China's 40 Years of Reform and Open Door Policy: A Giant Leap

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On 22 December 1978, the eleventh Central Committee of the Communist Party of China (CPC) completed its third plenary meeting. The Jingxi Hotel in Beijing's Haidian district was the venue for one of the 20th century's landmark events, launch of China's reform and opening-up policy. In the intervening years, China and its relations with the international community have been transformed.

It is 40 years since Deng Xiaoping kicked off China's reforms with his famous speech calling on citizens to 'Emancipate the mind, seek the truth from facts and unite as one in looking to the future'. The speech brilliantly used Mao Zedong's own thoughts to depart from Maoism, rejected the 'two whatevers' of Mao's successor, Hua Guofeng ('Whatever Mao said, whatever Mao did'), and triggered decades of reforms that would bring China to where it is now—the second-largest economy in the world.

Because of China's economic success, as a result, China's reforms are increasingly important for the rest of the world. Understanding the path travelled, the circumstances under which historical decisions were made are good lessons for the decision-makers of other countries how to proceed in their countries.

In the nineteenth National Congress of the CPC held on October 2017, General Secretary Xi Jinping's speech in particular signifies a departure from China's past ambitions and aspirations. In discussing the success of China, and by implication the Communist Party, Xi stated:

"It means that the path, the theory, the system, and the culture of socialism with Chinese characteristics have kept developing, blazing a new trail for other developing countries to achieve modernization. It offers a new option for other countries and nations who want to speed up their development while preserving their independence; and it offers Chinese wisdom and a Chinese approach to solving the problems facing mankind." (Xi 2017)

In some ways, China's reforms followed many of the prescriptions mainstream economists would recommend (Figure 1). The country opened up for trade and foreign investment, gradually liberalized prices, diversified ownership, strengthened property rights and kept inflation under control. Continued (relative) macroeconomic stability allowed high savings to be turned into high investment and rapid urbanization, which in turn triggered rapid structural transformation and productivity growth. It was the unique way in which China went about reforming its system that makes the country's reform experience of interest.

