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China's Reform Experience to Date

Peter Harrold

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World Bank Discussion Papers
China and Mongolia Department

China's Reform Experience to Date

Peter Harrold

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Abstract

Since China launched its economic reform program in 1978, it has enjoyed an unparalleled period of economic success, which has generated interest around the world. The reforms that China has introduced have been well-documented in many studies and books. This paper provides an assessment of China's reform experience to date, since it was launched in 1978. This is done less from the perspective of a description of the steps that were taken in reform over this period, but rather it attempts to analyze the nature of this experience and its impact. It therefore looks at the distinct features of this experience, and provides a quantitative assessment of the impact of reform on output, productivity, external trade and investment, and the role of the state in the economy. Based on this assessment of the past achievements, it then goes on to examine the main areas where deeper reforms will be necessary if the Chinese approach is to prove sustainable over time. The paper concludes by attempting to draw some broad preliminary conclusions from the Chinese reform experience, which may be of wider applicability.

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ABBREVIATIONS AND ACRONYMS

7thFYP	-	Seventh Five-Year Plan, 1986-90
8thFYP	-	Eighth Five-Year Plan, 1991-95
DRC	-	Development Research Center of the State Council
GNFS	-	Goods and Nonfactor Services
IMF	-	International Monetary Fund
IOT	-	Investment Orientation Tax
MME	-	Ministry of Materials and Equipment
MOF	-	Ministry of Finance
PBC	-	People's Bank of China
SAEC	-	State Administration of Exchange Control
SOE	-	State-Owned Enterprise
SPC	-	State Planning Commission
SRC	-	State Commission for Restructuring the Economic System
TVE	-	Township and Village Enterprise

FOREWORD

The World Bank's economic and sector work program in China is a very active one ranging over a wide spectrum of topics from macroeconomics to health and education. Each year we publish a handful of our formal studies, but thus far most of the background papers and informal reports, many of them containing valuable analysis and information, have remained outside the public domain. We began last year, through the China and Mongolia Department Discussion Paper Series, to make available to a broad readership among the China watchers and development communities a few of the papers which can contribute to a better understanding of China's modernization. We are now continuing this process through the China and Mongolia Department's contributions to the new East Asia Discussion Paper Series, of which this paper is the first to appear.

The present paper by Mr. Harrold is a slight exception to the typical papers that we have been publishing recently. This paper is the reproduction of a chapter from our recently completed economic report on China, entitled, "China: Country Economic Memorandum: Reform and the Role of the Plan in the 1990s". As part of this report, it was decided that it would be appropriate to examine China's reform experience over the last decade, for two reasons. First, the report was concerned with assessing China's reform priorities for the next decade, and obviously such an assessment should be set against the background of the achievements and failures of the past. Second, the success of China in maintaining reform and growth simultaneously has generated much interest, and with the availability of recent quantitative evidence, this seemed a good time to carry out such an assessment.

We hope that this brief review of the Chinese reform experience is of interest both to those who specialize in Chinese affairs, and also to those who are struggling with the issue of economic reform of other economies undergoing transition.

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China and Mongolia Department
East Asia and Pacific Region

CHINA'S REFORM EXPERIENCE TO DATE

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SUMMARY

1. This paper attempts to provide an assessment of the successes and failures of China's reform experience since 1978. Such an assessment can now be done on an objective basis because of the passage of time and the availability of recent research results. However, in drawing broader lessons from this experience, it is important to understand clearly the initial conditions under which the reform was launched. Three factors are key in China in this regard: the absence of severe macroeconomic crisis at the start of the program, so that harsh stabilization measures could be avoided; the state of agriculture, with its good infrastructure but poor incentives; and the presence of Hong Kong, as a source of inspiration, expertise and investment.

2. As the reform program has developed in China, four distinctive features in terms of reform style have emerged:

- (a) Gradualism and Experimentation. China has tended to spread changes over several years, and usually after considerable experimentation and adaptation. Its large size and provincial structure foster such experiments and make such an approach appropriate, if not inevitable.
- (b) Partial Reforms. One of the distinctive features of China's reform has been the apparent success of partial reforms within sectors, notably the two-tier price system, which has created a situation in which marginal decisions are based on market prices, and market skills can be learned without economic dislocation.
- (c) Decentralization. Decentralization of decision-making power to enterprises, individuals and local governments has been a key theme of reforms, enhancing microeconomic incentives and creating a strong interest group in favor of continued reform deepening.
- (d) Self-Reinforcing Reforms. Reforms in one area created pressures for matching reforms in other areas, and policymakers have in general seen their interests served best by meeting such pressures with new reforms rather than by administrative protectionism, albeit sometimes with a considerable lag.

3. China's approach to reform has been demonstrably effective, particularly in terms of its impact in four distinct areas:

- (a) Output and Welfare. GNP has grown about 50 percent faster during the reform period, especially in light industry and services. This has resulted in enormous improvements in consumption levels (more than doubled over the decade) and in the lifting of 160 million from poverty since 1979.

- (b) Productivity. The key to this has been that growth has come via productivity gains, which were close to zero in the 1949-79 period, but accounted for 3-4 percent per annum of growth during reforms.
- (c) The Role of the State. The state used to dominate savings and investment, but now, most savings are generated by individuals and enterprises, and investment is financed by retained profits and banks. Even more dramatic is the changing role of state-owned enterprises, which accounted for almost all output in the prereform period, but now nonstate industry employs almost 100 million people and produces 45 percent of industrial output.
- (d) Trade. The share of trade in GNP has risen from just under 10 percent in 1978 to over 30 percent in 1990, and there are over 20,000 sino-foreign joint ventures in operation.

4. The paper describes the most important reforms that have been carried out during this period. Despite the great progress achieved to date, the gradual approach means that much remains to be done, and reform priorities can be identified in six key areas: (a) enterprise reform, especially the question of ownership reform for the state-owned enterprises; (b) financial sector issues, especially the reduction of forced policy lending by commercial banks; (c) fiscal reforms, to replace the present revenue generation system with a diversified tax system; (d) external reforms, and especially reduced import protection; (e) further price reform, particularly for such distorted prices of raw materials and agriculture; and (f) social sector reforms, primarily those which improve labor mobility by converting nonwage benefits such as housing and pension rights, to wages. In addition, the government will need to be increasingly concerned in this decade with issues that affect the environment and with poverty alleviation, although these topics are not addressed directly in this paper.

5. The final issues addressed in considering China's reform experience to date are concerned with conclusions of more general applicability that can be reached, and the sustainability of the approach. Five key features of China's experience seem to have wider applicability: agriculture as an entry point for reform; the success of "marketization" of the enterprise sector, instead of privatization; the key role of changing the interest of the bureaucracy; the impact of developing exports at an early stage; and the role of the state in maintaining stability by looking after the most affected.

6. Given the lack of historical precedents for the Chinese approach, the question of its sustainability overtime must be addressed. On balance, it is judged that the approach is sustainable, because: (a) the Chinese reform has generated intensive development, and the consequent generation of true welfare changes; and (b) China has generally responded to the problems arising out of reform by deepening reforms, which suggests that deep crisis can be avoided via a process of continued incremental change. Nevertheless, the key to sustainability will be in how well China responds to the reform challenges still to be addressed.

CHINA'S REFORM EXPERIENCE TO DATE

A. Introduction

1. It is now more than a decade since China launched its program of economic reform in late 1978. Much has been written and said about China's progress and experience since that time. This paper is an attempt to examine the period of reform as a whole, to extract the essence of the Chinese reform experience and approach, and to assess the impact of the reform period on the Chinese economy. There are two main purposes for such an exercise. First, the length of the reform experience, and the availability of research results, now offer the scope to carry out such an assessment on a more rigorous basis. Second, now that the 1988-91 rectification program has been completed, China appears to have the opportunity and interest to enter a new reform era. In this regard, therefore, it seems appropriate to take stock of China's considerable reform achievements to date, to assess not only how far China has already gone along the reform road, but also how much further it has to go in order to have in place the new economic system for which it is striving.

B. The Initial Conditions

2. It is clear that the initial conditions under which China entered its reform era were very different from those of other reforming socialist economies, and were such as to be in general favorable to the rapid achievement of economic gains. It sometimes seems to be the opinion of commentators both inside and outside China that it is only in the reform period that China has achieved any economic or social success. However, there were many well-documented achievements of the first 30 years of China's socialist system since 1949,¹ most importantly in health and education. Moreover, China was not impelled to enter upon its reform path because of deep macroeconomic crisis, which removed the need for a strong dose of deflationary policy to accompany the launching of reforms.^{1/} Indeed, the fiscal and external accounts were in broad balance at this time, and savings mobilization was already high. Rather, the launching of reform stemmed from two main factors:

- (a) dissatisfaction with the "extensive" growth model that had generated overall growth, but little if any improvement in productivity, and required increasing levels of investment to be maintained, thus preventing significant gains in personal consumption; and

^{1/} For Central and Eastern European countries, stabilization measures are estimated to account for about half of the output losses that have followed the launching of their reform programs.

- (b) a political rejection of the extremes of "leftism" associated in particular with the period of the "Cultural Revolution."

It should be noted, however, that even at that time and despite the excesses of that period, and the deaths of Mao Zedong and Zhou Enlai, there was no rejection of the socialist system per se, but rather a call for a radical reform away from the earlier approach to its implementation.

3. The initial economic conditions appear to have laid the basis for a situation whereby the immediate benefits of the reforms selected outweighed the immediate costs. In agriculture, where reforms were launched, the Commune system of socialized agriculture had achieved four of the five main goals for which it was established:

- (a) It had developed rural infrastructure, especially in terms of irrigation facilities and use of improved seeds and fertilizers.
- (b) It had created a rural management system, which not only served political and social needs, but also fostered economic support systems, such as input supply and marketing.
- (c) It had served to foster social aims, such as preventive medicine and attainment of universal education, through local (compulsory) funds mobilization for such purposes.
- (d) It had diversified the rural sector from being a peasant agriculture on a self-sufficient basis.

4. What it had not done was improve agricultural productivity and thus output, either in quantity, quality or variety. Grain output per capita was 283 kg in 1952, but had risen to only 317 kg in 1978. Moreover, agricultural productivity probably fell over this period (para. 55), not least because of the absence of alternative, off-farm employment, as well as the two problems of the incentive system: there were virtually no incentives for individual efforts,^{2/} and agricultural prices were kept intentionally low in order to generate a surplus for industrial investment. Thus, prior to reform, the agricultural sector was endowed with reasonable physical, marketing and human infrastructure, but without incentives. It was the sense of agricultural crisis that was perhaps as important as any other factor in creating the initial impetus for reform. Once individual incentives were introduced, and the role of the state was reformed, it was not surprising that the output response was rapid. It was improved output and

^{2/} The commune system incorporated an arrangement for awarding "work points" to individuals in relation to individual effort. In practice, however, measurement of effort proved very difficult, not only because of intrinsic problems, but also because of the general ethos of egalitarianism in that period. See Perkins and Yusuf "Agricultural Development in China."

productivity which were the aims (and, indeed, the result) of agricultural reforms. As will be seen, increased savings available for investment and the release of surplus labor were unforeseen but perhaps even more significant side-effects.

