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Opportunities and challenges in China's economic development

China was one of the most advanced and powerful countries in the world for more than a thousand years before the modern era. Even in the nineteenth century it dominated the world economic landscape. According to Angus Maddison, the famous economic historian, China accounted for a third of global GDP in 1820 (Figure 1.1). But with the Industrial Revolution in the eighteenth century, the West quickly rose, and China slid. And with a weaker economy, it was defeated repeatedly by the western powers, becoming a quasi-colony, ceding extraterritorial rights in treaty ports to twenty foreign countries. Its customs revenues were controlled by foreigners, and it surrendered territory to Britain, Japan, and Russia.

Since China's defeat in the Opium War in 1840, the country's elites, like those in other parts of the developing world, strived to make their motherland a powerful and respected nation again. But their efforts produced little success. China's share of global GDP shrank to about 5 percent and stayed low until 1979 (Figure 1.1).

China's economic fate then changed dramatically at the end of the 1970s when it started to implement the reform and opening strategy. Since then, its economic performance has been miraculous. Annual GDP growth averaged 9.9 percent over the next thirty years, and

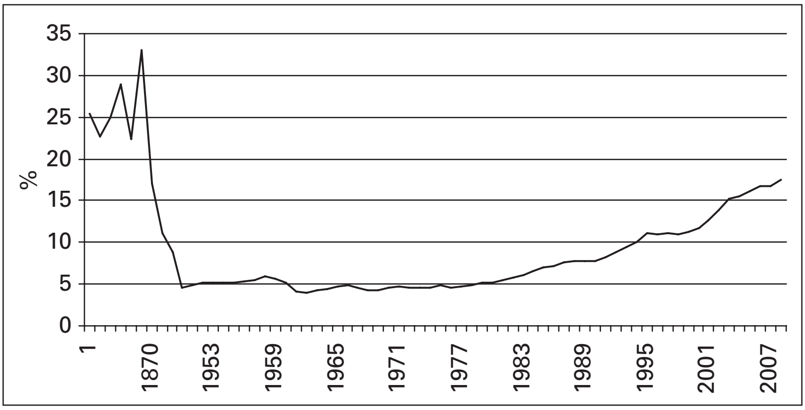

Figure 1.1 China's share in global GDP (%)
Source: Maddison (2006).

annual growth in international trade, 16.3 percent. In 1979 China was one of the poorest countries, with a per capita income of $210, a third of the average among the developing countries in sub-Saharan Africa, the poorest continent in the world.

Today China is a middle-income country, with a per capita GDP of $3,744 in 2009. It overtook Japan in 2010 as the world's second largest economy and replaced Germany as the world's largest exporter of merchandise. It is now the world's largest car producer, and Shanghai has been the world's busiest seaport by cargo tonnage since 2005. If China can sustain the current pace of growth, it will again become the world's largest economy by 2030 or even earlier.[1]

Against such a historical background, this chapter focuses on the opportunities and challenges in China's economic development. It sets the stage for answering five questions in the following chapters.

- Why was China the largest and most advanced civilization before the Industrial Revolution, yet lagging far behind western countries after it?
- Why was China's economic performance so poor before its reform and opening at the end of the 1970s, yet so miraculous after the reform?

- Why is China plagued by fluctuations in the economic cycle, fragility in the financial system, difficulty in the reform of state-owned enterprises (SOEs), widening in the gaps between regions, and unfairness in the distribution of income in the reform and opening process?
- To sustain rapid and sound growth in the twenty-first century, which aspects of China's economy should be reformed?
- Is China's economic growth real? Where is the exchange rate heading? And what about other issues of common concern, like the construction of a new socialist countryside and a harmonious society?

By reviewing both successes and failures of economic reform and development in China, as well as in other countries and regions, I put forward a general theory of economic transition and development. Based on this theory, I analyze China's achievements during its reform and opening, its major economic and social problems, the reasons for those problems, and the suggested solutions.

