Sustainable Development and the Open Door Policy in China

A Paper from the Project on Development, Trade, and International Finance

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A Council on Foreign Relations Paper

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Printed in the United States of America.

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FOREWORD

In the wake of the 1997–98 financial crises in emerging economies, many prominent thinkers focused their energies on what went wrong, how it could have been prevented, and what reform measures are required for the future. While some concentrated specifically on financial markets within the economies in question, others examined the larger system wide implications. The Council on Foreign Relations Project on Development, Trade, and International Finance convened a Working Group in an attempt to look at the problem from both levels, to investigate the problems in the world economy that led to the crises, and to propose policy options calculated to prevent future large-scale disturbances.

Specifically, the goal of the Working Group, which began in 1999, was to promote discussion of different perspectives about the necessity for change in the world economic system, and to look at concrete forms that change might take. These included, but were not limited to, discussions about reforming the international financial architecture to facilitate a transition away from export-led growth to internally or regionally demand-driven development strategies that offer the populations of the developing world an improved standard of living.

One of the Working Group's several undertakings was to commission papers from the participants on a broad range of subjects related to the international financial architecture. The authors come from a variety of backgrounds, and their papers reflect a diversity of perspectives. However, we believe that all of them provide useful insights into international financial architecture, and that they represent collectively factors that should be considered by both U.S. and international economic policy makers.

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ACKNOWLEDGMENTS

The Project on Development, Trade, and International Finance was made possible by the generous support of the Ford Foundation. This project was directed by Walter Russell Mead, Senior Fellow for U.S. Foreign Policy at the Council on Foreign Relations, with the close assistance of Sherle Schwenninger, the Senior Program Coordinator for the project. The members of the Working Group—a collection of more than thirty experts from a wide range of backgrounds—participated in several sessions at which they provided key feedback on each of the papers. David Kellogg, Patricia Dorff, Leah Scholer, Benjamin Skinner, Laurence Reszetar, and Maria Bustria provided editing and production assistance. In addition, the authors thank Tang Ying for comments and editorial help.

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INTRODUCTION

How can one best explain China's remarkable economic growth during twenty-one years and its rise from autarky to world economic power? The exercise requires chutzpah; it demands simplification; it cries out for the trained capacity to present a unifying theme with a weighty set of policy implications.

Fortunately the academic establishment possesses these traits in abundance. Examples range broadly from the socialist romantics[1] to the capitalist romantics[2]; the former believing that China has developed its own and specifically noncapitalist path, the latter that it is transforming itself into a free-market system. The two camps hurl paper missiles at each other in a satisfying postlude to the Cold War.[3]

But this battle is not, alas, about China. At least, it is not about China *specifically*. It is about economics, the economics profession, the indoctrination of students and policy analysts,

[1]Barry Naughton, *Growing Out of the Plan* (Cambridge: Cambridge University Press, 1995)

[2]Jeffrey D. Sachs and Wing Thye Woo, "Understanding China's Economic Performance," NBER Working Paper no. 5935 (Cambridge, Mass.: National Bureau of Economic Research, 1997).

[3]See Thomas G. Rawski, "Reforming China's Economy: What Have We Learned?" *The China Journal,* no. 41 (January 1999), pp. 139–56; and Wing Thye Woo, "The Real Reasons for China's Growth," *The China Journal*, no. 41 (January 1999), pp. 115–37.

and the politically and academically correct set of beliefs for those who practice development. As a result, it bears an eerie resemblance to the long history of policy discussions in China itself, which similarly are not about the actual problems of the country. Rather, they focus on the correct line and the ascendancy of adherents of one line over the adherents of another.

> *"We must stick unflinchingly to the socialist road. The road is tortuous and the struggle intense. But the future is undoubtedly bright."*

To get beyond this point, it helps to adopt an analytical framework that is rooted in the tortured history of China and of the People's Republic itself. We do not claim that what follows presents a definitive view. It is, rather, an attempt to point to the main features of the scene, and to place some of the otherwise perplexing developments since 1978, and recent choices, in their own context. Our thesis is that while political discourse in China reflects the larger intellectual conflicts familiar in the West, most decisions of policy are rooted in conditions and struggles inside China, and reflect both continuity and change in internal institutions of very long standing, rather than the importation of models from the outside.

BUDGET DEFICITS AND CULTURAL REVOLUTION

First, a basic fact. Under the traditional system in China, both after the Revolution of 1949 and beforehand, fiscal process was the linchpin of the entire economy. The government collected revenue and then allocated funds to various entities and activities in China through its budget and expenditure management system. In particular, government capital spending was the dominant investment source. Therefore, the fiscal situation of China prior to economic reform almost completely reflected China's economic health. Even as late as 1994, when one of us began service as a technical adviser to the State Planning Commission, the term "macroeconomic control" meant public fiscal control almost to the exclusion of other connotations.

Thus the catastrophe of the Great Proletarian Cultural Revolution, beginning in 1966 and lasting for a decade, presented itself to the Chinese leadership as first and foremost a fiscal problem. The decade of debate, political struggle, and factional fighting, the decimation of the civil administration and the professions, and the shutdowns of schools and factories, had led the economy to the verge of collapse. All of the previous factors dramatically reduced the government's tax revenue, and the budget deficit in 1976 reached 10 billion yuan[4] for the first time in China's history[5]. The situation was further worsened by a series of events, including the 1976 earthquake in Tangshang and the death of Chairman Mao.

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[4]The Chinese currency is the Renmimbi (RMB); the unit is the yuan. As China was isolated from the world economy at this time there is no very meaningful conversion rate between yuan and dollars for this period, especially for large budget and national accounting measures.

[5]Unless specified otherwise, all data cited in this paper are based on the *China Statistical Yearbook* 1997, and on *Key Indicators of Developing Asian and Pacific Countries*, 1992 and 1997 issues.