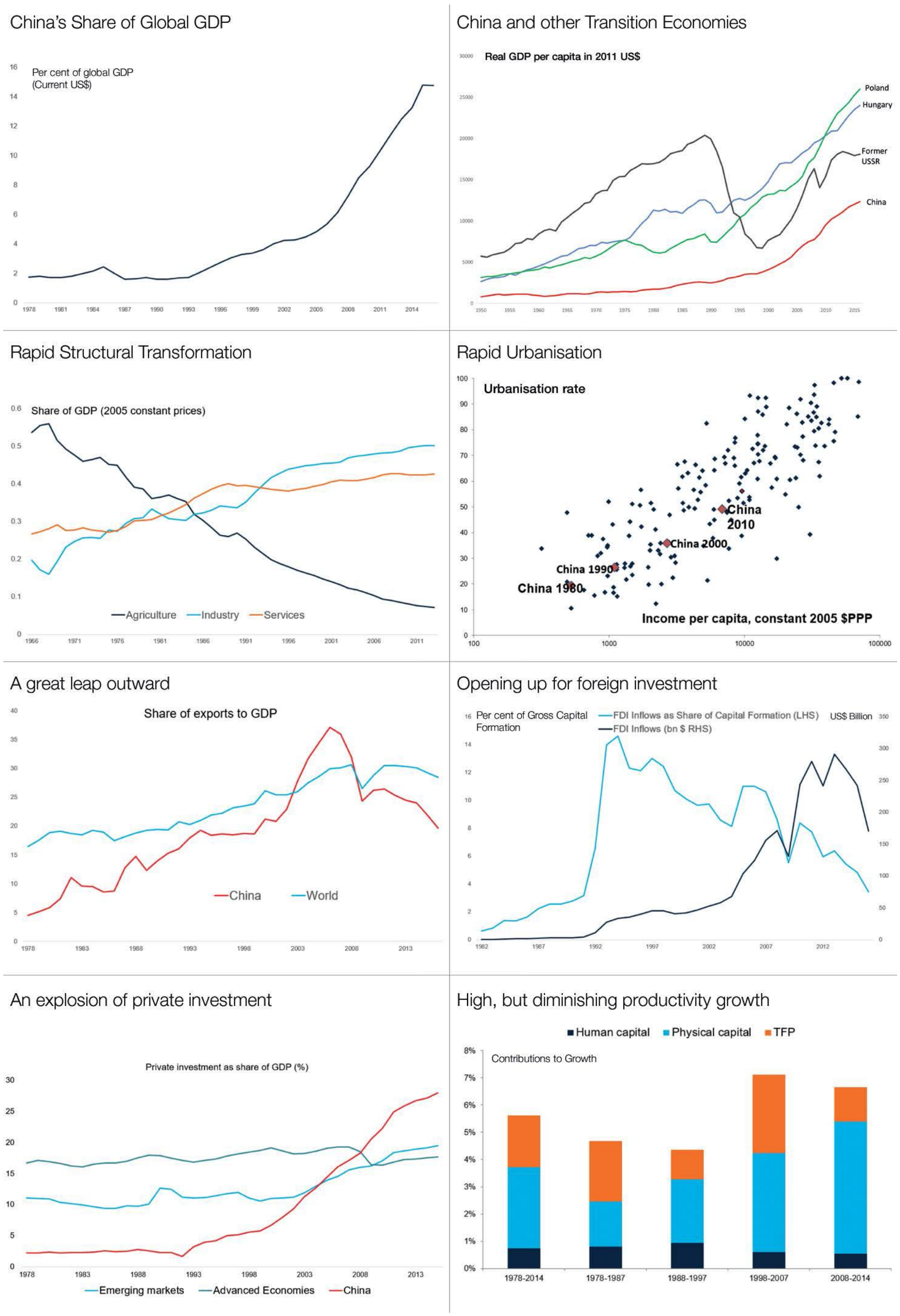

Figure 1. China's economic development, 1978–2016 Sources: World Bank (2018); Bolt et al. (2018).

At the onset of reforms, China was among the poorest nations on earth and a predominantly rural, agricultural country. China had barely 25 years of history of central planning, which had been marred by the failure of the Great Leap Forward and the political disruptions during the Cultural Revolution. The country was neither integrated into the world economy nor a member of the Council for Mutual Economic Assistance (Comecon). Gradual reforms meant that the physical and human capital built under socialism did not become obsolete as a consequence of a transition shock. Perhaps most importantly, although major political reforms of the party and state were implemented over time, the state and the ruling party remained intact throughout, so China could focus on its economic and social transitions.

How did China reform?

Gradual reforms

Reforms in China developed only gradually, starting in rural areas with the household responsibility system and township and village enterprises (TVEs) and some initial steps to open up the economy to foreign trade and investment, which only started to play a significant role in the 1990s (Table 1). Gradual also were the moves on the financial sector and state-owned enterprise (SOE) reform, which were much discussed throughout the 1980s, but gained momentum only in the mid-1990s. 'Crossing the river by feeling the stones' became China's mode of economic reform, implementing partial reforms in an experimental manner, often starting in a few regions and expanding them on proven success. Only with the 1993 'Decisions of the CPC Central Committee on Some Issues Concerning the Establishment of a Socialist Market Economic Structure' did a broader overall strategy emerge. Yet, this, too, was implemented gradually and experimentally rather than comprehensively.

There were several reasons for this gradual approach. First, gradualism was a means to circumvent political resistance to reform (Wu 2005). While the Cultural Revolution's political ideology of class struggle had been put to rest after Mao's death, many in the Communist Party retained a deep suspicion of the market and instead trusted the 'administrative' system (including the party) more.

Experimental reforms, confined to specific regions or sectors, allowed the authorities to gather information on the effects of reforms that could not be anticipated. They were also necessary to develop and test the administrative procedures and complementary policies needed to implement the reforms. With proven success, the experiment could be expanded to other regions and sectors.

Decentralisation and incentives

Decentralisation to local government became a powerful tool for progress within the confines of central political guidance. Provinces, municipalities and counties were allowed, and even encouraged, to experiment with reforms in specific areas, and successful experiments then became official policy and were quickly adopted throughout the country. In a way, by decentralising, China turned the country into a laboratory for reforms. The fiscal reforms introduced in 1980, which became known as 'eating from separate kitchens', formed a de facto tax contracting system, with high revenue retention rates for local governments—in particular, for those that were set for growth. For instance, Guangdong province only had to pay a lump sum in revenues to the central government and could retain 100 per cent of the rest. This distributed the benefits of reforms to a large part of the population as well as to local government and party officials, who therefore had strong incentives to pursue growth and promote a market economy.