5. In the industrial sector, there are three key factors with respect to the initial conditions. First, China had changed from being an essentially rural, peasant economy in 1949 to one in which industry was very significant. The share of industry in national income had grown from 20 percent in 1952 to 49 percent in 1978. Of particular significance during this period was the first decade, and the 156 heavy industrial projects carried out with the assistance of the former Soviet Union. The second factor of critical importance was that by far the largest share of this industrial expansion was in heavy industry, and light industry was neglected, as would be expected in a Soviet-influenced approach. Heavy industry accounted for 57 percent of total output in 1978. The significance of this was twofold: first, it meant that there was a significant industrial base from which to build; but second, it meant that there were enormous opportunities for light industrial investment once investment decision making was decentralized.

6. The third factor was that almost all this early industrial development took place through large- and medium-sized state-owned enterprises, with only a relatively small share in smaller, local enterprises. Indeed, these SOEs accounted for 78 percent of industrial output in 1978. This is of course to be expected given the emphasis on heavy industry. But these large SOEs were burdened with excessive workforces and heavy social obligations and were managed in a largely administrative fashion, and this rendered them highly inflexible. Thus, when controls were released on small firm creation, the large SOEs were not able to squeeze out such firms or react rapidly to new opportunities. As with agriculture, the socialist system had laid a solid basis, but which lacked incentives, and thus was ripe for reform.

7. The third aspect relevant to the initial conditions is provincial autonomy. China after 1960 was never truly a centrally planned economy in the same sense as the former Soviet Union: there were only about 500 commodities under mandatory planning, compared with over 20,000 in the former USSR; and local governments always took the primary role in plan formulation and interpretation. This had three particular consequences for the initial conditions. First, it meant that local implementation capacity was rather well-developed, with officials well able to respond to improved incentives. Second, with obvious exceptions, there was significantly less pressure for provincial autonomy in China than in other reforming socialist economies, such as the USSR or Yugoslavia, made easier by the relatively high ethnic homogeneity of the Chinese population. Third, while the emphasis on regional autonomy had generated good government capacity, it had also bred serious inefficiencies, especially in agriculture. It therefore offered enormous scope for gains from interprovincial trade.

8. Thus, China's initial domestic conditions in several key areas can be seen to have been ideal for reform. Unlike the case of many other socialist economies in transition, China's reform responded to socioeconomic pressures rather than deep crisis, and the absence of the need for major stabilization meant that "shock therapy" was not needed. China also had the

good fortune of its historic ties to Hong Kong and the overseas Chinese community, which have played a critical role. Above all, it had a set of conditions whereby the economy and its system of government were well-situated to respond rapidly to improved incentives by increasing output. Of course, not all results would be positive and not everyone would be a winner from reform, as the stop-go pattern of reform in China has amply demonstrated. Moreover, it is clear that several of these elements were distinct to the Chinese case, possibly reducing the applicability of the lessons from this experience. It is important to bear these initial conditions in mind in assessing the gains from reform: it can be cogently argued that part of the returns to reform in terms of efficiency gains and output growth are the delayed returns to the physical investment of the prereform era, which could not be reaped at that time because of inadequate incentives.

C. China's Reform Style

9. Because China began its reform program at the particular point in its economic history noted, it was able to develop its own distinctive approach to economic reform. This is most frequently described as "gradualist," although this only refers to the time taken rather than the depth of reforms. Indeed, the transformation of the Chinese economy that has occurred in these relatively few years since 1979 can hardly be regarded as a gradual change. China has not developed a well-defined reform strategy, nor has it drawn up a clear reform blueprint. Pre-announced reforms have often been withdrawn--such as the price and wage reform plan of 1989--and at other times, deep reforms have emerged suddenly, as with the grain price reform of May 1991.

10. It can be argued that China's reform philosophy or strategy is indeed to not plan reforms, but to push forward reforms in a coherent way when the economic, political and social climate permits or demands it. This may itself be a response to the perceived failures of the planning system. It is generally agreed that a key reason why central planning fails--and must fail--is that it requires too much information. Not only cannot this information be assembled and processed, much of it is unobtainable by definition. It can be argued with equal coherence that to draw up a comprehensive reform blueprint would require a similar amount of information, much of it unobtainable. China did not and could not have foreseen the response of the rural sector to the agricultural reform, and the easing of restrictions on entry to the industrial sector. Therefore, it is argued, it is better to use the Chinese approach which moves and adapts as responses and results become evident.² But throughout the reform period, four features of the Chinese approach can be traced as consistent themes in implementation; gradualism, partial reforms, decentralization and self-reinforcing reforms. It can perhaps be argued that these features, and especially the first three, were necessitated by the sheer size and diversity of China.

Gradualism and Experimentation

11. In almost all areas of reform, implementation has been spread over time, often several years, and usually after experimentation.^{3/} Typically, such experiments take place in designated "reform areas," and after the results of trials are observed, they then spread to other parts of the country. Sometimes, this is the result of a well-publicized central government decision, and sometimes this happens "spontaneously," as other provinces copy the originating province. For example, the household contract responsibility system in agriculture began as an experiment in Sichuan province in 1980/81, and by the time it was formally endorsed by the central government in 1985, it had already spread throughout the whole country. Similarly, though less spontaneously, openness to foreign investment--and to foreign ownership of assets in general--started in a few areas and continues to be extended gradually over the whole country.

12. Sometimes, this gradualism is the result of the trial process. Other times it is opportunism frequently in response to rising fiscal pressures, and this is especially the case in price reform. In this area, there have been two attempts at formulating a comprehensive reform strategy, both of which have been abandoned. At other, sometimes unexpected times, progress has been rapid. The period from late 1989 to the end of 1991, when reforms in general were receiving less attention, perhaps saw the most radical changes in relative prices in China in the whole reform period.³

13. For some reforms, by their nature, gradualism is not possible, and an overnight change occurs. The central bank was established in 1984, and all its commercial transactions were rapidly transferred to the newly-created Industrial and Commercial Bank, although, of course, it took longer for the People's Bank of China to take up its new functions fully. The foreign exchange swap centers were all opened to domestic enterprises at the same time in 1988. But even in these areas, where arbitrage would suggest the impossibility of gradualism, the sheer size of the country and the inadequacy of the transport and telecommunications systems make gradualism possible.

14. The great advantages of this gradual approach, where it is possible, are clear⁴: severe shocks are avoided, trials permit mid-course corrections, institutional development can occur in line with the new systems, and economic agents can adjust slowly to the new conditions. China has thus been able to first bypass and later dismantle its administrative controls at the pace that market mechanisms capable of regulatory functions have emerged.⁵ This has meant not only that severe dislocations have in general been avoided, it also has meant that China has been able to enjoy growth with reform. Of course, much of the reason that this has been possible has been the favorable initial conditions under which reform was launched.

^{3/} What the Chinese call "Feeling the stones to cross the river," in contrast to the maxim coined by President Havel of the Czech and Slovak Federal Republic: "It is impossible to cross a chasm in two leaps."

15. But this approach has its drawbacks, and two in particular. The first is that some economic agents are unable to predict their future economic environment. In most areas of reform, the advantages of pragmatism override this,^{4/} but in other areas advance planning is important. This will be the case in the near future as China sets about reforming its import framework, for advance announcement of reduced protection will permit enterprises to adjust to the future set of arrangements. In such cases, there is a case for rapid implementation of the reform itself, but with adjustment to the new situation spread overtime.

16. Potentially more serious is the charge that gradual reforms can give time for those whose interests are threatened by reforms to re-group and either block progress along the gradual slope, or even reverse some reforms, and that failure to introduce reform rapidly will reduce the credibility of such reforms. This is clearly the fear of many policymakers in Central and Eastern Europe. There have indeed been such periods of reversal in China. The Communique of the Fifth Plenary Session of the 13th Central Committee in December 1989 clearly espoused a view that planning could solve the problems that had arisen during the course of reforms designed to address the shortcomings of planning.⁶ However, so far, each such reversal (or "one step back") has been temporary. It is clear that the new momentum of enterprise reform evident in 1992 is partly a conclusion of China's leaders that, during the rectification program, the instruments of planning failed to come to grips with the fundamental problems of the state-owned enterprise sector. Thus, while periodic reversals occur, the overall direction continues. The reasons why planners have failed to re-group effectively in China are discussed below (para. 90).

Partial Reforms

17. Closely related to the gradual/experimental approach to reform has been the use of partial reforms within sectors, and one of the more interesting results of the Chinese reform experience has been the apparent success of this approach. This has perhaps been most obvious in the two-tier pricing system, under which state enterprises have been permitted to sell above-plan output at market prices. It has been estimated that in 1989, on average, 38 percent of an SOE's outputs were sold on markets, and 56 percent of its inputs were procured on markets.⁷ This dual price system has been of particular importance in the materials sector, for commodities such as coal, steel, timber, and cement, where differentials were sometimes very large indeed.^{5/}

^{4/} Indeed, in some areas, pre-announcement is to be avoided. It was the announcement of future price reform in 1988 which triggered inflation, not the reform itself. Similarly, in late 1990, a devaluation came to be known in advance, compressing the parallel exchange rate.

^{5/} Coal prices in 1989 were Y 30/ton at minehead in Shanxi, but Y 250/ton on a market basis in Guangdong.

18. The two-tier price system, like the partial reform approach in general, has two particular advantages. First, it has been a powerful instrument of the gradualist approach, providing an underlying assurance of continuity of supply, while creating a situation where market skills can be learned. Second, and most important, it has created a situation where marginal resource allocation decisions have been made on the basis of market prices. In almost all sectors, enterprises' output targets are such that enterprise managers have sufficient capacity to make decisions based on the market as to how much above-plan output to produce. Only in the state coal, crude oil and power sectors, as well as transport, does the command plan continue to leave little room for market-based resource allocation decisions.

19. This system has, however, had certain obvious drawbacks. The most important of these has been the incentive for leakage from the planned sector to the market sector, and the associated corruption this has engendered. One explanation of the difference between the percentage of outputs and inputs under the planning system is that output leaving enterprises under the plan then gets diverted to the market, or else undergoes price adjustment. One researcher has estimated that of output under the plan, one third arrives at its intended destination at the plan price, one third arrives at the intended location but with the price adjusted to the market rate, and one third gets diverted entirely. Clearly, the incentives for corruption in this have been realized and this not only has concerned policymakers in China, it was also one of the overt factors behind the May-June events of 1989. What remains unclear is why these price differentials have persisted for so long, without arbitrage eliminating them. One factor is clearly the undeveloped transport and information system, but beyond this, provincial protectionism and import barriers explain how such differentials can continue. This partial reform approach is one whose benefits appear rapidly, but whose costs increase over time. Thus, if used as a transitional device, the approach has merits, but it has severe drawbacks as a long-term system. As discussed later (paras. 82-83), integration of the domestic market remains one of the major challenges.