Aware of the peril, Party Secretary Hua Guo-Feng[6] launched a round of modernization known as the *Yang-mao-jin* (or Great Leap Forward by Imitating and Importing from the West), in the hope that China could invest its way out of trouble. But this program only worsened the situation. Overspending on capital investment and imports caused overheating, which led to a more than 52-billion-yuan deficit in the government's capital investment account. In 1979, China's current budget deficit surged to more than 17 billion yuan (more than 20 billion according to some sources), of which about 5 billion was associated with the China-Vietnam border war.[7] Overall deficits accounted for 17.7 percent of Chinese GDP in 1979. Chinese leaders had to find a way out, and this mundane fact, rather than philosophical change or ideological revelation, prompted the first wave of reforms.

[6]Chinese names are normally presented family name first. Here we adhere to that convention, except for references to published work, where we respect the Western order for bibliographic clarity.

[7]Tiejun Wen, "Four Cyclical Economic Crises in China". http://forum50.cei.gov.cn/. Beijing: China Economic Information Network, 1999.

BOTTLENECKS AND HEAVY INDUSTRY

The failure of *Yang-mao-jin* was rooted in the critical imbalance of China's industrial structure. By military necessity and from Soviet example, China had long targeted heavy industry as its strategic industrial sector. China's industrial strategy was reflected in the pattern of state control. In industry[8], the state had a dominant share. Sixty-six percent of state-owned enterprises' (SOEs)net fixed assets in 1978 were in industry, while agriculture accounted for only 2.8 percent of state assets. Also in 1978, SOEs accounted for 77 percent of gross industrial output and 78 percent of urban employment—74.5 million of 95 million workers. But 76.3 percent of total employment was rural, and there the state had never taken any significant share.

This heavy-industry-oriented, urban-development, state-sector policy carried an intrinsic flaw. Over time, it became obvious (as it had in Russia) that the strategy was bottlenecked by the underdevelopment of other sectors. As a result, it became a typical practice that whenever bottlenecks occurred, the government temporarily slowed down the expansion in heavy industry and allocated some resources to the bottlenecking sectors—light industry—a so-called readjustment process. Yang-mao-jin therefore put money into a sector that was already overbuilt, with the result that efficiency gains were nil while bottlenecks arose very fast.

Agriculture had of course suffered from the orientation of policy toward heavy industry. China is basically an agricultural country, and agriculture was the major income source for more than 800 million people of the one billion population in the late 1970s. Farm technology was still very primitive, and extremely labor-intensive. Output per capita in 1978 in rural China was 174 yuan, com-

[8]Industry was defined by China as all sectors excluding agriculture, construction, commerce, grain and foreign trade, urban public utilities, transportation, postal services, and telecommunications.

pared to a GDP per capita of 360 yuan. People were starving in many of the remote regions. To increase agricultural output was therefore not only a means of solving the imbalance problem (hence the budget deficit problem), but was also a way to increase incomes that might in turn build demand for other industrial sectors. In other words, in 1979 structural and Keynesian remedies converged at a moment of fiscal crisis.

At the same time, conditions in Chinese agriculture in the late 1970s presented major opportunities; the potential rewards to policy change were not only high, but were known to be high by the national leadership.

Much has been made, of course, of the effects of the People's Communes on agricultural productivity in China and their responsibility for the low living standards of the countryside. It is true that under the communes farm incomes were low, and investment even lower. But collective agriculture in China did not resemble that of the Soviet Union. It was not driven by a desire to realize economies of scale, and did not lead to the gigantism of the Soviet agricultural machinery industries, with their fleets of *traktorii* churning dust on the steppe.

Moreover, weak control by the state meant relatively large freedoms in the rural regions. Even after People's Communes were implemented, farmers still had their own small vegetable plots (*Zi Liu Di*, or The Land Left for Family), allocated by family size. And in many regions, families might also have a piece of mountain land that supplied their fuel for cooking and heat. Several families might also share the rights to a pond for fishing and irrigation; though the reservoirs were usually owned by either the village or the commune.

Because of these spheres of private control, so-called free-trading-markets or agriculture-trading-markets remained active in China, even through the Cultural Revolution. Launching reform first in rural areas was therefore quite a simple matter: it meant only allocating the land owned by the village to the families, and declaring that farming tools owned by villages were to be shared by farmers. These were little steps. This is important, because in the early stage any policy that radically challenged state ownership might have incurred a backlash.

Furthermore, for those leaders who launched the reform, these steps were relatively easy for another reason: they had been tried before. After the Great Leap Forward collapsed China's economy in early 1960s, Deng Xiaoping and Liu Shaoqi had launched agricultural reform, using the same prescription. Their programs dramatically increased rural income and productivity, improved agricultural supply, ended the famine of 1960–62, and to a great extent, facilitated the mini-boom in 1963–66. Mao's Cultural Revolution—with its productivity-depressing "work point" system and campaigns against market activity—was, in part, a reaction to the success of these measures, a reaction that finally ended Liu's life and sent Deng to labor camp. Fifteen years later, Deng relaunched the interrupted reform. To some extent, one may say that Deng simply fought the old enemy—the collapsing economy—using the old weapon of agricultural reform.

It is well known that China's agricultural reform was very successful. Our point is that the policy was not new to most Chinese in late 1970s, because it was simply the same policy as that of the early 1960s. According to the so-called Household Responsibility System, lands owned by villages and People's Communes were allocated to the household, as were other production resources such as mountains, small ponds, and farming tools. Work points were eliminated, and markets opened. The policy dramatically enhanced, or more precisely, restored, farmers' motivation, and also increased both output and productivity. Agricultural output increased 126 percent from 1978 to 1984, and agricultural output per rural laborer increased by 113 percent. During this period, China's growth of agricultural output outpaced GDP growth by about 28 percentage points (from 1978 to 1984, GDP increased 97.8 percent). As a result, the agricultural share in total GDP grew from 28.1 percent to 32 percent. Food poverty declined very sharply. Of great importance, the rural share in total national saving deposits increased significantly: from 26 percent in 1978 to 36 percent in 1984.[9]

[9]Authors' calculation, based on the data sources stated in the Footnote 4.