Fruits of China's reform and opening

The change in China's fate started in December 1978 when the Third Plenary Session of the 11th Central Committee of the Communist Party of China ushered in the reform and opening strategy – to reform the economic structure and open the economy to more foreign trade. An economy's openness is usually measured by the ratio of foreign trade-to-GDP, the "foreign trade dependency ratio." Mainland China's foreign trade at $20.8 billion in 1978 was 12% less than that of Taiwan, China. China's imports accounted for 4.8% of GDP, exports, 4.7%, and total trade, 9.5%.[2] Early in 1980, Deng Xiaoping, the architect of China's reform and opening strategy, proposed a target for that program: to quadruple China's 1980 GDP by the end of the twentieth century, possible only with average annual growth of 7.2 percent. Then a major in economics at Peking University, I doubted the attainability of the target. According to the theory of natural rate of growth, then widely acknowledged, no country can sustain long-term annual growth above 7 percent, except after a war or natural disaster. True, Japan and the four Asian Tigers managed it over two decades since the 1960s but their stunning performance was regarded as exceptional: the East Asian Miracle.

At the end of 1978 China had a population of 1 billion, with farmers accounting for 80 percent of the total, and a huge number of illiterates. So it was less than credible that a country as backward and impoverished as China could sustain 7.2 percent growth for two decades. But as an old Chinese saying puts it: "Striving for the best, you will be an average at worst; striving for the average, an underachiever at best." Quadrupling GDP was seen more as a slogan than an attainable target.

Two decades later Deng's aim turned out to be timid. As stated, in the thirty years from 1979 to 2009, China's average annual growth was 9.9 percent, 2.7 percentage points higher than the targeted 7.2 percent.[3] Those added percentage points, seemingly small, translate into an aggregate economic volume 18.6 times that in 1978, more than twice the sevenfold increase from quadrupling GDP at 7.2 percent. Since 1978 the average annual growth of foreign trade has been 16.3 percent, 6.4 percentage points higher than GDP growth. By 2009 the volume of foreign trade exceeded $2.2 trillion, a 107-fold jump in thirty years.[4] Deng was thus a true statesman with great vision. Embarking on a seemingly impossible mission, he would prove that his ambitious targets were attainable.

When I returned to Peking in 1987 after finishing my doctorate at the University of Chicago and a year of postdoctoral work at Yale, China was embarking on a globalization strategy, "attending to the international economic circulation" through trade.[5] Specific practices included: "encouraging sizable exports of processed products while promoting sizable imports of raw materials" and "processing imported material according to supplied samples, assembling supplied parts, and compensation trade." The topic of the first policy brainstorming I took part in was: What would China's foreign trade dependency ratio be if the strategy of attending to the international economic circulation was implemented?

That ratio can be pretty high, even above 100 percent for small economies, such as the four Asian Tigers. But for larger economies, it is usually much lower. Among countries with a population over 100 million, Indonesia's dependency ratio was 23 percent in 1984, according to the 1986 *World Development Report*, an annual publication of the World Bank.[6] In my opinion, China could do better if it tried harder; so I argued that China could hit 25 percent. But that number was dismissed, for most people did not believe that I, educated in America, truly understood China's affairs. China's dependency ratio had grown from 9.5% in 1978 to 16% in 1984. In the same year, the ratio was 15.2% for the United States, and 23.9% for Japan.[7] So, popular sentiment was that 25% was not a reasonable target, even with the new strategy. My prediction proved as conservative as Deng's in 1978. By 2008 the ratio reached 62%.

Besides expanding foreign trade, China has been vigorously attracting foreign investment. In 2008 foreign direct investment flows to China were $692 billion, making it the world's number two investment destination, second only to the United States.[8] And thanks to continuous economic growth and ever-expanding foreign trade, China has amassed the largest foreign exchange reserves, approaching $3 trillion, giving it more bargaining chips in the international arena.