Decentralization

20. One of the features of China's initial conditions discussed above (para. 8) was the presence of a capable, in-place decentralized administration. This became a critical element in China's reform approach. As the central government released control, provincial, municipal, county, township and even village administrations were ready to respond. This decentralization element of the reform approach is controversial in two ways: first, governments at local levels have frequently replaced reduced central planning with increased local planning; and at times, the decentralization ran ahead of other reforms, so the local response was reacting to distorted relative prices, leading to inappropriate local investments, as in, for example, over 100 car assembly plants each with a capacity of less than 5,000 vehicles per annum. But in general, and taken over the period, the unrelenting pursuit of economic development at the local level has clearly been a tremendous force for good and for progress, as, for example, through the creation of so many new jobs in the township and village enterprises.

21. Moreover, decentralization has not just been to local governments, but to actors in all spheres of economic activity: to enterprises in making production and marketing decisions; to foreign trade corporations in selection of export products; to farmers in selecting crops; and, most important, to individuals, to a large extent with respect to purchases, though to a much lesser extent with respect to employment. Of course, this form of decentralization is how markets get created, for it is the absence of concentration of decision-making that makes markets work, and thus the decentralization of decision-making that is at the heart of market creation. In China, the key to market creation without severe disruption has been twofold: as noted earlier, via gradual change which releases administrative controls only as markets develop; and via judicious balancing of markets and local governments. By decentralizing administrative power to lower levels of government, other forms of economic decentralization have been made more effective by local governments. For example, for most consumer goods, the government decentralized price controls to local governments in 1986, leaving it to them to decide when to release controls entirely, depending on the state of local market conditions. This moved rapidly in the dynamic South, with its many small firms, but more slowly in the North-East, where state firms dominate. The direction of causality is open to debate, but the results seem to be positive in general.

22. Such decentralization has its dangers. Some conservative parts of China have moved slowly in some areas, such as price decontrol in the North-East, and public ownership in Shanghai. It has also created a tendency towards overheating, as local development aspirations have forced a more rapid growth of credit than desired at the center. Thus, while the microeconomic effects appear to have been positive, it is less clear that the macroeconomic impact of decentralization has been wholly desirable.

23. Perhaps the greatest advantage of the decentralization approach has been to create interest groups in favor of further reforms, and to foster a climate for reform initiatives and "spontaneous" reform at the local level. This comes in two forms. First, many central reforms are "enabling," in the sense that they remove central prohibitions. Trade reform, for example, began in the mid-1980s with the removal of the prohibition on the creation of local foreign trade corporations: by 1990, 6,000 had been created, where only 15 existed before. Second, as noted earlier, local reforms frequently spread, often from experiment in one area, and are later sanctioned nationally. This was the case in agriculture with the spread of the household contract responsibility system in 1981/82, and appears to be being repeated in the case of social security systems at the present time. This is often the result of arbitrage pressures, when one province moves faster than a neighbor. This not only helps to build up increased confidence and interest in reforms, it also creates innovative approaches to reform.

Self-Reinforcing Reforms

24. The fourth characteristic of China's approach to reform has been the self-reinforcing nature of reform: "Once a crack is opened in the monolith that is the centrally planned economy, natural forces take over and force the crack open ever more widely."⁸ It can thus

be seen with the benefit of hindsight how reforms in one area lead naturally to reforms in other areas, and indeed force those reforms by creating pressures for change, and this seems to refute the thesis that the gradualist approach permits the rise of countervailing forces. The initial agricultural reforms created surplus savings and labor, which created pressures for decentralization of enterprise creation authority in rural areas, spawning the massive expansion of township and village enterprises (see para. 60-62). The creation of nonstate firms in turn generated pressure of competition on the state-owned sector, forcing the state to relax control on the SOEs. This itself compelled the state to restructure its own sources and uses of revenue, and to reform the financial sector.

25. The key to the successful linking of one reform to another requires the appropriate response of policymakers. It would be possible, of course, for the pressure emerging from one area to be met with counter-pressure rather than a complementary reform. For example, competition from TVEs was met in 1989 by an initial attempt to restrict availability of credit for these enterprises and to close some of them administratively. Some of this did occur for a time, but it was short-lived, and soon attention returned to how to solve the more serious problems affecting the SOEs. There is no clear way to ensure that the response of policymakers will be appropriate, but two factors seem paramount: the dynamics of the reform process create opportunities for government to push forward with new reforms; and second, attempts to reverse reforms and reintroduce planning soon reveal those limitations again--just as attempts to solve the SOE problem in 1989/90 via planning have had little impact on restructuring and have instead fostered new interest in market-based solutions to these issues.

D. China's Major Reform Steps

26. As noted earlier, this is not the occasion for a detailed review of individual reforms in China, a subject on which several books have already been written, and many more will come.⁹ Nevertheless, it seems appropriate to consider briefly the main steps that were taken in each major reform area, and how they linked to others, not least so that the discussion of future reform priorities in part "F" can be seen against the achievements of the past. The discussion that follows is divided into nine major sectoral areas, rather than chronologically. While it is useful to have this kind of periodic overview--and for the Chinese to put together the sort of document seen in the reform plan that accompanied the Eighth Five-Year Plan--the emphasis of China's reform approach will continue to be on individual interventions at the sectoral level, rather than the formulation of grand, cross-sectoral comprehensive blueprints, and we have already discussed the strengths and weaknesses of this approach. It does seem likely that the approach will be more balanced than in the past, with an absence of emphasis on a leading reform sector, and with coordinated reforms in different areas, but this will remain well short of a blueprint approach.

Major Reform Turning Points

27. There are different ways to define turning points in economic and political history. However, in this context, we are primarily concerned with key decisions taken by the Communist Party and the Government of China with regard to reforms. These decisions then became important reference works,¹⁰ and bear rereading for what they do and do not say about what is permitted after such decisions have been taken. The first of these is, of course, the decision of the 3rd Plenary Session of the 11th Central Committee of the Communist Party of China,^{6/} the Communiqué of which officially launched the reform program, and spawned the agricultural reforms and the beginning of the opening up to the outside world. Reforms in urban areas were only on a very limited experimental basis until the Third Plenary Session of the 12th CCP, which adopted the "Decision on Reform of the Economic Structures" in October 20, 1984. It was this document that launched the acceleration of reforms in urban areas in 1985, and especially the two-tier price system, and decentralization of enterprise management.

28. Despite these two milestones, the reform lacked a theoretical background and basis in socialist principles--it being based on Deng Xiaoping's principle of "seeking truth from facts," the basis for pragmatic decision-making--but this came in October 1987 in the Report of Government to the 13th Party Congress "Advance Along the Road of Socialism with Chinese Characteristics." This adopted the theory of the "Primary Stage of Socialism," which provided the theoretical basis for Deng's approach, by showing the acceptability of multiple forms of ownership and of economic systems during the early period of socialism that China would be likely to be under until well into the 21st Century. This also spawned the important guidelines of "the state regulates the market, and the market guides the enterprises," which remains the fundamental principle for China's "planned commodity economy." Finally, the adoption of the "Outline of the Eighth Five-Year Plan and the Ten-Year Development Program" is very significant, as it includes a clear description of China's reform approach for the coming period, and sets out reform intentions in a wide range of areas, marking the first occasion when the Plan has focused on policy issues as the key to development. However, it is likely in the future that this turning point will be seen to have been overtaken by the 14th Party Congress scheduled for the last quarter of 1992, which can be expected to take major decisions to guide the next phase of reforms. Each of these four documents/decisions should be regarded as part of the enabling framework which has permitted the central and local governments to move on to define specific reform moves, which are addressed in subsequent paragraphs.

^{6/} The Communist Party holds a Congress about every five years, and elects a Central Committee. This Central Committee meets in plenary session about ten times between Congresses, to make important decisions. The last (13th) Congress was in November 1987. Since then eight plenary sessions have been held, and the next (14th) Congress is scheduled for the last quarter of 1992.

Rural Reforms

29. These are listed first, not only because this is where the reform started, but also because these remain the most significant of all the reform efforts. As noted, China began the reform period with socialized agriculture operating on a reasonable technical basis, and at the heart of the reform was a return to individual, household agriculture with the break-up of the communes. With the return of the land to individuals on a long (15-25 year) lease basis, farmers had to agree to turn over a percentage of output to the state, and in some areas, the particular crops (especially rice in the south) were specified, and thus the phrase "Household Contract Responsibility System." This was accompanied by a 25 percent (average) real increase in relative agricultural prices. Together, these improved incentives elicited a very rapid output response (para. 52), and generated large cash savings. Pressure for permission to utilize these for industrial use grew, resulting in the formal decision in 1984 for local authorities to create township and village enterprises.

30. Much has been written about the growth of rural industry,¹¹ and this remains the key to much of China's success in the 1980s (see Part E). But why did this mushrooming of rural industry occur, apparently without positive policies, and as a result essentially of an enabling environment? We would offer three main reasons:

- (a) As suggested, the agricultural reforms created a surplus available for investment and released a pool of labor eager and available for new sources of employment.
- (b) The initial industrial conditions had, by having neglected the light industrial sector, and as a consequence of the socialist pricing system which favored light industry, created major opportunities for entry of small firms into this sector, where rapid, very high profits could be made.
- (c) Local governments were heavily committed to local economic development and played a key facilitating, and even sometimes entrepreneurial role in fostering such industries.

In the South, the role of overseas Chinese is also relevant, while in other provinces with large rural industrial sectors, such as Zhejiang and Jiangsu, domestic factors are paramount.

31. These are, in essence, the only two reforms of significance, and it was not until 1988 and 1991 that new reforms were launched, on the pricing/marketing side. In 1988, it was in the prices of nonstaples (sugar, eggs, vegetables and pork) that a new round of price reform was successfully launched, before being abandoned after an attempted widening in the face of inflationary pressures. But this approach--of converting product subsidies into wages--was the basis for the important grain and oilseeds price reform of 1991 and 1992. These have been accompanied by the introduction of wholesale and futures markets in grain, and together, these indicate that China is slowly moving to a situation where markets will dominate agriculture.

Foreign Direct Investment

32. It is sometimes forgotten that it was in the area of foreign direct investment that the first industrial reforms were made, with the passing of the joint venture law in 1979, and the opening of the first four Special Economic Zones in 1980. Since that time, FDI has poured into China (para. 66). The importance in Chinese terms of this was that it represented a major break with the autarkic principles of the pre-reform era, recognizing that China could not rely on its own resources alone to catch up with the rest of the world in terms of technology. Thus, the importation of foreign technology and management techniques and their financing by overseas capital became a key strand of Deng Xiaoping's reform approach from the outset. Nevertheless, the early approach, focussing solely on export-oriented industries, severely limited the volume of FDI. Major modifications were introduced by the "22 Articles" in October 1986, which paved the way the following year for the opening up of the foreign exchange swap centers, which removed the most serious constraint, which had been China's attempt to force joint ventures to achieve self-sufficiency in foreign exchange. These "Articles" were further improved in 1990, when regulations were introduced to limit administrative interference with the operation of joint ventures.