The entrepreneurial role of local government officials also compensated for the lack of the formal institutions of a market economy and ensured the alignment of investors' and local officials' interests. Taken together, this environment provided a strong incentive for growth. A disadvantage was imperfect macroeconomic control and repeated bouts of inflation driven by local government loosening of investment and credit controls. Further, these conditions gave rise to local protectionism, which threatened to undermine China's unified market and competition among domestic firms. It also encouraged corruption among officials as the dividing line between official roles and private interests became increasingly vague. While in the first decades of reforms corruption was controlled by harsh punishment, in the decade leading up to Xi Jinping's anticorruption campaign, corruption became a major political and economic challenge.

Pragmatism and transitional institutions

The 'dual track' system for growing out of the planned economy was preeminent among all transitional institutions. It allowed a continuation of the planning system at planned prices, which avoided a collapse in production, but at the margin, the system allowed an unplanned economy to emerge. This also provided the information needed to gradually reform planned prices in such a way that, by the time of the abolition of most material planning in the mid-1990s, prices within and outside the plan had been largely aligned. Local officials' growing control over resources provided them with the incentives to pursue reforms and attract the investments needed to promote growth. The price, however, was a growing loss of macroeconomic control and, when inflation became the dominant concern in the early 1990s, the system was replaced with a more mainstream tax-sharing system, although not without a considerable political struggle led by then vice-premier Zhu Rongji. Perhaps the most successful example of a transitional institution was the TVE— an enterprise form that operated outside the plan, but was owned and to some extent managed by local governments across rural China.

China used its distinctive land policies to accelerate the country's development. Since the 1950s, land has been owned by the state in urban areas and by collectives in rural areas. Decentralising user rights to households in rural areas triggered sharp productivity increases in agriculture, which made rapid industrialisation possible. In urban areas, land value increases and conversion of rural to urban land played an important role in financing rapid urbanisation and infrastructure construction. By the early 1990s, lack of infrastructure had become a bottleneck for growth.

Starting in large cities, urban development and infrastructure companies (UDICs) became part of the solution. Often capitalised by land user rights from local governments, UDICs were able to borrow funds to develop the infrastructure needed to expand cities for industrial and residential use.

By the second decade of this century, this mechanism of land-based finance had run out of steam and the disadvantages of the system started to outweigh the advantages. Local governments' overreliance on land revenue had led to excessive land conversion, inefficient city design, debt accumulation and social unrest among those communities whose land had been expropriated. Thus, the 2014 revision of the Budget Law opened up formal channels for local government borrowing, while gradually closing the off–balance sheet route.

Institutionalisation of reforms

The study and formulation of reforms and new policies—which is of importance to other countries that aspire to reform—was itself institutionalised in China. Starting with the China Academy of Social Sciences in the early days of reform—the only place in which the study of 'Western' economics had continued throughout the Cultural Revolution—a variety of think tanks sprang up to study and promote reform. Among the most influential was the Development Research Center (DRC) of the State Council, a policy research organisation directly under the Cabinet, which provided a continuing stream of inputs for reforms. In recent years, the DRC has been a partner of the World Bank, among others, in the *China 2030* (2013) and *Urban China* (2014) studies. Today, the Center for Knowledge for International Development under the DRC, founded in 2017, is tasked with studying China's reform experience to make it accessible and digestible for other countries. Another highly influential body was the Systems Reform Commission (SRC) (formally, the State Commission for the Reform of the Economic System), whose task was to propose reforms in the system. The DRC and SRC, while government organisations, were set up to provide China's leadership with options for reforms in the economic system and in economic policy. Not burdened by institutional interests like many traditional government departments, these organisations became the source of many of the reforms undertaken in the 1980s and 1990s.

Three Phases of Rforms

It is helpful to analytically distinguish three phases of reforms: market-seeking reforms, roughly from 1978 to 1993; market-building reforms, from 1993 to about 2003; and market-enhancing reforms, from about 2003 onwards (Figure 2). This division is to some extent arbitrary, and the timing of the phases is not exact. Nevertheless, such a division captures the distinct policy directions taken in each of the phases.