Stabilizing and driving the world economy

China's rapid economic growth since its reform and opening has exerted great influence at home and abroad. Domestically, the most visible outcome is that living standards have dramatically improved. In the 1980s those who returned from overseas were allowed to bring home "three major items" duty free. With an overseas stay of more than half a year, six items were allowed. When I prepared to return in 1987, eight items were allowed in an effort to encourage more overseas graduates to come back to China. My eight-item package included a color TV, a refrigerator, a washing machine, an electric water heater, and four electric fans for my family. It was unimaginable in those days that school offices and almost every household in town would one day be equipped with air conditioning.

The living standards of both white-collar workers and farmers have been greatly enhanced. In 1978 an estimated 30 percent of rural residents, about 250 million, lived below the poverty line, relying on small loans for production and state grants for food. Contrast that with 36 million in 2009.[9]

Chinese people are not the sole beneficiaries of its reform and opening. China's exports of consumer goods and life's necessities, inexpensive and of good quality, improve the living conditions of the poor in many other countries.

Another contribution of China to the world economy is its stabilizing effect, as in the East Asian financial crisis starting in October 1997. During that crisis, countries in the region devalued their currencies one after the other. The South Korean won fell from 770:1 against the US dollar before the crisis to 1,700:1, the Thai baht from 25:1 to 54:1, and the Indonesian rupiah from 2203:1 to 11950:1.[10] East Asian economies were similar to China in their stage of development and export mix. And the substantial depreciation of those currencies made their products a lot cheaper in world markets, putting great pressure on Chinese exporters. The international financial community then expected China to follow suit, since exports meant so much to the country. But devaluing the renminbi (RMB) could induce "competitive devaluations," putting the crisis-afflicted countries in an even more precarious position.

The economic outlook in East Asia was even gloomier than in the United States during the Great Depression of 1929. Many experts in international economic and financial circles felt it would take a decade – or even longer – for the East Asian economies to recover. The world's eyes were on China and whether it would devalue. Despite the doubts and suspicions, China put the stability of neighboring economies high on its agenda, committed not to devalue its currency, and then honored this commitment, contributing much to Asia's rapid recovery in just a couple of years. What made that contribution possible? The substantial foreign exchange reserves that China had piled up since the reform and opening – and its enormous imports from East Asian economies.

Similarly, when the global financial crisis erupted after the collapse of Lehman Brothers in September 2008, China, counting on its large fiscal space and abundant foreign reserves, immediately adopted a stimulus package of $685 billion. The Chinese economy started to recover in the first quarter of 2009. Its GDP growth rate reached 9.1% in 2009 and 10.1% in 2010 despite global GDP's contraction of 2.2% in 2009 and growth of only 3.9% in 2010. China's strong growth during the crisis was the most important driving force for the global recovery.

Indeed, China's economic growth has benefited far more countries than just its neighbors. Over 2000–07 two-thirds of the economies in Africa grew at more than 5.5 percent a year, and nearly one-third reached 7 percent. Again, such unprecedented growth in Africa was in large part thanks to China. Its massive raw material imports have boosted prices in world markets, good for resource-rich African countries.

The same is true for many Asian and Latin American countries. Take Japan's Nippon Steel Corporation. Booming in the 1950s and 1960s, it waned when iron and steel became a sunset industry in the 1970s in Japan. Yet in the 2000s, its profits have been on the rebound. The biggest reason: rising international steel prices driven by Chinese imports. Argentina, Brazil, Chile, and other Latin American countries have also benefited from trading with China.