33. It would have been surprising if the opening of China to FDI would not have been successful, given the size of its market and the cheapness and quality of Chinese labor. But the role of overseas Chinese communities, and of Hong Kong and Taiwan in particular cannot be over-emphasized. Fully three-quarters of all foreign investment in China originated in Hong Kong, of course much of it being not by Hong Kong residents but rather channelled, but this is of no matter. The turning point for this was the adoption of the "one country, two systems" policy, which led to the signing of the Sino-British accord in Hong Kong in 1986, which has in turn permitted a remarkable integration between the economies of China and Hong Kong.¹² While the regulations have been an important and appropriate enabling environment, it is the Hong Kong factor that explains, in our view, most of the great success of the open door policy.

Commercial Reforms

34. One of the earlier reforms in China that appears to have been repeated in other reforming socialist economies has been the effective privatization of the commercial sector. This began in 1982 and, by 1985, 75 percent of all state-owned commercial and service companies had been sold or leased to private owners, and entry was permitted for any newcomers. The state sector remained important in three main areas: wholesaling of a wide range of products, especially agricultural; retailing of commodities under price controls and under the ration system; and operation of major commercial outlets employing large numbers of people, such as department stores. In addition to these formal retail channels, local governments have fostered the emergence throughout the country of "free markets" for food and consumer goods, especially clothing, frequently by providing basic facilities such as covered market stalls. Again, we have seen here the combination of the initial conditions of neglected consumption and facilitative local government.

35. It is no surprise that this proved a popular and successful reform, as it has in other countries, where improved commerce has been an early reform result. But two parallel results of this reform seem to merit mention. First, the private commercial system has provided a demand for backward linkage to the emerging new industrial sector, not least in alternative transport systems to deliver small quantities of goods to these outlets. This spawning of nonstate services seems set to continue in the 1990s, and indeed is now recognized by policymakers as a key source of future employment creation. Second, this area of reform has served as much as any to create a constituency in favor of the preservation and continuation of reforms, especially among the younger generation. It seems likely that this reform also had such instant results in China because the state commercial system had never been as all-encompassing in China as in other countries, and private commercial skills never completely disappeared, especially in rural areas.

State-Owned Enterprise Reforms

36. There have been many detailed reforms related to the SOEs, but they really come down to two basic changes in the system. First, in 1983/84, the system of profit remittance to the central government was changed to one whereby enterprises paid income taxes, and shared profits with their supervisory authority, with an increasing role for local industrial bureaus in this, compared with the earlier dominance of central ministries. This was accompanied in 1984 by incentives to generate those now retainable profits by the lowering of plan targets and permission to sell above plan output on markets, together with the further decentralization of plan formulation and implementation. This led to investment hunger and very rapid industrial expansion in 1985, so the system became more structured from 1986 onwards, as the agricultural contract responsibility system was applied to the SOEs under the enterprise contract responsibility system, which fixed profit remittance, retention rates, investment targets, etc., usually for a three-year period. By 1988, over 90 percent of all SOEs, accounting for over 50 percent of industrial output, were operating under this system, and by the end of 1991, most had signed a second contract.

37. Further innovations have been made, such as the Bankruptcy Law in 1987, the Enterprise Law in 1988, the use of enterprise groups and leasing of enterprises, but these are merely codification or variation of these two basic changes. Contrary to many general impressions, important efficiency gains have been achieved in the state sector (Table 3), as well as in the nonstate sector. What these have amounted to is this: gradually changing the focus of SOEs from concern with meeting output targets to one of meeting financial targets, by specifying the latter targets as the main performance criteria of the contracts, and by offering incentives for attaining and exceeding such targets. The key to ensuring that such gains have come via efficiency improvements has been the role of competition, not only from new nonstate enterprises, but also from other SOEs, given the size of the market in China. On the positive side, more gains have been made via this route than is frequently acknowledged. The key difficulty, as we discuss more below (paras. 73-75) is that the system is primarily one of positive inducements, without clear negative consequences of failure.

38. In short, China's enterprise reforms can be summed up in this way: it has been the "marketization" of such enterprises, as contrasted to the "privatization" approach of many other countries. Can state-owned enterprises operate fairly and effectively in the market? That is at the heart of the assessment of China's future (para. 89).

Financial Sector Reforms ¹³

39. Like most other socialist economies, China operated an essentially monolithic banking structure, and this has been one reform area where a classic sequencing of reforms over time has been planned and followed. The first step, in 1984, was to separate central banking from commercial banking, by creating the Industrial and Commercial Bank to take over the latter functions, leaving the People's Bank of China to focus mainly on central banking. This was extended in 1987 by the creation of two new universal banks to introduce slightly more nonprice competition into the banking sector. At the same time, financial innovations were encouraged, first by decentralizing authority to create nonbank financial institutions beginning in 1987, and secondly, by forming new capital markets, essentially for secondary trading of government bonds in 1988/89 and more recently, for trading in shares, beginning officially in 1991. This gradual deepening of the financial sector--at times ahead of the central institutional capacity to supervise and manage it--has been rapid and logical.

40. These financial innovations were necessary and "forced" by the change in the respective roles of the state and enterprises and individuals with respect to savings. The enterprise reforms meant that no longer would most surpluses be channeled via the government, but rather they would be retained by enterprises for investment, or passed on to workers in the form of rising wages and bonuses, who then needed somewhere to lodge their financial savings. It was this rapid financial deepening of the economy which also explains why China was able to sustain monetary expansion of close to 20 percent per annum throughout the decade of the 1980s without either revealed or repressed inflation.¹⁴

41. And yet these financial innovations took place extremely rapidly in the mid-1980s, with little change since then. The commercial banking system remains 100 percent state-owned and operated, with a considerable share of total (especially working capital) lending influenced by the state through direct intervention to support its industrial policy, and seemingly only a relatively small proportion of total lending decided by banks on purely commercial grounds. Further reform in this area, then, also remains one of the major items on the unfinished agenda (para. 77).

Fiscal Reform

42. Many would argue that China has never had, and continues not to have, a tax system, but rather it has a revenue system. It should first of all be noted that China has always operated a decentralized taxation system, with the central government relying on provincial taxation bureaus to collect their taxes. The main changes that have taken place have been less

concerned with a fundamental restructuring of sources of revenue, but rather changes in the way it has been collected and shared. In particular, the first big change has already been noted: profits began to be retained at the enterprise level, instead of being remitted almost in total to the state. This, of course, relieved the state of most of the burden of funding enterprise investment (see para. 64). The second big change came from the introduction of the fiscal contract responsibility system, the third of the four contract systems. This was introduced over a few years beginning 1985-86, when contracts were signed between the central and local governments, specifying the taxes to be handed over to the state, those to be shared--and in what proportions--and those to be retained.^{7/} Similar arrangements had always been in place but the contract system formalized them.

43. These contract systems, together with the high initial reliance on profits taxes, meant that central revenues were bound to be squeezed, as the former did not take account of inflation, and the profitability of enterprises was reduced in the face of competition. However, after the initial rapid decline in revenues following the measures noted (see para. 42), the central government was able to introduce minor tax adjustments, especially on indirect taxes, to permit revenues to remain reasonably buoyant. China's tax or revenue system remains very unusual, however, with its reliance on contracted tax payments, layered indirect taxes and near-total absence of personal taxes, together with the absence of any centralized tax collection system. This is a second area where two major reforms occurred early (in 1986-88) with only minor adjustments since.

Foreign Trade

44. In contrast to fiscal and financial reforms, the foreign trade area has seen evolutionary, gradual change, very much exemplifying the "Chinese model"¹⁵ Not only has it progressed gradually as opportunity has arisen, it has also involved partial reforms and has seen the "two steps forward, one step back" phenomenon. From its opening position of a system of about 15 foreign trade corporations operating under a near total mandatory trade plan, China rapidly moved to decentralize authority to create foreign trade corporations, while simultaneously reducing the scope of the trade plan, and permitting retention of foreign exchange at the local level. This rapidly spawned 1,500 new FTCs by the end of 1987, when the next two innovations were launched: sectoral reforms, whereby certain sectors (garments, electronics, and agricultural sideline products) were essentially forced from planning (and subsidy) and given high retention, and the institution of the fourth contract system, providing for the sharing of foreign exchange between central and local governments and the level of "support" from the

^{7/} A common misconception is that all taxes are subject to sharing. In fact, a significant proportion (about 40 percent) are collected by local finance bureaus on behalf of central government, about 50 percent are collected and retained; and about 10 percent gets handed over for redistribution. In fact, transfers from the center exceed amount handed over from shared revenues. Taxes from centrally-owned SOEs are handed over to the state, as are certain other taxes, such as the salt tax and the extrabudgetary tax.

center. Further power to create FTCs was delegated, and the number reached over 5,000 by 1990.

45. The third wave came in January 1991, when the second round of trade contracts was put in place, which eliminated central subsidies for exports and increased local retention of foreign exchange, which has increasingly been traded on the official parallel market. Over the last five years, a series of devaluations has gradually corrected the over-valued exchange rate and eliminated all but 7 percent of differentials between the official and parallel rates, with more than one third of all transactions now taking place at the parallel rate. The results of all this in terms of export performance are well-known (para. 80), and have permitted a rapid increase in technology imports. However, the emphasis of trade reform has always been on export promotion to finance "modernization" imports, and the import sector has never been seen as a source of competition. Now, however, with China once again seeking to resume its seat in the GATT, the fourth wave of trade reform can be expected to focus on liberalizing the import regime and making it more transparent.

46. It can thus be seen that the successful trade reforms have been driven by the desire to increase foreign exchange earnings to finance technology and materials imports. China has succeeded in this because of competition in the export sector, constant improvement in export incentives, and openness to foreign traders, especially from Hong Kong. In this regard, it has mirrored the Korean export experience a decade earlier. One final similarity should be noted: while import liberalization was left to last, imports of raw materials, intermediates and other inputs for exports have been open from the start, especially in the assembly industries of electronics, toys and garments.

Social Sector Reforms

47. China has left social sector reforms to last. The reason for that seems to be twofold: first, by keeping the enterprise-based social safety net in place, it has postponed, or possibly avoided, many potential social problems; second, China continues to be very concerned about growth of large urban areas, so has resisted major labor reforms. Thus, within the labor area, the main reform has been a preparatory one: the introduction of the labor contract system, whereby all new workers in SOEs since 1986 have been on contract not permanent status, and can theoretically be fired, and this system now covers about 20 percent of all state workers. The wage system has seen greater reliance on bonuses, but, on a national basis, the biggest change has been the growth of employment in nonstate enterprises, where rewards are usually on a piece-rate basis, and where the nonwage benefits (housing, pension, health) generally do not exist, or are far less significant. Thus, the main change has not been to the basic state system, but in the development of a parallel system.

48. It is only very recently that the government has begun to move on a national basis with respect to areas such as housing, social security and health financing, having largely focused on experiments so far. The difficulty is to move from a system of nonwage benefits

tying the worker to his enterprise, to one where rewards are essentially monetary, with such social facilities and services being made available to the worker through other mechanisms, both public and private. Given its potential for creating social instability, this is an area where the Chinese government is moving very cautiously indeed, as these reforms will also serve to loosen the state's control over labor mobility. Nevertheless, they are vital to permitting greater and more rapid restructuring of state enterprises through creating the willingness of labor to change employment.