In the first phase, there was a genuine search for the right economic institutions for China. As argued above, in part driven by politics, experimentation and decentralised initiatives, China was searching for ways to allow more of the market into its system. After the retrenchment policy, Deng Xiaoping's tour through southern China made it clear that market reforms were there to stay.

The decisions of the third plenum of the fourteenth National Congress of the CPC in 1993 triggered the second phase by laying out a comprehensive plan to build the institutions for a market-driven economy, including a modern tax system, enterprise reforms and a financial system that separated policy banks from commercial banking. The start of serious SOE reforms in the mid-1990s allowed those commercial banks to become commercial, the credit plan was abolished in 1995 and housing and (urban) social security reforms followed. Entry to the World Trade Organization (WTO) in 2001 not only served as a lever for domestic reforms, but also ensured much greater competition on the goods market. The slashing of import tariffs made China far more competitive in exports, as well as a viable platform for final assembly of much of the Asia-based exports hitherto produced elsewhere. The unification of the exchange rate at highly competitive levels in 1995 helped boost China's 'great leap outward' and its emergence as a major exporting power.

The inclusion of private property rights in the Chinese constitution in 2004 concluded the market-building phase. This phase—the Zhu Rongji years, if you will—can be seen as one in which the state retreated and left increasing room for the market. Perhaps the best indicator of this was the explosion of private investment, which increased its share in the economy from less than 2 per cent in 1992 to some 15 per cent by 2003. The share of private enterprises in industrial production rose from less than one-third in 1995 to 72 per cent in 2003. In 1999, the Chinese Government also consolidated all industry-related ministries into the Ministry of Commerce and the Ministry of Industry and Information Technology.

Since then, reforms have focused on *enhancing* the market. Perhaps to signify a new phase, the SRC, which played a key role in the reforms shifting from plan to market, was merged with the State Development Planning Commission in 2003 to form the National Development and Reform Commission (NDRC). With the publication of the 'Medium-Term Plan for Science and Technology' and initiation of the '16 megaprojects' (both in 2006), industrial policy has returned to the forefront of the government's agenda. This has since been amplified with the fifth plenum of the fourteenth National Congress (on productivity and innovation), the thirteenth five-year plan and the 'Made in China 2025' strategy (in 2015). This return to prominence for industrial policy was supercharged by the GFC, which China countered with a large domestic stimulus, and which provided ample resources for central and local governments to pursue those policies. State banks and SOEs were called on to serve as instruments to implement this policy. Although the third plenum of the eighteenth National Congress in 2014 declared the market should play a 'decisive role' in the allocation of production factors, it also pledged adherence to the 'basic economic system', with public ownership playing a dominant role in the economy.

