistently strengthened the demand for new reform initiatives, for instance, allowing firms to recruit employees through public advertisements (during the 1980s) or establishing a legal foundation for equipment leasing (during the 1990s).

From an initial position of extreme isolation, China has now attained a high degree of economic openness. With few sectors of the economy effectively shielded from global markets, incumbent suppliers of soybeans, machine tools, retail services, and an endless array of other goods now confront the entry of rival producers from the United States, Italy, Japan, Bangladesh, or Brazil as well as Jilin, Zhejiang, or Sichuan. The resulting expansion of both dangers and opportunities has delivered enormous benefits. New export industries have raised the productivity and incomes of millions while accelerating the historic shift of labor from the farm sector. Imports have expanded consumer choice, contributed to the development of new industries and the improvement of old sectors, and pushed Chinese suppliers to raise standards and reduce costs. Foreign investment has injected immense flows of technology—for organization, management, and marketing as well as production—into China's economy.
Globalization

China's reform era coincided with a new stage of globalization powered by rapid reductions in the cost of transport, communication, and information management. China's experience to date powerfully supports the view of globalization as an engine for growth and prosperity. The open-door policy has tilted China's whole economy toward labor-intensive production, hugely benefiting the mass of Chinese workers whose labor is their chief asset. By rewarding firms that raise quality standards toward global levels and punishing laggards, foreign trade and investment have motivated Chinese firms to abandon long-standing neglect of quality in favor of a broad-based upgrading effort that has enabled a growing array of Chinese products to compete in overseas as well as domestic markets. Dramatic expansion of incentives, mobility, and markets created unprecedented opportunities for the formation of new enterprises and the expansion of existing firms (including foreign companies) into new markets. The scale of entry is startling: the number of industrial firms rose from 377,300 in 1980 to nearly 8 million in 1990 and 1996; the 2004 economic census, which excluded enterprises with annual sales below ¥5 million, counted 1.33 million manufacturing firms, with Jiangsu and Zhejiang alone reporting more firms than the nationwide total for 1980.

Competition

Reform has pushed China's economy toward extraordinarily high levels of competition. Despite pockets of monopoly and episodic local trade barriers, intense competition now pervades everyday economic life. The auto sector provides a perfect illustration: two decades of competition have sucked a lethargic state-run oligopoly into a whirlwind of rivalries in which upstarts like Chery and Geely wrestle for market share with state-sector heavyweights and global titans. The payoff—rapid expansion of production, quality, variety, and productivity along with galloping price reductions—has injected a dynamic new sector (not just manufacture of vehicles, components, and materials, but also auto dealers, service stations, parking facilities, car racing, publications, motels, tourism, etc.) into China's economy. Price wars and advertising, two unmistakable signs of competition, have become commonplace. Expenditures on advertising in 2006, estimated at ¥386.6 billion, now match total urban retail sales for 1990. The decline of former industry leaders like Panda (television sets) and Kelon (home appliances) and the ascent of new pacesetters like Wahaha (beverages), Wanxiang (auto parts), and Haier (home appliances) from obscure beginnings show that competition has added new fluidity to Chinese market structures.

The growth of markets and the expansion of competition, mobility, and price flexibility invite participants to pursue financial gain by capitalizing on market opportunities. Government agencies and political leaders also respond to reform-induced economic change, leading to a complex web of interaction between reform initiatives, economic developments, policy responses, and political strategies.

Chinese firms

Chinese firms have evolved from bureaucratic appendages to commercial operators that seek to enlarge strengths, remedy weaknesses, and capitalize on market opportunities. Two recent developments have strengthened the responsiveness of Chinese firms. One is the growth of research and development (R&D) spending, which reached 1.4 percent of GDP in 2006, and the shift of R&D activity from government agencies to enterprises, including many outside the state sector. The second is the growing influence of foreign firms, which elevates the risks associated with standpat business strategies, but also supports the efforts of domestic firms to generate a dynamic response to intense competition.

The rapidity with which large and small innovations now migrate to China—e-commerce, text messaging, health clubs, organic foods, environmental awareness, flat-screen televisions, and so on—demonstrates the vitality of entrepreneurship in China's business sector. The current rush of international firms to establish China-based research and design facilities can only strengthen China's capacity for decentralized innovation—a hallmark of market systems.

Cautious—but incomplete—reforms

Starting with the restoration of household agriculture in the late 1970s, China has implemented a long sequence of increasingly coherent, focused, but still partial, gradual, and as yet unfinished economic reforms. Chinese policy has eschewed the “big bang” approach, in part because political realities have repeatedly frustrated ambitious reform proposals. In hindsight, China's economy lacked some of the institutional underpinnings essential to the success of sweeping reforms; for example, the undeveloped state of domestic markets for capital and ownership rights might have derailed an early push for privatization. China's reforms consistently focused on the “big issues” of incentives, mobility, price flexibility, competition, and openness. China's experience, as well as the record of earlier growth spurts in Japan and South Korea, shows that improvements in these areas can power strong economic advance despite the costs and frictions associated with institutional shortcomings, distorted prices, entry barriers, corruption, and other limitations.

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