49. This brief overview of the main steps in China's reform hopefully displays many of the characteristics of Chinese reform discussed earlier, from gradual (trade), to decentralized (enterprise), to partial (price) and self-reinforcing (financial). It also shows a clear trend throughout towards marketization of the economy, and the gradual evolution of arm's length, rules-based systems, although there remains a considerable way to go. What we can also see is that reforms have made least progress, the more they can be seen to affect the state-owned enterprises in any adverse way, and most progress where the opposite is the case. Thus, the challenges appear greatest in enterprise reform, and in financial and fiscal reforms. However, before we address future reform priorities, it seems appropriate to review the impact of reforms to date, as an indicator of how far reforms have come.

E. The Impact of Reforms

50. Reform is not an end in itself: it is employed as a mechanism to foster development, and especially gain in efficiency, so that economies can enjoy growth and have a quality of growth that permits individuals to enjoy the benefits of growth. Fortunately, after more than 12 years of reform, and building on research results, we are now able to begin to assess quantitatively what has been the impact of China's reform. We look here at measures in four areas that seem most pertinent: output and consumption; gains in productivity; the changing role of the state; and openness to the outside world. As we shall see, these results are impressive indeed, and a powerful source of justification for China's approach. They do not prove that China could not have done better with some alternative policies, perhaps avoiding some pitfalls. Such a contrafactual argument can always be raised and will be partially true. But the numbers show a strong response to reforms, in particular in terms of achieving its main goal: to generate rapid economic growth on the basis of efficiency gains and opening to the outside world, through a growing role for the market.

Gains in Output and Welfare ¹⁶

51. China has had a strong growth performance for most of the period since 1949, and even during the period of the Cultural Revolution. This is not surprising considering that the state has seen to it that over 30 percent of GNP has been invested every year. During the period 1965-80, real GNP grew by about 6.4 percent per annum, with the gross value of industrial output rising by 10.3 percent and of agriculture by 3.1 percent. What we will see in the reform

era is thus an acceleration of growth and welfare gains, rather than their introduction, for it bears repeating that the purely economic gains of the prereform period were impressive, even if obtained at enormous cost, physical, political and social. The reform era itself saw most rapid gains in 1982-88, with significantly lower growth in the two tails, although 1991 saw a strong recovery.

52. At Table 1, we show various indices for the change in GNP and output over the reform period. With GNP growing at over 9 percent per annum--and per capita GNP at

Table 1: OUTPUT GAINS IN THE REFORM ERA
(average growth rates per annum)

	1979-89	1982-88
Gross output value	10.7	13.1
Agricultural output	6.0	6.8
Industrial output	12.5	15.3
of which:		
SOEs	8.1	9.8
Collectives	19.0	23.1
(TVEs)	29.9	38.2
Private	-	222.6
Other	-	45.7
GNP	9.1	10.9
of which:		
Primary	5.3	6.4
Secondary	10.5	12.4
Tertiary	11.1	13.3

Source: China Statistical Yearbook and Xiao, op. cit.

7.8 percent per annum--there was a remarkably sustained increase in output over this period. Moreover, this growth in output was relatively balanced, especially during the early period, for agricultural performance also responded well to the reform, as noted. It is also not surprising,

given the nature of reforms, that the tertiary sector saw the most rapid growth over this period. Indeed, the share of transport and commerce in national income fell from 13.6 percent in 1965 to 10.1 percent in 1980, but had risen to 14.8 percent by 1988.

53. But while output had grown during the prereform period, there had been relatively modest gains in private consumption per capita. Indeed, real wages saw little if any improvement over the period prior to 1979, with more increase in household income coming via

Table 2: CONSUMPTION INDICATORS, 1978 AND 1988

	1978	1988	1988 as % of 1978
Cloth (m/person/yr)	8.0	12.2	152
Housing space (m/person)			
Urban	4.2	8.8	210
Rural	8.1	16.6	205
Wristwatches	8.5	47.0	553
Bicycles	7.7	30.4	395
Food (kg/person/yr)			
Pork	7.7	14.9	194
Poultry	0.4	1.8	438
Eggs	2.0	5.8	291

Source: China Statistical Yearbook.

growth in employment. At Table 2, we show various indicators of consumption in 1978 and 1988, showing how basic consumer goods and housing improved in availability over this period. Perhaps an even stronger indication of the real change in living standards is possession of major durable consumer goods. To take the three most startling examples: in 1981, there was less than 1 color television set per hundred urban households, but by 1990, this number had risen to 59; there were 0.2 refrigerators per hundred households in 1981, and 42.3 in 1990; and for washing machines, the figure rose from 6.3 per hundred to 78 per hundred households. Thus, the rapid growth in output translated into a very significant change in the standard of living in China over this period. That this was possible was because the reform era has seen intensive rather than extensive development, and thus rapid gains in total factor productivity.

54. These welfare gains are reflected in sharp reductions in the measured incidence of poverty during the reform era. A recent Bank report¹⁷ found that the proportion of the population below the poverty line in China declined from 28 percent in 1978 to under 10 percent by the middle of the 1980s. However, no additional gains were made after 1984, as poverty in China is overwhelmingly a rural phenomenon, and the gains reflected the early gains from agricultural reforms. By 1990, some 11.5 percent of the rural population and 0.4 percent of the urban population remained in poverty. This meant, however, that over 160 million people had emerged from poverty during the reform era.

Productivity Gains

55. Several of the studies cited have begun to provide reliable estimates of gains in total factor productivity during the reform period, incorporating re-estimates of the value of China's capital stock. Some of the results are summarized in Table 3. 8/ These show very strong gains in TFP over the reform period, in all sectors of the economy. We have already noted that the first half of the reform period focused on agriculture, with industrial reforms coming later, and the TFP gains reflect this, with TFP growth accelerating noticeably in industry after 1984. In agriculture, by contrast, productivity gains were rapid for a while, but then fell off, as most gains from increased effort were by then achieved. It is also of interest to note that TFP explains most growth in agriculture--land area fell, though use of fertilizers grew rapidly--but extensive growth (meaning greater use of inputs) continued to be the most important factor explaining industrial growth.

56. These gains in factor productivity are in stark contrast to the prereform era. Various estimates have been made which indicate that productivity was stagnant during the 1957-76 period. Indeed, one study showed a decline in combined agricultural and industrial TFP of -1.41 percent during 1957-65 and a gain of only 0.62 percent per annum during 1965-76.¹⁸

57. These changes in TFP overtime are supported by more conventional measures of efficiency gain. The accumulation/national income ratio (the Chinese equivalent of a capital-output ratio, given the absence of GNP data before 1978) rose from 3.79 in the first decade (1953-59) to 4.30 in 1960-69, and to 5.39 in 1970-78. However, from 1978-88 it fell to 2.38, despite the surge in investment during the reform era. It is only during the slower growth performance of the rectification program of 1989/90 that the capital-output ratio has again risen.

8/ These results, based on survey data, confirm earlier results from Chinese researchers. They found TFP growth of 3.39 percent per annum during 1980-84, and 4.46 percent during 1984-88, although such growth turned negative during the 1989/90 rectification program, and results for the 7th FYP period were below those for the 6th. See Li Jingwen et al "Analysis of Economic Growth in China," Institute of Quantitative and Technical Economics, Chinese Academy of Social Sciences (1991).

Table 3: ECONOMIC GAINS DURING THE REFORM ERA
(Percent growth per annum unless stated)

<u>Productivity Indicators</u>	<u>1980-88</u>	<u>1980-84</u>	<u>1984-88</u>
<u>State Sector</u>			
Growth	8.49	6.77	10.22
TFP growth	2.40	1.80	3.01
Use of materials	4.31	3.72	4.90
<u>Collective Sector</u>			
Growth	16.94	14.03	19.86
TFP growth	4.63	3.45	5.86
Use of materials	9.70	8.30	10.85
<u>Agriculture</u>			
Output growth	6.12	7.71	4.13
TFP growth	6.44	9.52	2.60
Land under cultivation	-0.13	-0.38	0.12
Use of fertilizers	6.75	8.20	5.33
<u>Convergence of Returns</u>			
(Ratio of nominal marginal returns in collective industry as % of state)		<u>1980</u>	<u>1988</u>
Labor		48.5	55.4
Capital		168.7	153.7
Materials		95.4	100.7

Source: Statistical Yearbook of China and Jefferson et al. (op. cit.).

58. Other results show that the reform in China is beginning to make the economy behave in ways similar to market economies. One of the distinctive features of the socialist system is that the inability of factors of production to move between alternative uses means that the government can fix the price system so that profits are a matter of administrative decision, and can vary widely between sectors, and the returns to factors of production in different uses can be very divergent. Evidence of equalizing profit rates and convergence of returns is a sign of effective marketization.

59. In 1980, profit rates in industry ranged from 7 percent to 98 percent: by 1989, the range had fallen to 8-23 percent, which is much more normal. In 1980, returns to labor in collective industry were only 48 percent of those in the state-owned sector, while this same ratio had risen to 55 percent by 1988. In contrast, returns to capital, which were 69 percent higher in the collective sector in 1980 were only 54 percent higher by 1988. Thus, reforms are not only serving to generate productivity gains, they also appear to be improving resource allocation. This, it must be assumed, is the direct result of the rapid growth in competition, especially between state and nonstate industries.

The Role of the State

60. The primary purpose of reform in a centrally-planned economy is to change the role of the state from one of planning and directing economic resources directly, to one where the state manages the policies which direct the resources. The impact of reform on the role of the state is shown in a variety of indicators in Table 4, and these show how fundamental this change has been. The first, and perhaps most dramatic change has been in the structure of output. In 1978, 78 percent of all industrial output came from the SOEs, operating entirely under the planning system. By 1989, the share of SOEs in total industrial output had fallen to 56 percent. This was not the result of privatization--for the effect of change in ownership of SOEs during this period was negligible, as it mostly occurred in the commercial sector--but rather the growth of the nonstate sector. This should thus be seen as one of the results of the gradual approach: that small, incremental changes (in this case, via differential rates of growth) can over time add up to major structural reforms. Among these, we may note the growth of output of township and village enterprises, individual enterprises and joint ventures in particular, as shown in Table 5 and Chart 1. ^{9/}

61. What this shows very clearly is that since the inception of urban reforms, the share of nonstate industry in the total has expanded enormously by virtue of very rapid growth rates. SOEs have been growing fast as well, but at only half the pace of nonstate enterprises. In fact, despite their low base, nonstate industries account for more than half of the total growth in industry over the 1985-90 period. If this result is linked back to the productivity figures of Table 3, then it can be seen that part of the explanation for the rapid growth of total TFP is the relative growth of collective industry, where TFP gains have been particularly rapid.

