

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

Challenges of China's Economic Reform

Fan He *

China has successfully transformed itself from a planned, autarkic, mostly agricultural economy to a rapidly industrializing market economy. But managing China's massive growth surge requires continuing institutional change and reform and presents new challenges for Chinese leaders and policymakers.

On the eve of the 1978 economic reforms, Chinese political leaders were facing a number of difficulties in maintaining high growth and full employment. With a rapidly expanding population and the state owned sector placing an increasing burden on government finances, a fiscal crisis and a crisis that threatened the legitimacy of the regime were inevitable without reform.

The government chose a gradualist approach. In its initial phases this included the introduction of a household responsibility system allowing peasants to privately sell residual production once government contributions had been met. The household responsibility system created the incentives for vastly expanded agricultural production. With the rise of income and demand levels that this created, township and village enterprises (TVEs) mushroomed and became a driving force for China's growth.

The gradualist approach to economic reform has been outstandingly successful for the Chinese leadership but with the massive growth and increasing complexity of the Chinese economy the government now faces two new and major challenges. The first is how to handle the internal and external imbalances facing the economy. The second is how to reorient the country's growth to a more sustainable path.

Domestic savings (even compared to experience in other East Asian countries) are extraordinarily high, consumption is low and investment inefficient. In large part, these high savings rates are induced by the lack of a social safety net and the anxiety brought about by rapid social transformation. With domestic savings rising faster than investment, China's trade surplus, which is equivalent to the savings surplus, has increased. Typically, when one country has a trade surplus, it invests the revenue abroad and thus supports a capital account deficit. China, on the contrary, has a 'twin surplus' on both the current account and capital account. This external imbalance has resulted in China accumulating a huge quantity of foreign exchange reserves (now more than US\$1 trillion).

The first step in the correction of these imbalances needs to be a further appreciation of the RMB. Simply adjusting the exchange rate will not be sufficient to correct the imbalances in the Chinese economy, because China's trade sector does not seem to be very sensitive to relative price changes. But it is a necessary first step.

Paper of the Month

The paper of the month for April is **The Effect of Labor Market Institutions on FDI Inflows** by Dr. Chang-Soo Lee.

Latest News

The Australian Financial Review (11/04/07) published a revised version of the EABER newsletter article for April titled **Politics and the Japan-China Economic Relationship** by Shiro Armstrong.

EABER Supporters



Ministry of Finance,
Japan



Australian Government
AusAID



Centre for
Strategic and
International Studies
Indonesia

Secondly, domestic expenditure on public goods should be increased. An increase in expenditure will lead to an increase in imports, and a decrease in the amount of domestic products available for export, thus contributing to getting trade into closer balance. Compared with other countries and even developing countries with the same income level, China's expenditures on education and public health are far below average. The public expenditure program could include building a well-functioning social safety net for both urban and rural populations; increasing investment in human capital by providing better health and education; internal transportation and communication infrastructure to help achieve a more integrated domestic economy; and a rural development program for the poorest regions.

China's economic reform experience also demonstrates that establishing a sustainable market economy requires more than just price liberalization and privatization. There are many supporting institutions which are equally important for successful and sustained growth. Up until now, China has been muddling through all the unpredictable and complex situations it has faced with remarkable success. However, the "cross the river by touching the stone" approach adopted by the first generation reformists cannot guarantee that China can sustain its vigor. The issues that the second-generation reformists now confront are quite different from those faced by their predecessors.

The first generation reformists were charismatic political leaders. A handful of leaders relied on the leverage of an authoritarian political system to

pursue their agenda. They gave more freedom to the farmers and then there was no famine. They gave more freedom to private entrepreneurs and all kinds of non state-owned enterprises flourished. They gave more freedom to local government officials then they themselves changed from communist disciples to missionaries for a market economy. All these reforms were politically difficult but technically simple.

Second generation reformists come from the ranks. They do not have the aureole of the first generation political leaders. They must compromise with their peers, even subordinates and various interests in the community. Their style relies of necessity on consensus building. Carefulness and caution are their trademarks. This approach prevents the government making fatal mistakes but it may also cause it to miss the best opportunities.

The good news is that while growth continues, there remains a strong consensus across government and society on the need for reform. The government needs to tap this sentiment to work out a comprehensive set of changes. Public finance systems, financial sector reform, and social programs like education and public health are among the priorities on the new agenda for reform. The package of reforms will be complex, difficult and protracted.

The success or failure of these second generation reforms ultimately depends on the ability of China's political leaders to engage the cooperation of many more people in the endeavor – local officials, officials from many different ministries and agencies, and many different interests in society. The challenge now is to create the institutions and capacities, both technical and political, that will allow this to happen as a matter of routine and allow the remarkable growth of the past to be sustained in the future.

EABER Members

China Centre for Economic Research, China

The Central Institute for Economic Management, Vietnam

The Centre for Strategic and International Studies, Indonesia

City University of Hong Kong, Hong Kong

The Energy Research Institute, China

Economic Institute of Cambodia, Cambodia

The Institute of Asia-Pacific Studies, China

The Fiscal Policy Research Institute - Ministry of Finance, Thailand

The Institute of Energy Economics, 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 Philippine Institute for Development Studies, Philippines

The Japan Policy Research Institute, Japan

The Renmin University School of Finance, China

The SMERU Research Institute, Indonesia

Singapore Centre for Applied and Policy Economics, Singapore

Singapore Management University, Singapore

The Australia-Japan Research Centre, Australia

Crawford School of Economics and Government, Australia

EABER would also like to thank the following for their support:



Bulletin of
Indonesian
Economic Studies