China's Economic Miracles: Successes Amidst Glaring Hazards

Deng Xiaoping became China's paramount leader in late 1978. After decades of mismanagement, Deng's accession into power brought economic restructuring and modernization to China. Deng's approach to systemic transformation was calculated phases of economic liberalization. Politically, however, the Communist Party's control over the vast land and population of China would still remain absolute. Thus, economic freedom would not be accompanied by political liberalization.

The two major instruments of structural reform and economic development for China were inducing foreign investment and liberalizing foreign trade. After nearly three decades of reform, in 2010, China surpassed Japan as the second largest economy in the world. Its immense population has been providing low-cost labor for market-hungry foreign investors. Though competition for foreign investment has been on the increase from other less developed economies like India and Vietnam, China remains a favorite site for global manufacturing relocations. Since the early 1980s, China's economy has been achieving growth rates on a sustained basis that is unparalleled in the annals of world economic history. Nevertheless, behind the apparent accomplishments are glaring anomalies. This paper presents China's unique experience with successful systemic restructuring and some of its hidden perils.

Historical Background

The People's Republic of China was founded on October 1, 1949. The West immediately imposed an embargo on China. In response, Mao Zedong promptly allied China with the former U.S.S.R and its Warsaw Pact satellite-countries. Financial and technical assistance flowed into China primarily from the former Soviet Union. A host of development projects directed by Soviet experts were agreed upon between the two countries. After Stalin's death in 1953, Nikita Khrushchev denounced his predecessor's dictatorial reign. Mao, who later proved to be more ruthless than Stalin, engaged in an open quarrel with Khrushchev in 1960. The U.S.S.R. unilaterally annulled all treaties on economic assistance to China. Mao's distrust of foreign powers deepened. "Self reliance" became Mao's maxim for China's development path.

Thus, China closed its doors to the outside world. Some economies in the Pacific Rim busied themselves creating preconditions for economic takeoffs. But Mao took China on a path of economic destruction. Mao's talent resided in his ability to instigate political movements that espoused "class struggle" and "ideological purity." In the process, tens of millions of people from every social and political stratum ended up in labor camps and prisons. Through fear, Mao nurtured a cult that made him a demigod in China. By the 1970s, the stars over the four Asian Tigers began shining ever brighter while China's economy lagged farther behind its smaller neighbors.

Shortly before his demise in 1976, Mao designated Hua Guofeng as his successor. Hua attempted to gain support by adhering to Mao's ideology. Hua failed to realize that the first generation revolutionaries—many of them had been purged by Mao during the so-called "Cultural Revolution" — were setting the stage to dismantle Mao's legacy. During the Third Plenary Session of the 11th Central Committee meeting of the Communist Party in 1978, numerous leaders who had been purged by Mao were officially "rehabilitated." Party leaders who had been removed from office, exiled or publicly humiliated by Mao were brought back to center stage. Among them was Deng Xiaoping, who in time replaced Hua as China's paramount leader.

Deng was a pragmatist who wanted tangible results. For Deng, truth was to be found in facts and not in ideology. Among the resolutions of the Party's leadership meeting were eliminating "class struggles," restoring economic order, and "seeking truth from facts,"[1] However, under no circumstance was the public to question the absolute leadership position and authority of the Communist Party. It was made clear from the onset that political freedom would not be accompanying economic reform. Tight political control was to attend liberalizing economic policies.

The dawning of reform commenced in late 1979 under the reform-minded Premiership of Hu Yaobang, with Deng charting the overall direction. Therefore, two-front reform advances were adopted: (1) reforming facets pertaining to the structure and functioning of the domestic economy; (2) reforming foreign economic relations. Integration of China's domestic economy into the world arena began in 1979 with quasi-free market experimentation and phased opening-up of China's economy to the outside world.

Paving the way for a "Socialistic-Market" System

Under the directive from Deng, the 2nd session of the 5th Peoples' Congress approved the government's proposal to coordinate central planning with market forces. It was the first time since 1949 that the merits of the market system were given limited and tacit approbation. The proposed approach to remedying past mistakes was to permit market forces to play a subsidiary role alongside central planning in order to mitigate the structural imbalances among sectors as well as the perennial imbalances between aggregate supply and demand. According to Deng, planning does not equate with a socialist system because market economies also resort to planning. Conversely, market economies do not equate with capitalism because markets do exist in socialist economies. The role of the market, despite rhetorical jargons, began its official ascent in economic decisions and in due time replaced planning as the mainstay of economic coordinating mechanism.

The scope and the level of the Central Planning Commission were significantly curtailed. Provincial and regional governments concurrently received increased autonomy for planning their respective investment, production, distribution and consumption needs. On the enterprise level, the state-owned enterprises [SOEs] were granted emerging rights for self-administration, bringing into play the objective measures of costs, values, prices and profits in their decision making processes.