AUXILIARY REFORMS IN LIGHT INDUSTRY AND COMMERCE

There were several other efforts at this stage, including the Open Door policy, industrial structure adjustment, and decentralization in domestic commerce. We will reserve the Open Door policy for a later section; the latter two issues will be discussed briefly here.

At the same time as the agricultural reforms, Chinese leaders launched efforts to redress the imbalance between light and heavy industries. In early 1979, the Chinese Communist Party decided to accelerate development in light and textile industry, planning to make the growth of these sectors match or slightly exceed that of heavy industry. Later that year, the State Planning Commission set detailed priorities to guarantee the implementation of the light industry strategy. The package of favorable policies affected energy supply, transportation, bank credit, and foreign exchange for imports. As a result, construction investment in light industry increased dramatically, from an annual average of 1.35 billion yuan during 1953–78 to 4.2 billion yuan during 1979–84.[10]

To facilitate reform in both agriculture and light industry, China also began to reform its highly centralized and rigid commercial sector. Wholesale and retail sectors were granted more autonomy. In the services sector, particular emphasis was placed on transferring state-owned food services to communities or leasing them to individuals. At the same time, the agricultural price system was reformed and prices were adjusted up significantly. The categories of goods covered by the central plan were reduced from 274 in 1978 to 115 in 1982, and then to 60 in 1984.[11] The traditional "Centralized purchase and centralized selling" system was broken up.

[10] Jiaqing Lu, *Inequality and Industrial Change in China and Financial Crisis in Thailand*, Ph.D. Dissertation (University of Texas at Austin, 1999).

[11] Editing Department of the Serial Books on China's Market Economy Building (EDSB), *Volume 25: Commercial Economy* (Taiyuan, China: Shanxi Publishing House, 1994).

THE SECOND PHASE: URBAN ECONOMIC REFORM 1984–88

With rising agricultural output and productivity, nonagricultural industries also emerged in rural areas. Township and Village Enterprises (TVEs) developed quickly, because of the autonomy they enjoyed in the countryside: no plan, no control. By contrast, SOEs in urban areas were constrained by both ideology and the plan, and they still operated at a loss and without motivation to reform. After a debate in 1983 and early 1984, China decided to reform its SOEs under a modified planning economy: it would become a planned commercial economy, in which "commercial economy" was used as verbal substitute for market economy at that stage.

In October 1984, the Communist Party issued "Decisions about Economic System Reform," which outlined China's second stage of reform. This outline was very ambitious. It tried to reform virtually every aspect of the economy, including the enterprise system, plan, material supply, labor and wages, finance, commerce, prices, and fiscal and tax policy. The overarching framework was to change the type of reform pursued in China's economy from a single or isolated approach (such as reform in agriculture) to multiple and coordinated approaches (pluralistic approaches). The leadership wanted to deepen reform in rural area and allow TVE development, for instance, and at the same time reform SOEs so that there would be multiple ownership (cross-ownership) in urban areas in every aspect of the economy at once. At the micro level, enterprise reforms would go alongside such macro measures as fiscal, tax, and financial reforms.

In the event, the package proved too ambitious. Some of the new reforms, such as tax reform and further decentralization in SOEs and commerce, were successful. Others, such as financial reform and establishing a central-commercial bank system, made little progress. Thus, while fiscal reform and decentralization did give more motivation to local governments, the slow progress in banking reform led to incubation of localism and regional protection. Local officials forced banks to expand credits, even though the central government called for tightening. Local governments' purchasing increased, investment kept expanding, the economy overheated, and inflation went up. Traditional central control and adjustment instruments worked less effectively. In a long-familiar pattern, because the central government had lost control over the whole economy, fiscal conditions had worsened, and this became once again the signal for retrenchment.

THE TRANSITORY PERIOD (1988–91): ADJUSTMENT AND CRISIS

The difficulties of second-stage reform led to a second round of macroeconomic adjustment, beginning after the summer of 1988. At the same time, ideological debate heated up about the role of planning vis-à-vis the market economy. The debate centered on whether reform since 1984 had become too radical. Some Chinese leaders thought the reform itself had fueled overheating and inflation during this stage. Furthermore, the reforms involving decentralization had weakened the Communist Party leadership.

Then came the Tiananmen Square incident of early June 1989, itself brought on by widespread discontent with inflation. The June 4 crisis gave those who opposed reform more ammunition, and new initiatives in most areas came to a halt. Indeed, the adjustment was overdone; after 1990 the Chinese economy fell into a slump. When the slump became apparent, the government reacted as it had in 1976, by pouring funds into the SOEs in the hope that they might lead economic recovery. But help for the SOEs came far too late. In many cases their inefficiency was irreparable, and often the inflow of funds served only to prevent default on the SOEs' massive debts to state-owned banks. As a result, chain or triangle debt flows prevailed and the real economy showed little improvement. Clearly, yet another new round of reforms would be required.

THE THIRD ROUND OF REFORMS: 1992–97

China launched its new round of reform in 1992, on Deng Xiaoping's urging that the country create a "socialist market economy." Though still very ambitious, the new policy was much more sophisticated than the 1984 package. It covered areas such as fiscal reforms, taxation, the investment system, foreign capital policy, the foreign exchange system, and the banking system. Also, more favorable conditions were granted to foreign firms that invested in China.

Among the most significant aspects of the post-1992 reforms were the following measures:

- A goal was set to transform China's banking system into a U.S.-style central bank-commercial bank system. This goal was first enunciated in 1984, at the beginning of the second-round reforms, which were aimed at transforming the People's Bank of China into a central bank. At that time a deposit reserve system was created and reserve ratios were established. But the PBC's transformation didn't really start until three banks designed specifically for making policy loans were created in 1994 and a central bank law issued in 1995. The policy loans of China's four largest banks were transferred to the newly created policy banks, so that the big four might more easily make their transformation into commercial banks. Changing the People's Bank into a central bank meant major transfers of power from local officials, which in turn met heavy resistance from both the central bank and local governments. Overall, however, the reform proceeded as scheduled.