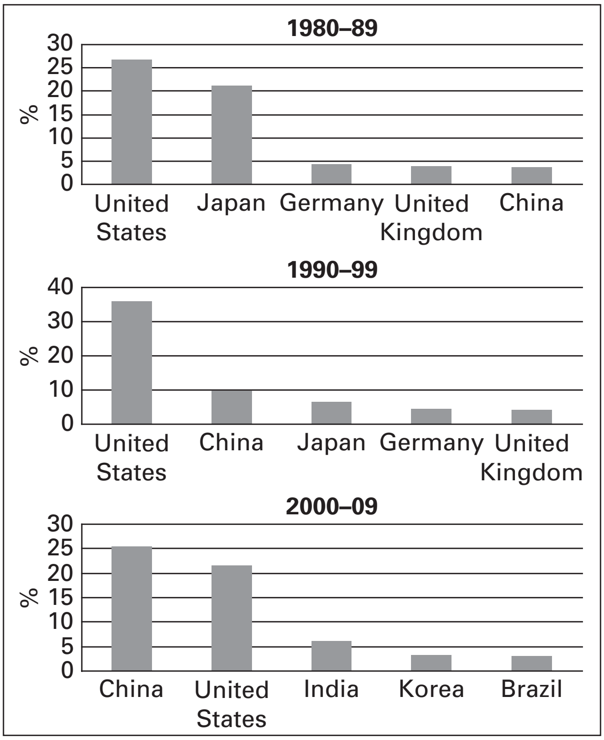

Figure 1.2 Top five contributors to global growth, 1980–2009
Source: World Bank, World Development Indicators.

China has thus become a major driving force for the world economy. In the 1980s and the 1990s, except for China, the other top five contributors to the growth of global GDP were all members of the G7 industrialized countries; in these two decades China's contributions were respectively 13.4 percent and 26.7 percent of the contributions of the United States. But in 2000–09 China became the top contributor, exceeding that of the United States by 4 percentage points (Figure 1.2).

Despite the rapid growth over the past three decades, China's per capita GDP was only $3,650 in 2009, about 8 percent of that in the United States. There is also a yawning gap between China and the rest of the developed world in per capita income, which China can narrow only with sustained growth, also critical to job creation for China's growing urban and rural workforce.

Reform could have undermined the interests of some groups, leading to social tensions. But China averted social unrest during its reform by not repeating the failures of the former Soviet Union and Eastern Europe. How? Rapid growth created resources for the government to compensate those groups.

The potential for China's continuing economic growth

Before the Industrial Revolution of the eighteenth century, growth across the world was rather slow – 0.05 percent a year. After that, growth accelerated but was quite unbalanced, and the differences between some countries were huge, with one or two as the locomotives of the world economy. First to take the lead was Great Britain, where the Industrial Revolution originated. But it was overtaken by the United States sometime between the end of the nineteenth century and World War I. After World War II Japan and Germany recovered rapidly, injecting new vitality to the world economy. But in the twenty-first century those four developed economies have had great difficulty in finding new areas for growth. And political and social issues in those countries have hindered their growth. Meanwhile, China has come to the fore as a new locomotive. How far China's train can roll will hinge on its fuel – on its potential for growth.

Opinions about the potential for China's growth vary greatly, with two typical takes. One holds that China will outpace the United States by 2030 or even earlier. The other is that China's economy could collapse at any time.[11] Which view is more sensible? Answering this question requires understanding the key determinants of economic growth. From the perspective of production functions, it is determined by the following:

- *Factors of production*. In economics the factors of production include natural resources, labor, and capital. If the factors of production increase in proportion, so will output. But in modern society, since natural resources are restricted by the area of the country, they can be regarded as fixed. The increase in labor is limited by population growth. So capital is the most variable of the three. Since China's reform and opening, savings and investments have exceeded 40% of GDP annually. For some countries, the figure ranges from 10% to 15%; for some African countries, it is close to zero. Of the factors of production, capital is the most critical for economic growth.
- *Industrial structure*. If the factors of production are allocated to industries with higher value-added, output will also increase. So the industrial structure also determines economic growth – moving factors of production to sectors with higher value-added, the economy will grow even without increasing those factors.
- *Technology*. Technology is another big determinant. Technological progress means higher productivity. Even when the industrial structure and factors of production remain unchanged, with better technology, an economy's output and growth will improve as well.
- *Institutions*. With the foregoing productive inputs, industrial structure, and technology, one can construct a production-possibility frontier, an economy's maximum obtainable output in an ideal state. How close it approaches that maximum hinges on institutions, which can help in upgrading labor, using resources effectively, and adopting appropriate technology.

Among these four determinants, technology is the most important in practice. The other three are subject, to some degree, to the speed of technological change.