Domestic Realms of Reform

Given three decades of structural rigidities and functional inefficiencies, the scope of reform was to be wide and the depth profound. Parallel reform measures were taken, with varying speeds, intensities, sequential orders and stages among them. All domains require reform. Some would reap more immediate and bountiful returns than others. It was upon the most pressing realms that the initial focus of reform was centered. Given the size of China's population and the complexity of China's social and cultural fabrics, reform in all major domains began with well-defined experimental pilot projects. Select few reform domains are briefly highlighted herewith.

Administrative Decentralization. Structural rigidities required administrative decentralization. The central planning system, at least on paper, was to remain as the primary coordinating mechanism for macroeconomic activities. Functions of the market were given limited standing, with the understanding that they were to play only a subsidiary role in a market-socialistic system. Private initiatives were given tacit permission to surface for the first time since 1949. Administrative decentralization began.

Legal Reform. For reform measures to be operative, the government needed to establish the necessary preconditions. Concurrent with administrative decentralization was reform in the legal sphere. With the foreknowledge that foreign investment and foreign trade were to be the catalyst for reawakening China's vast productive potentials, new legislative measures governing business relations became indispensable. Within the first ten years of economic reform (1979-1989), China enacted 580 new laws, of which 55 percent dealt with domestic and foreign economic operations and relations.

Agriculture. Reform began with the agricultural sector. More than three quarters of China's population were either still directly engaged or working in farm-related industries. Reform began with only 18 farm households in AnHuei province as participants. In late 1978, these 18 households were permitted to work independently from the agricultural communes. The sole stipulation was that they must deliver the assigned production quota to the commune at the end of the season. Yield over and above the assigned quota—instead of going into the commune's coffer—would be awarded to the participating households. The pilot project was a success. In time, land-leasing arrangements became a part and parcel of agricultural production throughout China and the system of production quota was abolished.

State-owned Enterprises. Before reform began, all productive units were state-owned enterprises. The central plan dictated investment, production and distribution decisions in all spheres of economic activities. Departing from past practices, enterprises were to function as businesses that are expected to turn a profit, actively divorcing politics and governmental interventions from business decisions. On the part of the state, the new slogan was "close supervision" of strategic SOEs and a looser grip on smaller ones. All SOEs were also mandated to render their respective assets transparent and corresponding rights defined in preparation for the process of privatizing non-strategic enterprises. In time, instead of surrendering all profits to the state, the SOEs were given the full right to retain their respective after-tax earnings.

Pricing System. The absence of an objective pricing mechanism in the past resulted in widespread misallocation of resources, including labor. Reform necessitated the introduction of a market-driven pricing system. For products and services whose supply was adequate at a given phase of reform, their respective prices were determined by supply and demand conditions. For those goods and services whose supply was less than adequate but whose supply were sufficiently price-elastic, then the prices were permitted to fluctuate within given parameters that were periodically determined and adjusted by the state authority. And, for those goods and services that were of pivotal importance to the nation's economic well being yet the supply of which were less than adequate, their respective prices remain fixed. The three-tiered pricing system was administered and monitored by the newly created State Pricing Bureau. Over the decades, overwhelming majority of prices has since adjusted to a market-based system.

Fiscal Reform. Prior to 1979, the Central Planning Board determined all sources of government revenues and expenditures. Surplus from all productive units streamed upwards while disbursements coursed downwards from the central government. Fiscal reform kept pace with phased administrative decentralization. Over time, respective rights and responsibilities of administrative units from the center down to local levels were streamlined. With stipulated respective shares of revenues and expenditures between a higher and a lower level of administrative unit clearly defined, each administrative unit was to be responsible for revenue generation and disbursement. The intent of fiscal decentralization was to individually and thereby collectively maximize the actualization of potentials in investment, production, distribution and consumption by respective levels of administrative entities.

Financial Reform. Prior to reform, banks ranging from the People's Bank of China (PBC) to special purpose banks such as The People's Bank of Construction and the Agricultural Bank did not function as financial institutions are understood elsewhere. Banks functioned as clearing houses, performing the basic tasks of holding deposits and disbursing outflows. Instead of mobilizing financial resources for productive uses, banks served as bookkeepers. The Five-Year Development Plan dictated disbursements for investment purposes. The concept and the reality of opportunity cost were not in the picture in a bank's decision-making processes.

The first step for financial reform was for the PBC to begin exercising the traditional functions of a nation's central bank. Four years after reform began, the PBC ceded all functions not relevant to the central bank to special-purpose and the newly sanctioned commercial banks. At least in theory, state-owned banks were expected to function as financial institutions for profit. Over the decades private banks and banks with foreign capital began emerging, actively competing with financial institutions of the public sector.