- On taxes, China created a system similar to that of the United States. Local and central tax collection were separated, which increased revenue for both local and central government. On the other hand, the reform also separated the obligations of central and local governments, streamlined the fiscal budget process, and made it more efficient.

- On January 1, 1994, China merged its official exchange rate with the trading market rate, and created a single exchange-rate system under a managed floating regime. At the same time, it made the Chinese renmimbi convertible under current account, a step that was believed not to be feasible before the year 2000.
- Finally, with respect to the SOEs, the new round of reforms made significant progress in establishing modern enterprise systems, especially share-holding systems. Many money-losing SOEs were either shut down, merged, or sold. Those survived were streamlined and began to operate under the new system.

With these reform policies in place, as well as a newly lowered interest rate, the economy burst to expansion. But the honeymoon did not last long. Real estate and capital investment fueled economic overheating, bottlenecks in the construction and investment sectors emerged, and double-digit inflation returned. Beginning in late 1993, economic policy was tightened again. Unfortunately for China, the difference between 1979 and 1992 is that in the latter period there were no longer large and easy gains to be had from fairly simple policy measures.

Since 1993, Chinese economic policy has in fact been comparatively tight. While growth has remained rapid by world standards, it has been far below what would have been required to absorb the massive increases in the urban labor force. Thus, while many Western observers continue to think of the Chinese experience as a success—partly because living standards continue to rise, partly because they compare it with crisis-ridden situations of Asia and Latin America, and partly because foreign investors have not suffered systemic losses in China—from a Chinese perspective the situation actually more closely resembles a crisis. The elements of this crisis include banking and debt problems, not to mention massive unemployment. To interpret the crisis, one should avoid falling into the tired argument as to whether it represents a crisis of socialism or of transformation. We believe that the problems in the 1990s fall into the classic pattern of reform-boom-overcapacity-bad debt-credit crunch-slump, already seen on numerous earlier occasions.

China experienced a real estate boom in 1992 and an investment boom in 1992 and 1993. Compared with the average growth rate of 18 to 25 percent in normal times, investment growth rates were 44 percent in 1992, rising to 62 percent in 1993, and falling back to 30 percent in 1994. Most of the new credits were extended to real estate and to the money-losing SOEs, where they fueled overcapacity in both of these sectors. Even worse, most of capacity expansion was at low levels of technology, and often highly redundant. For example, there are hundreds of automakers, most of which produce old-model and low-quality vehicles. Some of them can't sell one car a year. But still many local governments wanted to join in the race to develop the auto industry as a local "pillar industry," and so loans to the automotive sector continued.

To cool down the economy in the face of these structural problems, China has maintained a tight monetary policy since 1993. With high interest rates, demand growth became weak. At the same time, China began to reform its social-welfare system and its housing and education system, and Chinese people became more risk-averse. This deepened the structural imbalance, and consumer demand weakened further. It is true that the demand for housing loans, education loans, insurance policies, and other credit services grew. However, the financial sector had been so underdeveloped that these services barely existed beforehand. In a classic replay of the old pattern, reform and growth in one area generated a demand for linkages that could not be provided, and bottlenecks stalled the reform.

In the meantime, banking reform began. The transformation from policy banks to commercial banks reduced credit availability to the SOEs. This worsened the situations of SOEs, who have so far relied on banks for capital. Many defaulted on their loans.

In short, overcapacity, structural imbalance, weak demand due to risk-aversion (which, in turn, was due to slow progress in setting up a functional social-welfare system), and banking reform were the major factors behind the problems in China in 1990s. This is ironical and paradoxical, because risk-aversion resulted from enterprise overhaul and massive layoffs, and from the reforms in housing, education, and medical service. These reforms may yield long-term benefits. But they do have short-term adverse effects, and sometimes very fatal side effects. Can China's reform and policy and overall economy survive that long? The question is open, and we will return to it after discussing the Open Door policy.

THE OPEN DOOR POLICY: WHAT WAS IT?

The Open Door policy consists of two major types of policy change: the opening up of geographic regions to foreign investment, and the opening of specific institutions nationwide.

The geographic opening began in July 1979, when China granted the frontier provinces of Guangdong (bordering Hong Kong) and Fujian (across the strait from Taiwan) preferential policy flexibility. In May 1980, the Shengzhen, Zhuhai, Shantou, and Xiamen Special Economic Zones were created. In February 1982, the Yangtze River Delta, Zhu River Delta, and three other regions in Fujian, Liaonin, and Shandong were opened. In May 1984, fourteen additional coastal cities were opened. In 1988, Hainan Island Province—heretofore a fishing community—became the largest Special Economic Zone.

During the new round of reform in the 1990s, Pudong of Shanghai was opened first. In 1991, four border cities on the China-Russia frontier were opened. In August 1992, fifteen more hinterland cities were opened, and since that time, major cities all over China have followed suit.

Compared to the speed of geographic opening, institutional openings for foreign trade and foreign capital were slower, and have always been driven by the geographic opening.

China's sectoral opening policies have included:

With respect to trade: China has implemented a progressive decentralization of its foreign trading system and a system of export tax refunds. Moreover, it has applied the corporate system to foreign trading companies. Later, an export promotion policy was launched, which included further decentralization, introduction of the market system into foreign trade, and reform of the foreign exchange system. The Chinese currency became convertible under current account, non-tariff barriers have been cut (reducing import quotas and shortening the control list), and tariffs reduced. Most recently, of course, China has been negotiating its entry into the World Trade Organization, and further major reductions of tariffs and trade barriers are in prospect.

