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The People's Republic of China at 70:

Reforms, Achievements and Challenges

By Bert Hofman

On 1 October this year, China celebrates the 70th anniversary of the founding of the People's Republic of China.

A central part of this celebration focuses on the country's success in economic development and poverty reduction. Indeed, by next year, China hopes to eliminate absolute poverty.

This momentous occasion is a good time to reflect on China's journey over the past 70 years for three reasons. First, getting the historical record right. This record is still shifting despite the many volumes already devoted to the topic.

Second, understanding the basis of China's success can help shape its future reforms.

Third, recognising China's increasing role as an example for other countries. Furthermore, China's presence in the world economy, as investor, as destination for exports, and increasingly as innovator and provider of ideas should increase the need for understanding its development trajectory.

THE SOCIALIST ERA

At the time of the founding of the People's Republic in 1949, China was among the poorest countries in the world. Its per capita income was a little over US$700 (in internationally comparable prices, see Figure 1), barely five per cent that of the United States at the time.

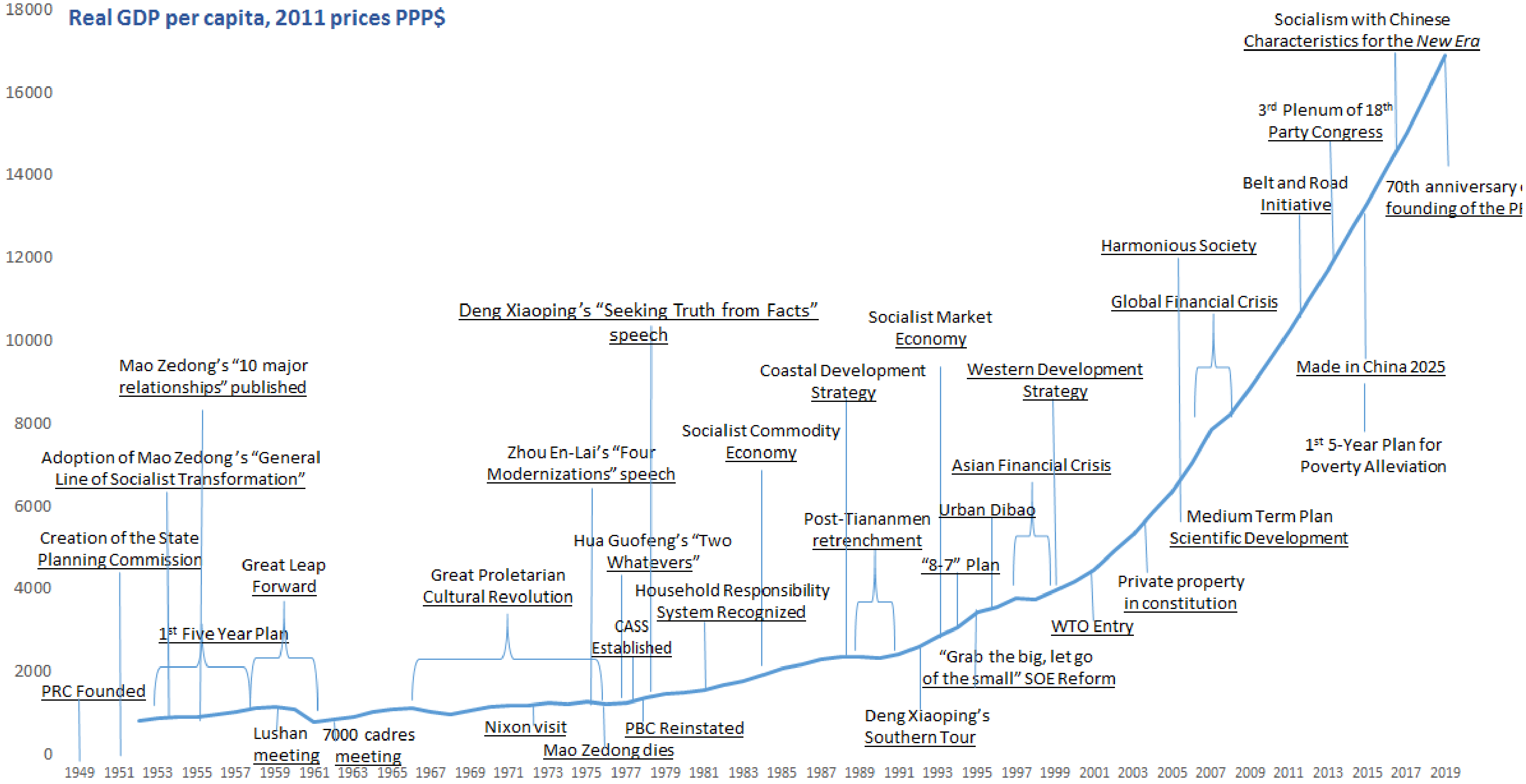
Though no official poverty statistics exist from that era, poverty based on the World Bank's extreme poverty line was likely to have affected more than 95% of its population.