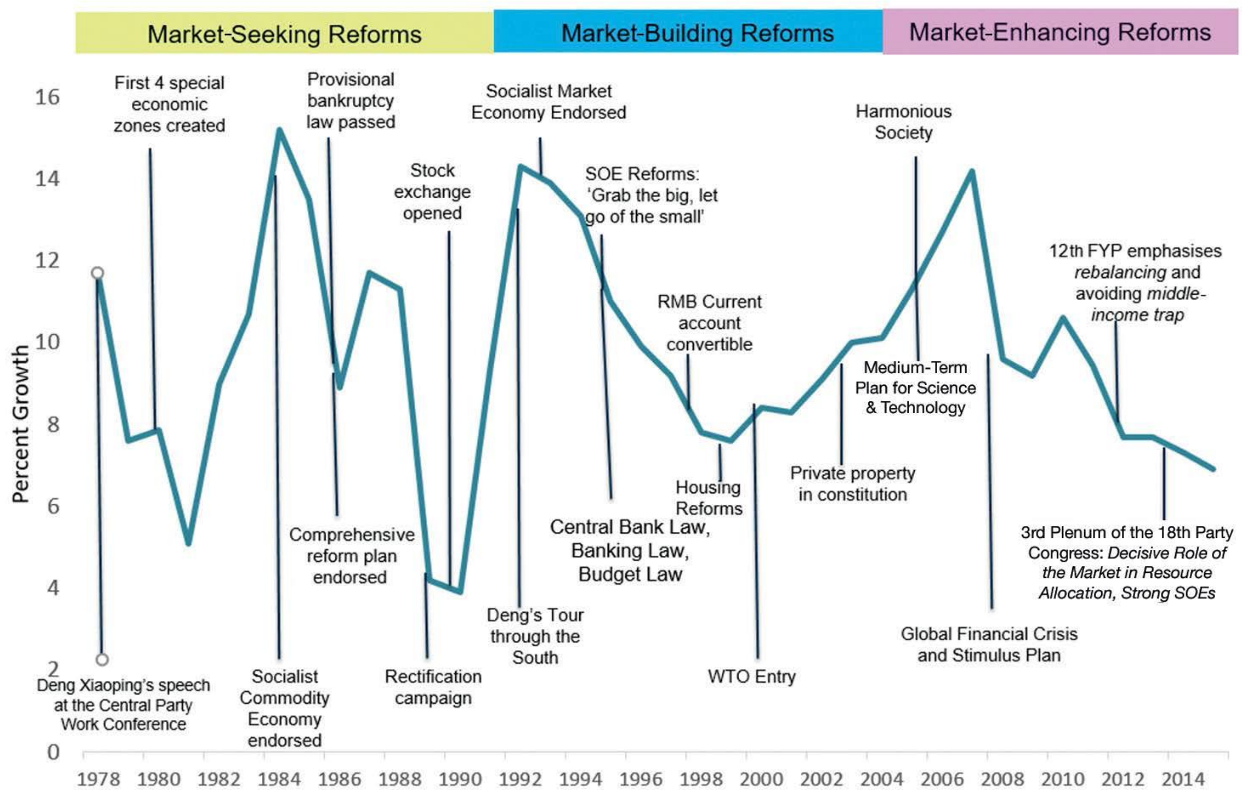

Figure 2. Phases of reform Sources: Wind Database; Hofman and Wu (2009); Gewirtz (2017); Bottelier (2018); various official documents and publications of the Chinese Government.

The next stage

The nineteenth National Congress and President Xi's report confirm these policy directions: market-based allocation, a dominant role for public ownership and a strong emphasis on industrial policy and science and technology to achieve the goals of the 'first phase of the new era' (2020–35)—namely, socialist modernisation.

Interestingly, socialist modernisation was also what Deng Xiaoping envisioned when he set out on his reform program in 1978. Deng spoke of the 'four modernisations' of industry, agriculture, national defence and science and technology, the idea of which went back to Zhou Enlai, who first formulated this concept in the 1950s; it became policy in 1963, but was disrupted by the Cultural Revolution. With 'socialism with Chinese characteristics for the new era', China seems to have found its own distinctive economic system, with markets and state ownership existing side by side and with industrial policy guiding the market. No doubt, the GFC contributed to the idea that a

Western-style market economy was not the panacea for China's economic development, and that China had to develop its own economic system. China's current economic system has its own complexities and issues—both internal to China and in the international arena. Domestically, there is tension between the central government's vision and industrial policies and their decentralised implementation. Once an engine of growth and institutional innovation, decentralised policy implementation has increasingly led to waste and overcapacity, as local governments pursue their own industrial policies and support their own enterprises at the expense of others—foreign and domestic alike. The government reorganisation announced at the 2018 National Congress promises increased central control over government policies and more limited space for local governments to pursue their own course, and is an attempt to resolve this tension. Changes in competition and budget policies further limit this space, while the government's anticorruption policies have reduced incentives for local officials to pursue their traditional entrepreneurial role. At the same time, the government's 'mass entrepreneurship' policies shift that entrepreneurial role further to the market—with a stronger role for the CPC in private enterprises to balance this. Internationally, China's mixed system encounters increasing resistance. Aside from geopolitical considerations, recent trade tensions reflect the unease of many Organisation for Economic Co-operation and Development (OECD) countries with China's model. They see China's state-led and state-supported enterprises as unfair competition for their enterprises in trade and investment. Aside from trade measures, these countries increasingly call for reciprocity in investment restrictions, and are enhancing their restrictions on acquisition by foreign interests of enterprises with key technologies. These measures could undermine the international system that has much benefited China in the past, and which China's leaders have strongly supported in recent years against a rising tide of protectionism. It is too early to tell how well 'socialism with Chinese characteristics for the new era' will serve China in achieving its two centennial goals, how the balance between the state and the market will shape up in the years to come and how China's industrial policies will remain compatible with the existing international economic system.

Irrespective of the outcomes, those who believed that by 'crossing the river' China would reach a familiar bank on the other side—a market economy not that different from the many varieties found in OECD countries—need to think again.

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