With respect to capital flows: In 1979, the joint venture law was issued, and foreign investment in Special Economic Zones and other coastal cities was encouraged. Later on, China improved its law and regulatory system, and began to guide foreign capital to regions or industrial sectors preferred by China. Until 1997, China's policy was to encourage foreign capital in manufacturing and other industrial sectors. By contrast, services were not a priority. Since 1997, however, various services have begun to enter China. Several foreign banks have been allowed to offer Renmimbi service. Overall China's policy was to encourage foreign direct investment (FDI), but at the same time to maintain central control of foreign borrowing and to discourage portfolio inflows. By early 1997, there was a plan to open the capital account, but the Asian crisis interrupted it.

THE ROLE OF THE OPEN DOOR POLICY

From a closed economy at the end of the 1970s, by the mid-1990s China had become the world's eleventh largest trading country. Its openness (measured by total foreign trade as percentage of GDP) increased from 17 percent in 1978 to about 40 percent in the mid-1990s. Foreign capital investment also surged; China has become the second hottest investment destination country, second only to the United States. During the surge period of 1990 to 1996, China attracted $230 billion of foreign capital, accounting for 20 percent of total capital flows to developing countries in the period.

Chinese leaders well understand that they need capital from external sources to finance their development goals, and that they need it on terms they can afford. China's capital inflow has three characteristics under its overall open door policy package:[12]

- China has encouraged FDI. As a matter of policy and fact, external borrowing kept shrinking during this time, while FDI continued to rise. FDI is more stable than bank lending, and it can also generate industrial capacity and improve infrastructure. Finally, it is less sensitive to interest-rate fluctuations and other short-term macroeconomic factors. FDI management is also highly decentralized while foreign borrowing is relatively centralized; thus the borrower is in a relatively stronger position in dealing with FDI investors than with banks.

- China relies on developed countries for loan and debt inflow, but on Hong Kong and Taiwan for FDI. Actually, attracting capital from the large and wealthy populations of overseas Chinese was the initial motivation for China's Open Door policy, especially for its Special Economic Zones. This has, of course, proved very successful.

[12]Jiaqing Lu, *Capital Inflows in China: Challenges and Policies* (Taiwan: Eurasian Foundation, 1999).

The Open Door policy was also vital for meeting China's need for hard currency reserves and for paying for imports of capital equipment. From 1990 to 1996, average annual growth of exports was 16.6 percent; in 1996, manufacturing exports accounted for 85.5 percent of total exports. Mechanical and electrical goods had by that time replaced textiles as the biggest export item. In 1992, exports by foreign and joint ventures accounted for about 20 percent of total exports. But by 1996, this proportion reached 40 percent. In some coastal regions, it is as high as 50 to 60 percent.

- Finally, China's Open Door policy provides a means for importing technologies to which China would not otherwise have access. A notable example is aircraft; China has arranged with Boeing to assemble many of the passenger aircraft it purchases from that company.

In brief, China's Open Door policy is basically a mercantilist endeavor. Its goals are not a liberal trading order *per se*, but the accumulation of hard currency and technology, the encouragement of FDI, and the reduction of reliance on bank loans. In these respects, the Open Door policy has certainly contributed to relaxing supply constraints that might otherwise have derailed the reform process altogether. But it should not be mistaken for a policy of global integration and liberalization, nor has it ever been a major source of aggregate savings and investment in China. Whether this will change under the World Trade Organization agreements remains to be seen, and whether China will eventually take the risky step of capital account liberalization remains uncertain. It is difficult to see what China would gain from such a measure, and the cost of higher externally induced instabilities would be a high one for the Chinese to pay.

THE CRISIS OF THE 1990s

China in the 1990s faced problems not fundamentally dissimilar from those of the 1976–79 period: it had reached the limits of one type of expansion, and it needed the balancing effect of expansion in other sectors in order to move forward. However, while the path toward agricultural reform had been a familiar one in the early 1980s, the institutions of modern social, financial, and services sectors familiar in Western countries had never been properly developed in China. Slow progress in putting these institutions into place has emerged as a principal limitation on the rate of growth in China. The reaction of the authorities, which was to pursue a moderately tight policy, has led to deepening problems for the surviving state-owned enterprises, in turn leading to rising inequality of wages and earnings and massive unemployment.

In the new wave of economic reform, China began to overhaul its SOE system. The goal of the reform was to build a modern corporate system. Since then, many money-losing SOEs have been shut down, merged, or sold. This caused a sharp increase in unemployment. According to a study by Angang Hu, the government's reported registered unemployment rate was 3.1 percent in 1998.[13] But Hu's own estimate is 8 percent—a reasonable figure in our view. In 1998, new employment growth was 0.1 percent, the lowest since 1949. Overall unemployment, including layoffs and rural immigrants who lose their jobs, is higher still. Hu estimates urban unemployment at around 160 million and rural unemployment at 170 million, for a total of 330 million: a huge figure, and possibly exaggerated, but indicative nevertheless.

Living standards for those who lose their jobs are low. According to Hu, average monthly living fees a laid-off urban worker can get were 77.1 yuan in 1996, and 82.7 in 1997, about 15 percent of the

[13]Angang Hu, "China's Biggest Challenge in the New Millennium: High Unemployment" http://forum50.cei.gov.cn/. (Beijing: China Economic Information Network, 1999).

average monthly wage of Chinese workers in the same year. For those laid off in remote regions and provinces hosting large SOE's, particularly in northern China, the monthly living fees they can get are surprisingly low: Heilongjiang, 5 yuan per month, Qinghai, 25 yuan per month.

As a result of increasing restructuring and massive layoffs, inequality in China has jumped sharply since 1992. We have independent measures of this, which we computed from payroll and employment data by sector in the *China Statistical Yearbook*; these measures are presented in Figure 1. Our calculations—the between-groups component of Theil's T statistic—closely correspond to measures of the Gini coefficient recently prepared by Qiang Li of Qinghua University.[14] Figures 2, 3, and 4 show the regional pattern of rising inequality of wages and earnings, 1989–96. Inequality has gone up everywhere, but much more to the north and west than in the relatively prosperous southern and coastal regions, or in Beijing.