62. This can be seen on a regional basis as well, as demonstrated in Chart 2. This traces gains in total factor productivity at the provincial level with the share of nonstate industry in total industrial output in different provinces. As can be seen, there is a generally close

^{9/} While all collectives and TVEs are defined as "nonstate," many would also fall under the definition "publicly owned." While many TVEs (the "Wenzhou" model) should be seen as akin to private enterprises, others (the "Suzhou-Nanjing" model) are closer to local state enterprises, with the role of the entrepreneur being critical in the former, and local government in the latter. See Byrd and Lin, op. cit.

Table 4: CHANGING ROLE OF THE STATE

	1978	1984	1989
<u>Output of state-owned enterprises as % of total</u>	77.6	73.6	56.1
<u>Gov't revenues as % of GNP</u>	34.4	26.4	20.9
<u>Extrabudgetary revenues as % of GNP</u>	9.7	17.1	16.8
<u>Financing of investment (1981)</u>			
Budget	28.1	23.0	8.3
Loans	12.7	14.1	17.3
Foreign investment	3.8	3.9	6.6
Other	55.45	59.1	67.8
<u>SOEs as % of total</u>	<u>69.5</u>	<u>64.7</u>	<u>61.3</u>
<u>Financing of SOEs Investment</u>			
Budget	37.7	39.0	13.4
Loans	n.a.	15.4	20.9
Foreign investment	n.a.	2.2	10.2
Other	n.a.	43.5	55.6
<u>Bank deposits as % of GNP</u>			
Total	31.6	47.6	56.8
Enterprise	10.3	19.2	19.5
Urban savings	4.3	11.2	23.6
Rural savings	4.3	5.4	4.5
Treasury & government	9.7	7.1	5.8

relationship between high-productivity provinces such as Zhejiang, Jiangsu and Guangdong, and the high share of nonstate industry, which in the extreme case of Zhejiang reached 68 percent in 1989. In contrast, provinces with very low shares of nonstate industry, especially those in the North-West of China, had the lowest productivity. The only significant outlier is Shanghai, where the state sector appears to be most productive, perhaps as it is in Shanghai where much of the state's final goods production (automobile, bicycles, electronics, cigarettes, processed food) is located.

**Table 5: SHARES OF INDUSTRIAL OUTPUT OF
NONSTATE INDUSTRY
(percentage)**

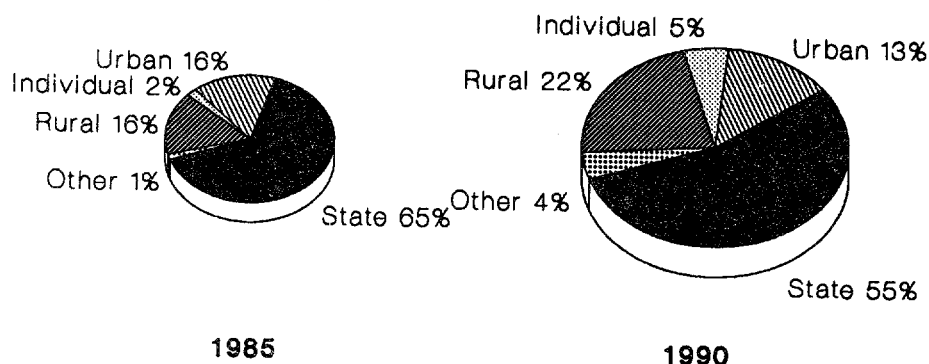
	1985	1990
Total collective	32.1	35.7
of which:		
Township	7.8	10.4
Village	8.4	12.3
Urban collective	15.9	13.0
Individual enterprises	1.9	5.4
Others, including joint ventures	1.2	4.4
<u>Total nonstate</u>	<u>35.2</u>	<u>45.5</u>
excl. urban collectives	<u>19.3</u>	<u>32.5</u>

63. The reforms of the budget system and decline in the role of budgetary financing show up very clearly in the fiscal statistics. About one third of GNP used to pass through the budget in 1978, but this had fallen to only 21 percent by 1989, with the fall in budgetary revenues being more than compensated for by increases in extrabudgetary revenues, 80 percent of which belong to enterprises in the form of profits. The main change that this has brought about is with respect to the structure of government spending and the financing of investment.

64. The change in the budget has meant that investment is now financed primarily from retained profits and bank loans. This is especially the case for the state-owned enterprises. In 1978, when they were remitting profits to the center, about 40 percent of their investment came from the budget: by 1989 this had fallen to only 13 percent, with most of this change coming after 1984. While the state continues to influence investment very heavily through its approval system and via the banking system, it no longer has any significant direct financing role, especially in the productive sectors, for almost all of the budgetary investment is in infrastructure.

65. The corollary of the declining influence of the state in the financing of investment is the rising importance of the banking system in mobilizing savings. Not only has the use of bank loans for financing investment risen, but it has been made possible by the rapid growth of

Chart 1: OWNERSHIP SHARES IN INDUSTRIAL OUTPUT



Urban - Urban Collectives; Rural - Rural Collectives & TVEs.

Other - Foreign Joint Ventures & all other.

Source: China Statistical Yearbook 1991.

personal and enterprise deposits, although this does raise some of the key issues for the future (paras. 76-77). In 1978, savings deposits were only 8.6 percent of GDP, since when they have more than tripled to 28 percent in 1989, and enterprise deposits have about doubled as a share of GDP, with the corollary being a decline in treasury and government department deposits. Indeed this overall marketization and financial deepening of the Chinese economy is one of the more noticeable features of the reform period.

The External Sector

66. The fourth area of impact has been in the external sector, and in ways that distinguish China's reform effort from earlier socialist reform experiments. The key result has been that China has become a much more significant participant in the world economy. This has been an area of reform where decentralization of decision-making has been the primary factor behind the change. There are four aspects in which the impact can be seen: trade, technology, foreign exchange arrangements and foreign direct investment.

67. Perhaps trade is the most significant of these in many ways, and this is shown in Table 7. It should perhaps be noted that, even in 1978, trade was relatively high in China, as by this time the program to import western technology was already under way, but via the planning system. However, since 1978, trade has consistently grown at rates well above GDP

Table 6: STRUCTURE OF GOVERNMENT EXPENDITURE, 1978-90
(percentage)

	1978	1984	1990
Current expenditure	56.5	71.2	79.7
of which:			
Defense	(13.7)	(9.3)	(7.6)
Culture, education, health	(9.2)	(13.6)	(16.2)
Administration	(4.0)	(7.1)	(8.1)
Subsidies	(9.3)	(21.1)	(25.2)
Development expenditures	43.5	28.8	20.3

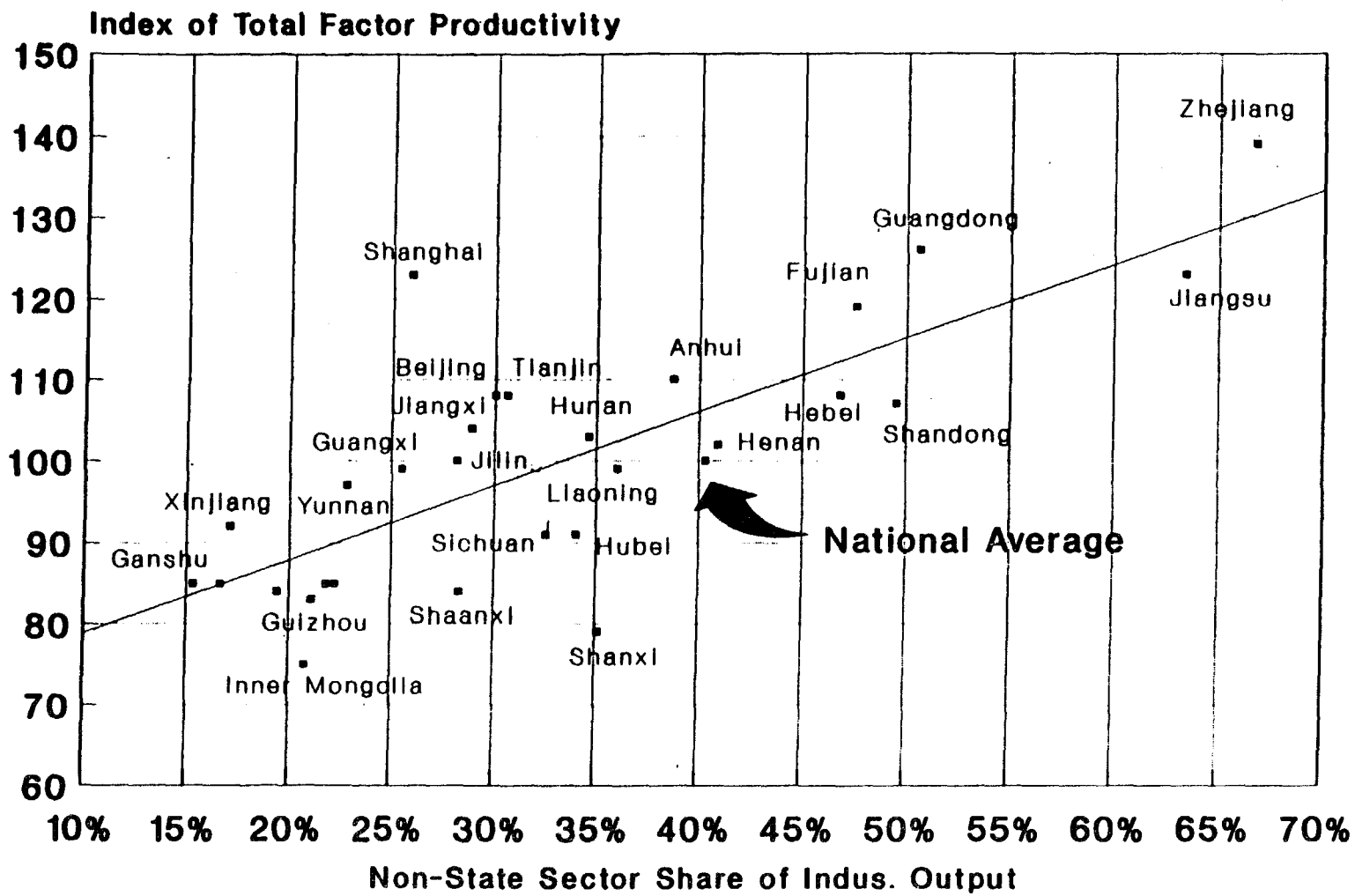
Source: Statistical Yearbook of China.

growth, so that by 1990, trade had risen to the equivalent of 31.3 percent of GDP, making China, by this measure, the most open of all large countries, and with a degree of openness more than twice that of India, Brazil, USA or Japan.^{10/} Note also that with the exception of the two retrenchment programs--1982/83 and 1990/91 ^{11/}--a trade deficit has been recorded every year. While no doubt some part of this growth in exports is the result of planning, more than half of all exports by the end of the 1980s fell outside any sort of planning, so these can be regarded as the result of the strong export incentives China has had in place.¹⁹

68. Of all such incentives--including foreign exchange retention, tax rebates, and direct subsidies on planned exports--the most important has been use of the exchange rate and foreign exchange markets. The exchange rate, which at the time was almost irrelevant for the determination of trade, was only Y 1.72/\$1 in 1978, but stands today at Y 5.38/\$1, despite there having been only less than 30 percent more inflation in China than in the United States over the period, and thus we have witnessed a very strong real effective exchange rate depreciation in

^{10/} Although it would not alter the conclusion, care should be taken in using these statistics. GNP may be somewhat underestimated, and trade statistics include the full value of exports based on processing of imported inputs, which tends to exaggerate the true role of trade in the economy.