China made progress in the early days of the PRC under the planned economy. By 1952, China had brought inflation under control, had collectivised land and the newly established State Planning Commission had formulated the country's first five-year plan. With the adoption of Mao Zedong's "General Line of Socialist Transformation", nationalisation and collectivisation accelerated. Subsequently, the planned economy, following the Soviet example and at first implemented with Soviet assistance, was to remain the mainstay of the economy until 1978.

Between 1951 and 1977, consumption per capita increased by some 50%, according to national accounts data from the Penn World Tables. This progress was made despite major setbacks during the Great Leap Forward: Mao Zedong's attempt to catch up rapidly with the West cost almost a third of China's GDP while millions of lives were lost.

Despite the disruptions and human tragedies of the Cultural Revolution, which practically halted university education, human capital improved due to investment in primary education and expansion of basic health care by "barefoot doctors". In 1950, the average worker enjoyed only a paltry 1.3 years

FIGURE 1 70 YEARS OF ECONOMIC DEVELOPMENT AND POLICY IN THE PEOPLE'S REPUBLIC OF CHINA



Sources: Hofman, Bert (2018). "Reflections on 40 years of China's Reforms". In R Garnaut, L Song and C Fang (eds.), *China's 40 Years of Reforms and Development* (pp. 53-66). ANU Press. Bottelier, P (2018). *Economic Policy Making in China (1949-2016). The Role of Economists*. Oxon, UK and New York, NY, Routledge. Penn World Tables Version 9.1; World Development Indicators; author's calculations.

of education. By 1980, this had tripled to almost four years by 1980, according to Barro and Lee Data.

The World Bank's 1981 Socialist Economic Development study records: "Despite slow growth of the average level of consumption China's most remarkable achievement during the past three decades has been to make low income groups far better off in terms of basic needs than their counterparts in most other poor countries".

Nevertheless, by 1978, at the onset of reform and opening up, China was still very poor. Almost 90% of its population lived in absolute poverty, its share of the world economy was barely 1.5%, and its economy was predominantly agricultural, rural and closed.

THE FIRST PHASE OF REFORMS: SEEKING THE MARKET

Forty years of reform have turned China into the second largest economy in the world, the largest manufacturer and exporter, and the second largest spender on Research and Development. Six out of 10 Chinese now live in cities.

China will likely complete the journey to become a high-income country in the next decade and eliminate extreme poverty by next year.

Per capita income in constant dollars rose 25-fold, from US$308 in 1978 to US$7,329 in 2017 (in prices of 2011);[1] and more than 800 million people escaped poverty, according to World Bank numbers.

To a large extent, China's success in reducing poverty can be attributed to the sustained rapid economic growth unleashed by the reform and opening up after 1978.

"Poverty is not socialism, not communism", Deng Xiaoping famously said.

Deng kicked off reforms in a famous speech from 1978 titled, "Emancipate the mind, seek truth from fact, and unite as one to face the future".

Though he quoted Mao Zedong, the speech was a major departure from Maoism – a shift away from class struggle to economic development and a shift away from ideology to the emancipation of the Chinese mind by learning from others.

China's reforms followed prescriptions recommended by mainstream economists. The country opened up to foreign trade and investment, alongside new ideas on economic management.

It also liberalised prices, diversified ownership, allowed the private sector to flourish, strengthened property rights, and invested in infrastructure and people.

Relative macroeconomic stability allowed high savings to be turned into high investment and rapid urbanisation, which enabled rapid structural transformation and productivity growth.

That summary, however, obscures the importance of the incremental and pragmatic character of China's reform process. In Chinese, that approach is captured in the phrase "Crossing the river by feeling the stones", often ascribed to Deng, though it was another party leader Chen Yun who said it.

Deng's own "It does not matter whether the cat is black or white, as long as it catches mice", which he first used in 1962 after the Great Leap Forward, became the credo for pragmatic reformers - doing what works.

Within this broad guidance from the leadership, reforms were implemented experimentally, often starting in a few regions, and expanding nationally only upon proven success and taking into account development level and implementation capacity.

Hence, in place of a pre-set formula for development and shock therapy, room for the country's own institutions and growth path to be gradually identified was provided.

Alongside, local officials were incentivised to succeed in implementing this reform agenda —

[1] Note that this is a different measure from the Penn World Tables, which measures income in Purchasing Power Parity or PPP.

their performance evaluation depended on success of their region. Competition among localities in attracting investment created good conditions for growth. "Directed Improvisation" is what Singapore Professor Ang Yuen Yuen has astutely termed China's idiosyncratic path.

Political reforms, within the Communist Party, reinforced economic reforms. The introduction of age limits brought younger, more reformist cadres into the leadership fold, whereas term limits and collective decision making limited government discretion, which in turn boosted investor confidence in reforms.

The first phase of China's reforms, roughly from 1978 to 1993, were market-seeking — seeking ways to build the market, first in agriculture, then in small-scale industries and further in urban areas and industries.

The Tiananmen tragedy in 1989 interrupted reforms, but they were rekindled by Deng Xiaoping during his "tour to the South" in 1992, which made clear that even though political reforms were not in the books, economic reforms were there to stay.