Unemployment and inequality are therefore major consequences of the 1990s reforms, even though average living standards continue to rise. In their efforts to combat these evils, the Chinese authorities face a perplexing dilemma. They have learned how to combat overheating, and to slow the economy down. But they have not developed effective means to bring it back to the high rate of growth required to absorb the newly unemployed. Indeed, price deflation has been under way since October 1997 and shows no sign of letting up. This is the legacy of incomplete sectoral development in the social sphere.

During the first months of 1998—in the wake of the Asian crisis and domestic economic slump—China began to loosen monetary policy. In addition to cutting interest rates twice, China also used both traditional and new monetary instruments to facilitate its monetary expansion. The package included removing the ceiling on commercial bank loans, encouraging commercial banks to increase loans to fixed-assets investment and to expand into con-

[14]Li Qiang, Presentation on Inequality in China at the Lyndon B. Johnson School of Public Affairs (University of Texas at Austin, March 2000).

sumption credits, and resuming the central bank's open-market operations. From 1998 to summer 1999, China has cut interest rates six times. Yet deflation has defeated these efforts: although nominal interest rates are low (around 5 percent to 6 percent in the summer of 1999), the real rate was still as high as about 10 percent. Therefore the squeeze on business profits remains as high as ever.

Fiscal policy has attempted to fill the gap. In 1998, China invested about 100 billion yuan in public facility and infrastructure, and in 1999, another 100 billion were expended. But fiscal policy of this kind runs into two limitations: bottlenecks in the construction sector, and the limited capacity of government to offset the massive fall of corporate investment. China's government—compared to that of the United States or Europe—is a small operation when one considers the ordinary functions of government proper. Also in 1999, China began to increase living fees for laid-off workers. But a 30 percent across-the-board wage hike fell short in most Chinese regions because local governments did not have the money to fund it.

Part of the problem is the insolvency of the banking sector. Since 1994, China had made a series of reforms to strengthen its banks, but they are still loaded with bad loans from financing SOEs over the years. There are various estimates of the size of China's bad debt, but about 30 percent to 50 percent of total loans extended is a reasonable view. According to Fred Hu, restructuring the banking sector may end up costing 26 percent of GDP[15]—a very substantial sum by any standard. There are two models in restructuring the banking sector. One is the U.S. model. After the crisis in 1980s, the United States used the Resolution Trust Corporation and other instruments to liquidate the bad debts of the banking sector. After a restructuring and consolidation, the U.S. banking sector was restored to health. But in Europe, after the crisis, the region's governments supported their banking sectors in carrying the debt. They thought the debt would evaporate during the hoped-for recovery, as well as through profit. This is a slower path, and

[15]Fred Hu, *China's Banking Reform: A Long March*, Goldman Sachs Global Economics Paper no: 28 (1999).

it relies on a recovery actually occurring in spite of the banking problems. China is obviously following the European model, and a recovery is by no means assured.

The Asian crisis also complicated China's external trade. Devaluation in competitor countries made China face cheap competition from those countries, and also reduced demand in those countries for Chinese goods. As a result, China tried various policies to promote exports, while resisting devaluation of the renmimbi. Export tax refunds have been a major policy instrument in this regard, but China also used other policies, such as a campaign against smuggling. This campaign was aimed at curbing illegal imports, and thus at reducing the crowding-out effect of smuggling on domestic production.

THE OUTLOOK AND WHAT IS REQUIRED

The core problem is, as always: Can rapid growth be restored? Since 1994, GDP growth in China has decelerated almost continuously. While it is easy to blame either the traditional system or under-reform in the economy for the problems in the 1990s, we believe that the core of the core lies in the interplay of growth and modernization. Without major institutional innovations, high growth can not be restored. Whether the institutions can themselves be created in a climate of slow growth is a difficult and so far unresolved question.

Two important issues lie at the top of China's development agenda. One is the need to create a coordinating mechanism to overcome the cautiousness of free-market business actors in an unstable domestic and world environment. The other, closely related, is to establish a social welfare system, including a social security system and other supporting systems such as a consumption credit system, and a system for education credit and small business support. All these measures are needed in order to overcome the extreme risk aversion of household actors in an insecure world.

The traditional means of investment coordination in China has been well described by Huang[16]: it consisted of central government personnel rotating through provincial and municipal bureaucracies with the mission of assuring a unified pace of total investment. But once the bulk of investment migrated out to the business and corporate sectors, and once the provincial governments and SOEs no longer provided the bulk of investment demand, this tool is destined to lose its force. With indirect measures, such as the interest rate and credit policy, it is much easier to slow the growth of aggregate investment than to get it going again.

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[16] Huang, Yasheng, *Inflation and Investment Controls in China : The Political Economy of Central-local Relations During the Reform Era.* Cambridge; New York: Cambridge University Press, 1996.

How is this issue handled in the West? Partly, by means of augmenting the purchasing power of consumers, through tax reductions. For this, a developed and centralized fiscal system is required; China does not yet have any such thing. And the modern history of the United States and Europe is replete with government credit initiatives—guarantees to agriculture, small business, housing, and so forth—that can be relied on to spur total effective demand. But such measures require the creation of flexible credit institutions that can extend and monitor loans to the smallest economic units in the country, including individual farms and households. Again, China does not yet have such institutions.

How did the consumption slump occur in the first place? Anti-inflation policies definitely played an important role. The boom of the early 1990s fueled rapid expansion in production capacity and economic growth. But aggregate demand was dramatically curtailed when the People's Bank adopted a tight policy in the wake of inflationary pressure in the fall of 1993. As a result, income growth slumped and so did consumption spending.