^{11/} Trade surpluses have occurred in the two years following the main stabilization efforts of 1981 and 1989.



Source: G. Xiao, *China Economic Review*, 1991

Table 7: TRADE IN THE CHINESE ECONOMY, 1978-90

	1978	1984	1990
Exports			
\$ billion	9.75	26.14	62.09
Y billion	16.76	58.05	298.58
% of GDP	4.7	8.4	17.1
Imports			
\$ billion	10.89	27.41	53.35
Y billion	18.74	62.05	257.43
\$ of GDP	5.2	8.9	14.2
<u>Trade as % of GDP</u>	<u>9.9</u>	<u>17.3</u>	<u>31.3</u>

Source: China Custom Statistics.

China. In fact, taking 1980 as 100, the real effective exchange rate index at June 1991 was only 34.6. Thus, with the reduction of trade planning and the aggressive use of the exchange rate, it seems reasonable to attribute a considerable share of the growth in trade to this factor. However, not all of this exchange rate change has been strictly "managed," since, as noted earlier, one of the reforms has been the introduction of the parallel foreign exchange market. In its first year, turnover on the parallel market was only \$4 million, but this rose rapidly to an estimated \$18 billion in 1991, accounting for about one third of all transactions. It has been the growth in this market which has forced the realignment of the official rate since 1987, to the point where the differential, which was close to 100 percent in 1988, is now less than 10 percent, and unification of the rates under a market-based system seems to be under active consideration.

69. One other factor about the growth of trade in China has been its impact on the level of technology in the country. About one third of all imports over the last ten years have been of machinery and equipment. In other words, each year China has imported the equivalent of about 3 percent of GDP in capital goods, accounting for about 7.5 percent of all investment, and about 15 percent of all investment in equipment. It can be assumed that this has had a marked impact upon the equipment manufacturing industry in China, and thus, while modernization and upgrading of equipment remains a priority, it can also be safely assumed that there is a wide

range of Chinese industries where the vintage of capital equipment is not the primary issue in terms of competitiveness.

70. The fourth area of openness has been the impact of reform on foreign direct investment, which was the very first of the urban reforms. According to official statistics, there have been contracts signed over the period 1978-90 for over 29,000 joint ventures, with a contracted value of \$45 billion. About half of these are in operation, with an investment value of about \$22 billion. This translates in the last few years to annual direct net foreign investment of \$2-3 billion, which is of the same order as inflows of either official borrowing (World Bank, ADB, Japan, etc.) or commercial borrowing. More important, as many of these investments have been export-oriented, especially in the southern provinces of Guangdong and Fujian, this has been the other major explanatory factor behind China's export growth, as the economies of China, Hong Kong and Taiwan have been more closely linked. Indeed, some 70 percent of all foreign investment originates in Hong Kong, and over one third of all trade. To put this in a global perspective, China is the destination for about 10-15 percent of all direct foreign investment in low- and middle-income countries, and is exceeded in Asia only by Singapore.²⁰

71. Thus, the reforms have led to a situation in which China has been a major player in world markets, both through its own trade links and the integration of its manufacturing sector through direct foreign investments, and this distinguishes China's reform efforts. However, as discussed below, this effort on the export sector has proceeded faster than and has not been the result of import liberalization, which remains high on the unfinished agenda.

F. Reform Priorities

72. We have seen from the preceding five parts of this paper that China has come a long way in its economic reform, and that the economic impact has been measurably strong. However problems remain, and, while progress has been great and the overall economic performance of the last decade remarkable, it seems clear that much indeed remains to be done. Indeed, this follows from the Chinese approach to reform, which expects the reform process to last a long time. The rest of this section therefore is concerned with the main items on the unfinished agenda. In terms of the major priority areas, it seems to us that there are six of particular importance. These are: the state-owned enterprises; the financial sector; public finance; trade; prices and markets; and the role of the state. While actions in each area are distinct, it is reform of the SOEs that is the key constraint, and the main obstacle to be overcome.

The State-Owned Enterprises

73. Many incentives have changed for the state-owned enterprises, and their focus has shifted considerably away from achieving output targets and providing social services towards making profits and improving efficiency. Nevertheless, while the role of the nonstate enterprise

sector has changed dramatically, the fundamental structure of the relationships between the state and the SOEs, and between the SOEs and their workers remains unchanged. Enterprises remain subjected to administrative interference in day-to-day operations, the negative consequences of failure remain unclear (in contrast to the positive rewards for success), and workers continue to be assigned to enterprises administratively and to be bound to those enterprises through the housing, health, education and social security systems. China's state-owned enterprises therefore continue to display many characteristics of public enterprises throughout the world, not least in making losses, funded both via the budget, and, in a less open way, through the banking system.

74. However, China requires that the publicly-owned enterprises must remain dominant in China's society. Therefore, the reform priority in the state enterprise sector relates not so much to the issue of privatization, as to the regulatory and competition framework. Three areas seem to be paramount in this regard:

- (a) In terms of ownership, property rights remain vague, and there continues to be the need for new institutional mechanisms to separate the roles of government as regulator, owner and manager of enterprises.
- (b) The regulatory and legal framework remains largely undeveloped--there is no company law for example--which makes the development of an arm's length trading system difficult.
- (c) The SOEs continue to be protected from the full impact of domestic and foreign market forces. Nonstate enterprises have less than equal access to credit; they are restricted from entry to sectors where they would threaten SOEs; foreign investment is not permitted to compete with existing SOEs; and trade is restricted. Finally, bankruptcy remains extremely limited, and while the use of mergers is gaining, it is being carried out in a largely administrative fashion.

75. The challenge is therefore to create a framework whereby public enterprises are operating within a clear system of regulation and are subject to the full force and consequences of competition, so that they behave much as private enterprises would in the same situation. Progress in this aspect will both be key to and closely linked to progress in the financial sector. While there are several reform experiments underway or planned in this area, it is not at all clear what Chinese policymakers are trying to achieve, or what concept of the future Chinese SOE they have in mind. While in such areas as price reform and the tax system, the final goal seems clear, it is in the area of SOE reform that new thinking seems most needed.

Financial Sector Issues

76. Dramatic change was introduced to the financial sector in China in the first years of urban reforms, but, aside from some encouraging developments in capital markets, reform in this area seems to have stalled since 1988. At the heart of the problem is the excessive use

of the banking system by the state to meet its own economic aims, via the use of directed lending and "policy" lending. This effectively prevents the banking system from performing its key role of allocating savings to their priority uses. Furthermore, if the state is directing resources towards, for example, the covering of SOE losses, this could be storing up enormous portfolio problems for the banking system.

77. Associated with this remains the continued relative weakness of the central bank in China, both in its ability to regulate and supervise the financial sector and to formulate monetary policy and implement it via the use of indirect instruments. Instead, monetary policy appears still to be heavily influenced by, inter alia, provincial leaders, and is implemented largely by use of direct credit controls. This suggests three key areas for priority development in the financial sector:

- (a) Development of alternative methods of financing for government policy objectives, including the budget itself and capital market developments.
- (b) Continued strengthening, both in terms of technical capability and status, of the central bank in formulating and implementing monetary policy and in carrying out its regulatory/supervisory functions.
- (c) Further efforts to increase the use of indirect instruments of financial control, such as the interest rate structure and use of open market operations via new instruments such as short-term treasury bonds.

Although the financial sector has yet to face a serious crisis, portfolios of banks deteriorated during 1989-91 through a combination of heavy lending (made possible by the very high savings rate) and the weak economy. While the recovery should bring some relief, this still poses a threat to the long-term success of the Chinese approach to economic reform, and short-term action in these three areas is most urgent.

Public Finance

78. The second of the three strands of macroeconomic management development in China relates to public finance. As with the financial sector, this underwent one massive reform--the shift from profit remittance to corporate income tax--but only minor change since. China continues to have a revenue system rather than a tax system, and it is one that is bound by contracts. As such, it is tied inextricably to the old economic system that links the state, enterprises and workers. It thus perpetuates the old economic system and will need dramatic overhaul if it is to promote a new economic system. This would seem to relate to three aspects in particular.

- (a) Taxes are contracted (both at the enterprise and at the provincial level) and taxes will have to be clearly separated from such contracts.

- (b) The tax system is heavily based in the state production enterprise system--this being the primary tax collection point--and will have to be diversified with greater reliance on personal income tax and final sales point taxes, in line with progress in converting nonwage into wage income.
- (c) The indirect tax system cascades and makes incentives very unclear and will need to be replaced by more transparent, rules-based systems, such as value-added taxes.

79. Finally, it must be noted that one third of all public expenditures are for price and enterprise subsidies, at the expense of infrastructure investment and social expenditures, although the solution to this lies primarily in the area of price and enterprise reform. The growing pressure on the budget seems to be lending some urgency to the attention given to fiscal issues, although fiscal system changes take time to implement once reforms are formulated. Therefore, this too appears to merit acceleration.

External Sector

80. It was observed earlier that great progress has been achieved not only in expanding trade, but in making exports responsive to economic signals on an aggregate basis. And yet two factors about the trade regime continue to be of particular importance. First, external trade continues to be dominated by foreign trade corporations of various kinds, and participation of production enterprises directly in trade is limited. Second, as suggested, the import regime continues to offer a high degree of protection to domestic industry, and thus imports continue to be regarded primarily as a source of embodied technology. This protection is provided by an opaque and unpredictable system of import licensing, and by an uneven tariff structure, albeit with apparent frequent exemptions to reduce the anti-export bias. This would suggest two primary areas of focus for future trade reform.

- (a) Reform of the import regime, by moving to a system of management by indirect control, under a lower level of protection effected by tariffs rather than licenses and administrative barriers, and with transparent control mechanisms.
- (b) Continued efforts at institutional reform of FTCs, through further reduction of their effective monopsony and greater entry to export markets for production enterprises.

81. It is logical that the existing import regime has been accompanied by a foreign direct investment system that, while offering good incentives, restricted the competitive impact of foreign enterprises, and, in order to achieve this, developed a complex and lengthy approval process. Similarly, therefore, efforts in this area would have to be directed towards further opening of the domestic market, and improved efficiency and transparency in the approval process. With a very strong trade balance, and about nine months of imports in foreign exchange reserves, this would seem a most opportune time to launch such reforms.

