

NEWSLETTER

in association with the South Asian Bureau of Economic Research (SABER)

Welcome to the East Asian Bureau of Economic Research (EABER). EABER aims to be the premier East Asian economics research forum and provide a single point of reference for the economics, finance and governance research community throughout the region and beyond. Through building research capacity and partnering initiatives, EABER facilitates the creation of high-level analysis and forward thinking on issues of importance to the East Asian economy.

Analysis

China: A Sixty-Year Experiment with Free Markets

Yiping Huang*

When Mao Zedong arrived in Beijing sixty years ago with his comrades from Yan-an, a remote town in Northwestern Shaan-xi province, he probably did not intend to ban free markets across the country. The socialist transformation began when Mao set his eyes on overtaking the United States. This was to be achieved, according to him, through the development of heavy industries, especially the steel industry.

The central planning system was established to maximize urban industrialization, but the development of urban industries required funding. At the time, China was a predominantly agrarian economy. Policymakers developed the Unified Purchasing and Marketing System (UPMS), which purchased agricultural products at below-market state prices and delivered goods to urban households and industries. Low material and labour costs enabled the urban industries to generate abnormal profits, which could be re-invested to accelerate urban industrialization further.

To facilitate the smooth operation of the UPMS, the government introduced new institutions in three other areas: first by banning free markets so that farmers had nowhere else to sell their products, second

by collectivizing agricultural production so that farmers would produce what the state required and finally by enforcing the household registration system so that farmers would have no option other than farming for the state.

This policy framework functioned quite effectively for a while. From the mid-1950s to the early-1970s, urban industries recorded an average growth rate of 11 per cent – a remarkable achievement. But the system eventually collapsed and by the late 1970s it was obvious that the thirty years of policy experimentation with the central planning system had failed.

Throughout the next thirty years, the government implemented a host of major economic reforms, including the adoption of a rural household responsibility system, the privatization of urban state-owned companies and the liberalization of foreign trade. The core element of all these reforms was the re-introduction of free markets into the Chinese economy.

This new policy experiment paid off handsomely. Over this thirty-year period, real GDP grew by an average of 10 per cent a year. Before reforms, China was a closed, agrarian economy. Today China is the world's third largest economy, and it wields significant influence over international markets, especially the foreign exchange and commodity markets. In fact, it has been proposed that the United States and China should form a 'G2' for the joint management of global affairs.

Paper of the Month

The most downloaded paper for August 2009 is **Health Care Services and Government Spending In Pakistan** by Akram and Khan.

Latest News

Visit the EABER Bookstore for recent publications from the EABER network. Visit <http://www.eaber.org/intranet/publish/Public/bookstore.php>

The SABER website is now live at <http://saber.eaber.org>

For daily content on economics, politics and public policy in East Asia and the Pacific, read www.eastasiaforum.org

EABER Members

China Center for Economic Research, China

The Central Institute for Economic Management, Vietnam

The Center for Strategic and International Studies, Indonesia

City University of Hong Kong, Hong Kong

Economic Institute of Cambodia, Cambodia

The Energy Research Institute, China

The Fiscal Policy Research Institute - Ministry of Finance, Thailand

The Institute of Asia-Pacific Studies, China

The Institute of Energy Economics, Japan

But the re-introduction of free markets into China is incomplete. For the past thirty years, consumer markets have been almost completely liberalized. But the fact remains that Chinese markets are still heavily distorted. The household registration system and the under-developed social welfare system distort labour costs. Interest rates are still highly regulated and the allocation of credit is dominated by state-owned agencies. Land is owned by the collectives in the countryside, and by the state in the urban areas. And energy prices are still set mainly by the authorities.

Some of these distortions, such as state control of energy prices, are the result of deliberate policy decisions. Others, such as the household registration system, result from the reform transitions. But they all share common features, generally depressing factor prices and lowering production costs. These producer subsidy equivalents were estimated to be 7.2 per cent of GDP in 2008.

In fact, this pattern of factor market distortion has a remarkable resemblance to the pre-reform urbanization strategy, which involved the lowering of production costs to maximize industrial growth. But there are two important differences. First, free markets for products help to allocate resources efficiently. Second, the autonomy and incentives they provide for firms and individuals ensure the achievement of technical efficiency.

This new institutional arrangement has been successful, judging from the present rates of rapid economic growth. The producer subsidy equivalents have increased production profits, raised investment returns and improved the international competitiveness of Chinese products. This has artificially lifted China's economy to levels that would otherwise not be possible.

But the new institutional arrangement is not without costs. The most obvious problems are the structural imbalance resulting from the overdependence of the economy on exports, and the high rates of investment and resource consumption. The result has been a decline in the household income share of GDP, with significant implications for consumption.

In Premier Wen Jiabao's words, the current growth path is 'unbalanced, inefficient and unsustainable'. China will have to make many changes in order to improve the quality of economic growth and to achieve the principles of sustainability. But a central step will be the liberalization of the factor markets: markets for labour, capital, land, energy and the environment.

China spent the first thirty years banning all free markets. It then spent the next thirty years freeing up the goods markets. Let us hope that the liberalization of factor markets will take less than thirty years.

EABER Members

Institute of World Economics and Politics, China

Japan Center for Economic Research, Japan

The Japan Policy Research Institute, Japan

The Korea Energy Economics Institute, South Korea

The Korea Institute for International Economic Policy, South Korea

The Malaysian Institute of Economic Research, Malaysia

The New Zealand Institute of Economic Research, New Zealand

The Philippine Institute for Development Studies, Philippines

Singapore Center for Applied and Policy Economics, Singapore

The SMERU Research Institute, Indonesia

Singapore Management University, Singapore

The Thailand Development Research Institute, Thailand

The Australia-Japan Research Center, Australia

Crawford School of Economics and Government, Australia

EABER Supporters



EABER is grateful to the Japanese Ministry of Finance and the Australian development agency, AusAID, who provided grants to assist with the establishment of EABER in 2006-7.

EABER is also grateful to the ongoing support of the Bulletin of Indonesian Economic Studies (BIES) and Dhurakij Pundit University of Thailand.

**Yiping Huang, Peking University and the Australian National University.*