But more importantly, the current consumption slump was led by China's reform policies themselves, which have brought about structural shifts in consumption behavior, choice, and spending. In the fall of 1993, the Third Session of the Fourteenth Communist Party Congress outlined a series of key reforms. Since then, China has taken major strides in overhauling its SOEs and commercializing the housing system. This had several effects on the consumption pattern in China, and none of them were favorable.

First, the relative price or terms of trade between future consumption and current consumption has dramatically increased, because of an expected surge in the price of future consumption. Put simply, households realize that they will need to set aside current income for future use, to provide for housing and retirement. As a result, the purchasing power of the total budget for both plans decreases sharply, and current consumption declines significantly. What follows is a decline in total income, and the budget shrinks further.

While life is always full of uncertainty and insecurity, the price of bad outcomes or misfortunes was depressed almost to zero under the traditional system in China. The government offered almost everyone a job, there was no job insecurity, and while the future was uncertain no private means of insuring against it existed. The employer, or work unit, offered every family an apartment and collected only symbolic rents. Every worker had full medical coverage. Education, an investment to reduce uncertainty or get more security, was basically free. Finally, after a worker retired, he/she would receive 80 percent to 100 percent of his/her last year's salary, depending on age at retirement. Moreover, workers carried over full medical coverage and other welfare packages.

But the reforms have been changing this pattern dramatically. Now, life security is becoming a private good, and very expensive to buy. As the ongoing economic restructuring continues, factories are shut down or merged, and thousands of workers are laid off or forced to retire early; those who have their jobs at the moment are paid a fraction of their official salaries. And this immediate problem is further compounded by the simultaneous reform efforts in areas such as housing, education, and the social welfare system. This means that the time of free housing, education, and medical services will be ended. Individuals will have to buy their shelter, invest in education, and pay for their health care.

In short, the early stages of reform worked in part because the *old safety net* was intact, and individuals felt at liberty to take risks. But now, the Chinese people are aware that the future is much more expensive and that life security costs dear. With a shrinking total budget, it is natural that individuals will scale down current consumption to make the future more affordable. Not surprisingly, savings increase sharply, and current consumption remains slack.

The problem is partly that Chinese people lack experience in managing risks after living in a risk-free society for decades. Dramatic changes in employment and social welfare conditions give them a huge psychological shock; and because the process is still going on, they seem not to know what will happen down the road.

Hence, they become overwhelmed by the future concern, and become extremely forward-looking. This future-overhang effect leads them to reduce current consumption dramatically in an effort to cover the worst ahead. They become more and more risk-averse, in effect dissipating their wealth on insurance. China is, in a word, caught in a pandemic of the Paradox of Thrift.

But there is a deeper issue as well. Not only do the Chinese people lack experience managing risks, but Chinese institutions to help them do so—in a capitalist as opposed to a communist setting—do not yet exist. Thus, the consumption slump has been worsened by lags in institutional design necessary to support the economic transition. Until a *new welfare* state comes into being, this problem will not go away. Specifically:

- There has been no consumption-enhancing mechanism such as a consumption credit market until most recently. Under the planning system, the economy was geared up for production, and consumption was a by-product. Actually, because increasing consumption would worsen shortages and lengthen lines at outside stores and supply centers, it was rational for decision-makers in the old system to pursue a consumption-depressing policy, instead of consumption-enhancing policy. This now needs to change.

  Generations of decision-makers since reform didn't feel the necessity to enhance consumption until the early 1990s, when housing reform was launched. Since there was no mortgage market in China, the sky-high price of apartments virtually all scared ordinary workers out of the housing market, and forced them to save more to afford an apartment in the future. There are similar stories in education reform, and in health care. This is in marked contrast to the Western system where consumers can use consumption-credit markets to spread the cost of housing or education over decades, and where private or public insurance similarly spreads the cost of health care.

- China didn't start to build a social welfare system for its economy until the SOE reform led to massive layoffs. As we mentioned earlier, under the traditional system, everyone had a life-time job, which also provided him or her with full medical coverage and generous retirement benefits.

  While reform has been eliminating most of these benefits, the government came in only very late to build a social safety net to stabilize workers' income and share the cost of insecurity and misfortune. There is as yet no social security system, no effective unemployment insurance, no disability insurance. These systems, which so effectively maintain consumption standards among non-working populations in the West, are a critical missing element in Chinese economic reform until now. Moreover, Western advisers are enthusiastic about market systems to provide these forms of income insurance-exactly the wrong prescription for China at present. Thus, progress toward overcoming this institutional bottleneck is destined to be slow.

Because they have been so slow to build the consumption-credit system and social safety net, China's decision-makers have found that they can do very little to influence consumers' choices directly. In particular, the consumption credit market was so underdeveloped that interest-rate cuts failed to increase house sales and other demand for personal consumption credit.

In the meantime, the social safety net remains in very preliminary shape, and a three-pillar system consisting of contributions from workers, employers, and the government still looks to be a long way off. Also, the insurance industry in China is still dominated by two big state companies, and China has a long way to go before it will have an efficient and accessible insurance market. When all these factors are taken into account, it is not difficult to understand why today's future-overhang dominates Chinese society. It is also not difficult to understand why the drive to raise public spending—while it definitely did increase personal income—has so far failed to generate more consumption spending.

In sum, China's reform process has once again run into the bottleneck of an underdeveloped sector. But whereas in former times the bottlenecks occurred in agriculture or light industry, they arise today in the mechanisms of social insurance and social security that the advanced industrial democracies of the West have provided for themselves since the 1930s. China lacks sophisticated, accessible, affordable institutions of consumer, household, and agricultural credit, as well as broad-based mechanisms to support household income through tax and retirement systems. Without them, and without the pervasive security provided by the previous state system, Chinese households are unwilling to use their incomes for their own current consumption, and as a result the massively unemployed and underemployed labor force cannot be absorbed.