Prices and Markets

82. In terms of reform progress, we stressed that more than half (perhaps two thirds) of all transactions were now carried out at market prices. Moreover, a key factor is that most marginal resource allocation decisions are made at market prices. However, this implies that at least one third of all transactions are at controlled prices and many of these remain subject to the materials allocation system. In theory, this need not matter, as the state should be able to adjust for this in other ways. For example, low coal prices reduce the attractiveness of investment in coal for local governments, and reduce available financial surpluses at coal mines for reinvestment. Theoretically, and in practice in the prereform situation, the planning system could compensate for this with fiscal transfers, but the state no longer has the fiscal resource control to do this. The result is unbalanced investment, and unfair interprovincial income distribution, in addition to obvious microeconomic consequences such as wastage of energy.

83. Price reform in these areas, in the sense of new price formulation systems, especially in raw materials and grain, will require not only lifting of controls or adjustment of fixed prices, but development of market infrastructure, such as transport and storage facilities, and information systems. It will also require price sensitive consumers, so a major accompanying reform will need to be the conversion of price subsidies into wages. Thus, reforms in these areas would need to focus on:

- (a) Removal of remaining price controls for most commodities, usually preceded by price adjustment, and accompanied by market infrastructure investments. Priorities seem to be in energy, transport, certain raw materials and in grain. This would need to be accompanied by the development of regulatory mechanisms and institutions to guard against abuse of monopoly powers.
- (b) Conversion of remaining consumer price subsidies--especially for grain--into wages, so that state procurement and distribution can be gradually eliminated.

It appears that, with recent price adjustments, there are no longer any "sacred cows" in pricing. Given the continued favorable demand-supply balance in most markets, there continues to be plenty of scope for rapid movement in this area at the present time.

The Role of the State

84. Much has already changed with respect to the role of the state, as it has fostered the growth of nonstate enterprises, and yielded control over prices, revenues and materials. Much of what has already been mentioned in this section is concerned with continued progress in this direction. Other elements that have been mentioned imply things that the state will have to do

more, such as indirect macroeconomic management and development of a legal framework. In short, the role of the state and of planning will have to continue to evolve.^{12/}

85. Over and above this, there are two other key areas where the role of the state will have to change dramatically and where little concrete progress has been made so far. First, social services of one kind or another continue to be provided primarily by the enterprise sector, especially housing, health insurance and pensions. Also, by virtue of the gradual reform process, and emphasis on development of new enterprises rather than radical reform of existing enterprises, the state enterprise system has continued to offer protection against unemployment. Here, there is a new role for the state, either in direct provision of such services, or by creating a framework for nonstate, nonenterprise based systems, such as private pensions and health insurance. It is only by removing this burden from enterprises that true enterprise reform can begin, and yet the state will have to directly promote appropriate solutions.

86. Finally, an area where virtually no significant progress has been made has been in the labor market. Most workers continue to be assigned jobs, and movement between geographical areas remains highly restricted. Movement between enterprises within one geographical area is even difficult, because of nontransferability of accumulated nonwage benefits and housing. These factors are compounded by a set of antiemployment-creation policies, such as low interest rates and low energy prices, coupled with bias against labor-intensive sectors such as service industries and private enterprises. These suggest three areas of primary focus:

- (a) Conversion of nonwage benefits into wages and separation of services provision from enterprises.
- (b) Gradual relaxation of labor allocation systems, both vocational and geographical.
- (c) Continued attention to removal of antiemployment policies, especially those that encourage high capital/labor ratios, such as low input prices and interest rates, and policies that discriminate against TVEs.

G. Some Tentative Conclusions

87. The discussion of this paper has been concerned with the way that China has gone about its reform program, and the impact on the economy of these reforms. It is clear that the Chinese approach has worked well in the initial conditions under which it was launched. This is not to say that the outcome was optimal, and it must be accepted that other measures could have made the results even better. For example, it is now generally accepted in China that stronger monetary management in 1988 and more rapid price reform in 1990 would have

^{12/} For a full discussion of this issue see "China: Reform and the Role of the Plan in the 1990s" (World Bank, 1992).

improved matters. It must also be stressed that one of the key features of China's initial conditions was the absence of a need for harsh stabilization measures, and no simultaneous external shocks, such as the collapse of the CMEA which has so strongly affected the countries of Central and Eastern Europe. This said, five key features of the Chinese reform experience do seem to be key elements of success, which may have some more general applicability, irrespective of the issues related to the gradual approach, and to the special conditions that are unique both to China and its approach to reform.

Five Key Features

88. At the start of the reform program, China had a large and relatively well-developed industrial system, but was nevertheless fundamentally a rural economy. Moreover, as the discussion of initial conditions suggested, the agricultural sector was highly repressed, and was thus ripe to respond to reforms. These factors supported the appropriateness of the decision to use agriculture as the entry point. Not only did agriculture respond rapidly--as it has in other countries such as Vietnam--but this generated the rural savings and surplus labor necessary to launch the next phase of reform, and created a constituency for reform.

89. The second element that seems to have been of particular significance in China was the emphasis on marketization instead of privatization, and on the role of growth of the nonstate sector in diversifying ownership patterns. The spectacular growth of nonstate enterprise has served two key functions.

- (a) It created economic growth and generated employment opportunities, thus bringing out significant gains from reform.
- (b) It generated competitive pressure on state-owned enterprises, forcing change in their behavior, even though this process remains far from complete.

This process is one that can be regarded as "privatization from below," in that, within just a few years, 45 percent of industrial output is now from nonstate industries. More generally, this emphasis on creation of new nonstate industries suggests the possibility of creating a competitive framework in which state enterprises can be made more efficient without recourse to direct privatization programs.

90. The gradual approach to reform runs the risk that the losers from reform can regroup either to oppose further change or even attempt reversal. Of course, this same factor can also work in the opposite direction, as reform skeptics can be won over when the pace of reform is gradual, and benefits start to emerge. The particular problem in a socialist system is how to change the interest of the bureaucracy and the Party. Bureaucrats, especially at the national level, are among the major losers from socialist reform, with loss of power, prestige and, in particular, nonwage income. Nevertheless, China seems to have had some success in reorienting the bureaucracy. The reforms created pressure on the planners because they reduced

central revenues and the profitability of state enterprises. Although to some extent, this caused part of the bureaucracy to seek to protect their profits and interests, it also redirected the interest of the bureaucracy towards ensuring that their enterprises were oriented towards profit-making. This has seen setbacks at times, but the periods of resurgence of planning theology, as in 1989/90, have proved short-lived as even planners have found it hard to preserve their interests through such methods in the face of past reforms. We can observe in 1992 a recognition of the failure of planning solutions to achieve significant restructuring of state-owned enterprises during the previous three years. Thus, the use of decentralization and promotion of nonstate industry generated a reorientation of the interest of the bureaucracy away from planning goals towards economic performance. This coincided with the interests of the Party, which saw its political interests geared increasingly to the achievement of economic success.

91. The fourth element of the Chinese approach that is distinctive has been its emphasis on export development and more generally its entry into world markets. The big contrast between this approach and that of other countries has been the postponement of import liberalization to late in the reform process, although it has had the result of a relatively high level of importation of advanced technology. This has been possible for two reasons: first, the size of the domestic economy has made it possible to generate competitive forces, especially among smaller enterprises vying for export business; second, while China had been closed to import competition, it has been very open to influence from outside in its export industry, and especially from Hong Kong entrepreneurs, who have been permitted to impose rigorous export design and quality control standards. The unique relationship between China and Hong Kong may reduce the replicability of this element of the strategy.

92. The fifth key factor in the Chinese approach has been the role of the state in maintaining social stability. By using the gradual approach, and by not subjecting the state sector to major shocks, China has succeeded in avoiding severe social costs during its transition. The Chinese effort has focused much less on changing old enterprises and more on generating new opportunities. Moreover, by postponing social reforms to the end of the reform process, this has given the opportunity to develop over time the institutional framework for a new social security system. What remains to be tested is whether China can now move beyond this approach to address the more fundamental issues of the state enterprise sector and the dismantling of this social system--and indeed the issue of whether the state wishes to carry out this aspect of reform. Nevertheless, it is clear that this approach has avoided some of the serious social consequences that could have undermined the case for further reform.

Sustainability

93. A key question in considering the Chinese approach to economic reform is whether this approach is sustainable over the medium to long term, or whether it is simply postponing problems that will later "come home to roost." Three potential issues for the future need to be addressed:

- (a) The danger of future insolvency of some large banks, as they acquire an increasingly weak portfolio by funding the losses of the state-owned enterprises, with limited capital bases and small loan loss provisions. It is further argued by some that this problem will worsen as the influence of nonstate industry rises, which would result in the squeezing out of such enterprises from resources.
- (b) The argument that so long as state-owned enterprises remain dominant, they will never be able to achieve efficiency at internationally competitive levels, so that so long as this position is maintained, China will always be a highly protected economy, and the benefits of present reforms will fade away to lead to stagnation until this issue is addressed.
- (c) That social tensions will mount in two directions. First, that increasing provincial autonomy and self-sufficiency will increase further the growing regional disparities in China, leading to increasing conflicts. Second, that the fight against poverty in China is showing fragile gains, with many persons only just above the poverty line. With reforms and further difficulties for the central government, the present social safety net could collapse, pulling millions back into poverty.

94. In other words, these arguments suggest that the gradual approach has limitations, and that China will eventually approach these limits. This argument is based primarily on the recent experiences of the formerly socialist countries of Eastern and Central Europe. These are serious issues, and the possibility of such a collapse--forcing China into its own "big bang"--should not be dismissed out of hand. Moreover, it must be recognized explicitly that China's reform is indeed one which does not have successful historical precedent. But two important factors must be stressed as sources of reassurance:

- (a) Over the existing reform period, China has generally responded to the problems arising out of the reform experience by introducing new reforms and by deepening existing reforms. Thus, we can see incremental reform movement over the entire period of the reform era, albeit at varying speeds. This gives reassurance that, as new problems emerge, so they too will be met by incremental movement, so that, as with the past ten years, deep crisis simply will not occur. For example, this could result in incremental reforms which restructure existing SOEs, such that these reforms in turn correct on an incremental basis the genuine portfolio problems of banks.
- (b) The gains of the reform era have been "intensive" rather than "extensive," as measured by the strong productivity gains that have been registered, and China has succeeded in maintaining the momentum of GDP growth even during periods of adjustment. These productivity gains are not restricted to the new industries, but have been recorded also in the existing SOEs. This suggests that the economic results of the Chinese approach to reform may be qualitatively different from the

experiences of some others that tried such an approach, and we would suggest that this could lend credence to sustainability, and to the possibility that China will grow out of its problems. The secret to this success has been China's use of "marketization" and the vigorous development of the nonstate sector, which has been unique to the Chinese approach, and is in marked contrast to the Hungarian experience of the 1970s.

95. The key to sustainability thus rests, in our view, not on any theoretical or philosophical issues about the ultimate level of efficiency that publicly-owned enterprises can achieve, but rather on the solutions that China will develop towards the unfinished agenda. In particular, this relates to solutions to the problems of the financial sector and the state-owned enterprise sector and its environment. If appropriate incremental reforms are instituted, stressing growing "marketization" and a continued associated increase of competitive forces via growth of the nonstate sector and trade reform, then the remarkable experience of the past decade lends hope that the Chinese approach can indeed lead to a sustainable pattern of growth with reform.

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