THE SECOND PHASE: MARKET BUILDING

The second phase of reforms, from 1993 to around 2003, or the Zhu Rongji years, were more outright market-building reforms.

The 1993 Third Plenum of the 14th Party Congress Central Committee had declared the socialist market economy as the prevailing system in China. This was the first time the term "market" was used to describe China's economic system.

The 1993 Plenum's decisions contained many features of China's economic management today, including the tax-sharing system, a modern central bank capable of designing and implementing monetary policy, and policy banks to relieve commercial banks of their policy function.

It also initiated state-owned enterprise reforms, which started in earnest after the Asian Financial Crisis under the banner of "Grab the big, let go of the small", which triggered privatisation of small state enterprises, privatisation of the housing stock and establishment of social security separate from people's employer.

China's entry into the World Trade Organisation in 2001 locked in market reforms and made China the production platform of choice for Asia's supply chains. Exports surged and economic growth, driven by productivity increases unleashed by the reforms made in the run-up to the WTO, surpassed 10% per year, until the Global Financial crisis cut it short.

THE THIRD PHASE OF REFORMS: MARKET ENHANCING

In the third phase of reforms, China's authorities increasingly sought to enhance the market.

Market-enhancing reforms came in two forms: First, the rapid expansion of social protection and insurance — pension, health-care and welfare policies, among others, and a sharp reduction of taxes burdening farmers.

Second, industrial policy returned to the scene. The 15-year Long-term Plan for Science and Technology laid the basis in 2006 for China to make the move from a labour-intensive manufacturer of low value-added goods to an innovative industrial superpower.

The practical translation of this notion became "Made in China 2025", the controversial plan at the core of the trade dispute with the United States.

Furthermore, state-owned enterprises made a return. The economic stimulus implemented after the Global Financial Crisis gave them a new lease of life; while the 2013 Third Plenum of the 18th Central Committee had assigned a decisive role for the market, it also reiterated the leading role of state-owned enterprises in China's economy.

What had also returned was ideology. The Chinese Communist Party's 2013 Communique on The Current State of the Ideological Sphere reminded all that China would not become a Western liberal economy, nor would it make concessions to the Communist Party's leading role. Indeed, the perception in China was that the Global Financial Crisis was evidence for some that the Western system had malfunctioned and could no longer serve as an example for China.

At the same time, the Party's anti-corruption campaign was to ensure that it remained fit to govern China. Indeed, the mesh-up of business and government, which had served China so well in the early days of reforms, had become a source of corruption. Moreover, the entrepreneurial official seemed redundant amid an abundance of entrepreneurs and the growing strength of the country's investment climate.

The 2017 19th Party Congress confirmed the new policy directions: Market-based allocation, a leading role for public ownership, and a strong emphasis on industrial policies and science and technology to achieve the goals of the "first phase of the New Era (2020 to 2035)", that of socialist modernisation.

Meanwhile, China abolished term limits for the highest office in the country and "Xi Jinping Thought" became part of the Party and country constitution.

OUTLOOK

China is well on its way to becoming a high-income country. At the same time, its level of income is only one quarter that of an average OECD country. Thus, China still needs relatively rapid growth to achieve its centennial goals.

Sustaining rapid growth has become harder for China, now that surplus labour from the countryside is almost exhausted, demographics no longer provide dividends and the marginal returns on capital are likely to decline.

The 2013 Third Plenum of the 18th Party Congress and the Secretary General's report to the 19th Party Congress reflect the leadership's understanding that China's growth will have to increasingly rely on productivity increases and innovation.

Productivity growth has been lagging since the Global Financial Crisis — and not just in China. Within China, though, the relative importance placed on state-owned enterprises is not helpful as most evidence suggest they are less efficient, in part because even inefficient state-owned enterprises do not go bust.

There is also evidence that a large presence of state-owned enterprises in a sector discourages the entry of private firms — yet entry of new enterprises is key to innovation. Indeed, there is no high-income OECD country with a large share of state-owned enterprises in the economy.

A second headwind for future growth comes from the trade dispute with the United States. The causes of this dispute are multiple, and the trade war is rapidly turning into a tech war, and perhaps even a new cold war. US domestic politics played its own part in this, but the perceived end of China's convergence to a more market-based economy and more open polity is a major cause as well.

Both sides will need compromise to reach a deal, but any enduring solution to this dispute will require further reforms in China — strengthening institutions that will make China's mixed economy work, further opening up of its markets, and acquiring the technology, managerial talent and ideas to catch up with more advanced countries.

Further opening up will also spur competition among its enterprises, enticing innovation and increasing productivity, which will be the main source of growth for the future.

Finally, China would do well to support reforms of the international trading system — a system of which it has been a principal beneficiary. Though China's record of living by WTO rulings is on a par with its current adversary, the rules are vague in areas of industrial policy, subsidies and state enterprises, and too all-encompassing in the area of national security. Changing them would benefit both sides of the dispute and the rest of the world.

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