Is this a problem of the market, or of socialism? It is an empty and pointless question. Advanced Western market economies that fail to provide adequate assurances of social security suffer from exactly the same syndrome, and most of them have long since built institutions to overcome the difficulty. In other words, the correct way to analyze China is not as either a socialist or free-market economy. Rather, China should be analyzed as a developing country facing exactly the same range of fiscal, demand management, and sectoral-balance problems that all developing countries face, irrespective of the ideological terms they use to describe themselves. At the same time, however, analysts must recognize China's particular characteristics, rooted in the evolution of its development up until now.

With this observation in mind, the way forward for China seems clear. More reform! More reform is always the solution, in China, for the deficiencies and difficulties of reform.

But this time, the reforms must truly move in a new direction for China. The new reforms must move toward the creation of market-friendly—but publicly provided—social welfare and credit systems. Moreover, such systems must be capable of creating for the Chinese people the framework of security that households, farms, and small businesses have enjoyed in the West during those periods of high prosperity and stability that have occasionally marked economic performance during the last century.

Whether such systems can, in fact, be developed under a Chinese leadership committed to a distorted free-market image of Westernization and under intense pressure to modernize by opening China to Western commercial institutions—without the benefit of the Western public institutions that accompany them in the West—remains a deep and troubling question.

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Figure 1

Data for Macau and Hong Kong are from the U.N. Industrial Development Organization (UNIDO); note that all series rise in 1993-94.

Figure 2

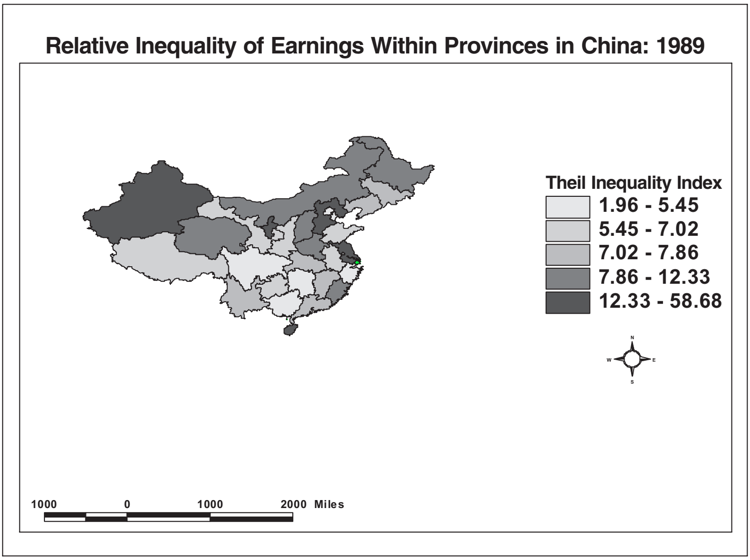


Figure 3

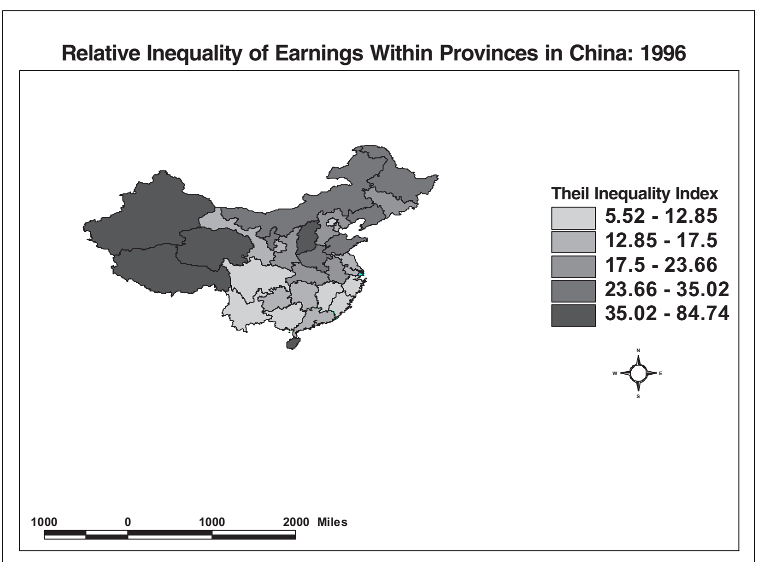
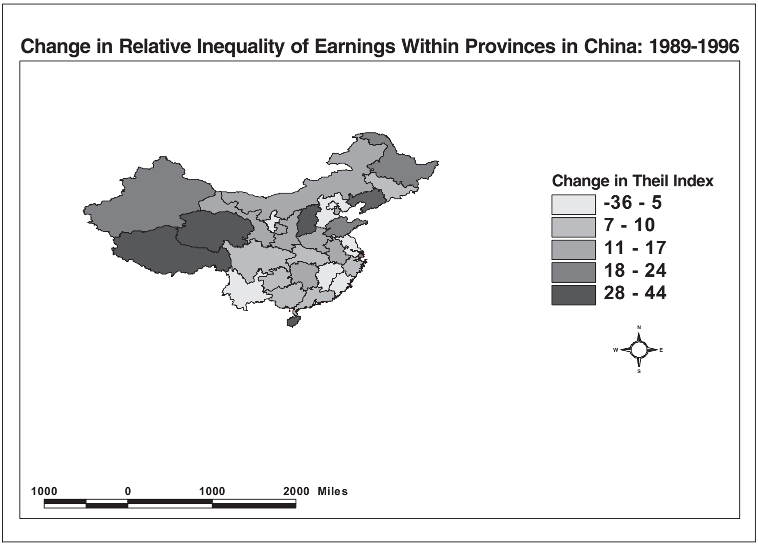


Figure 4



The measure is a between-groups component of Theil's T statistic computed by the authors across twelve major economic sectors for each province and region in China; changes are simple differences in Theil scores. Theil methods are described in detail in working papers on the website of the University of Texas Inequality Project, at http://utip.gov.utexas.edu. ArcView ' GIS software courtesy of Environmental Systems Research, Inc.

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