External Realms of Reform

Foreign Investment. Exceptional successes consequent upon initial steps in agricultural reform reassured the leadership of the merits of economic liberalization. The farmers' steadily rising income became the envy of industries and urban consumers. But China was by then still a second-rate developing economy. It lacked capital, technology and quality labor. Managerial talents were lacking while marketing experience was non-existent. Deng recognized the indispensable role that foreign capital and technology could and must play in China's drive towards reform and development.

Agricultural reform was to benefit the largest segment of the Chinese society. For more substantive and speedier reform as well as for accelerated growth, China resorted to the two primary engines of economic development: Foreign Investment and Foreign Trade.

A host of economic zones, cities, regions and areas, with respective well-defined targets and objectives, were opened up to foreign capital inflow. Initial targets were capital from the more developed economies in the region, namely: Hong Kong, Taiwan, South Korea and Singapore. Beginning in March 1980 through April of 1988, China designated five special economic zones (SEZ).[2] Foreign investments in these designated zones received the customary tax and import/export privileges. Products from foreign investments were destined mostly for exports. The open-door policy yielded exceptional dividends. In addition to foreign capital inflow and increased foreign earnings, foreign investments became the catalyst in reawakening the restive spirit of entrepreneurs throughout the land.

Early in 1984, Beijing declared 14 cities along the Pacific coast open to foreign capital inflow.[3] The historically more commercial cities along the Pacific coast became open to foreign capital. These coastal cities helped connect the dots fronting the Pacific into a frontier of industrial and commercial centers. Following closely upon the heels of SEZs and open cities were six Economic Development Regions, covering China's most vital delta regions and waterways as well as economic and technology development areas.[4]

In brief, through its open-door policy, China's policy to induce foreign capital and technology inflows evolved from initially targeting investments only from the more developed economies in the Pacific Region to developed economies in the West. Table I presents a succinct overview of China's successes in attracting foreign investment since reform began.

(Insert here Table 1: Capital Inflows (1979-2008)

The five-year cumulative foreign direct investment between 1979 through 1984 approximated $10 billion. Twenty years later, FDI exceeded $153 billion. During earlier years of reform, China depended more on foreign loans for needed convertible currencies. As the pace of reform successes accelerated, China's induced foreign capital originated increasingly more from FDI while concurrently reduced its heavy reliance on foreign borrowings. Foreign capital and technology played a pivotal role in thawing and revitalizing China's long-dormant economy. More important was FDI's contribution to China's phenomenal growths in its export sector and foreign reserves. The growth in China's foreign trade sector is briefly highlighted below.

Foreign Trade. Economic liberalization unleashed China's vast productive potentials that had long been suppressed by the rigidly structured command system. Increased productivity and production, however, would not find a ready outlet. China's per capita income was low; consumers' purchasing power was nearly nonexistent. Exploring and exploiting foreign markets provided the ready solution. Foreign trade reform commenced in tandem with that of foreign investment.

Prior to reform, foreign trade activities were centralized in the Ministry of Foreign Trade. Other than import quotas and export targets as assigned by the Central Plan, no producing or consuming units was permitted trading with external economies. State Trading Companies (STCs) that had been established under the aegis of the Ministry helped execute China's import-export orders.

The pace of trade liberalization lagged behind that of foreign investment reforms. Other than the import-export activities undertaken by specified foreign capital companies, the STCs continued maintaining state monopoly over trade activities. Import and export quotas progressively declined over the reform years as China's economy began awakening to increased interactions with external markets. As the quota system began giving way to accelerated integration with external economies, all domestic producers producing export-destined products were permitted to market their products abroad through the State Trading Companies.

During early years of reform, all earnings from exports were required to be exchanged for the Chinese yuan. Nevertheless, as an export-promotion incentive, a dual-exchange rate system was introduced. Earnings from exports were converted to the domestic currency at a notably higher exchange rate than the official exchange rate. After 1988, the practice of mandatory turning over of earnings from exports to the government for currency conversion was discontinued. Export fever caught the imagination of any domestic concern that could produce exportable consumer goods.

As administrative decentralization progressed, so did the foreign trade regime. Lower level administrative jurisdictions began instituting their respective foreign trade departments. In addition to the central government's STCs, authorized trading agencies began mushrooming. Through policies such as tariffs, hidden subsidies and undervaluing domestic currency, import and export activities initiated by domestic private enterprises in time became commonplace. Domestic investment in export-oriented productive activities proliferated. China's foreign trade volume accelerated over the three decades between 1980 and 2010. With it, the country's foreign reserve kept its rapid ascent. Instead of primarily a one-way capital inflow during early years of reform, China's immense earnings from abroad began flowing outward in search of investment opportunities abroad. Table II provides an overview of China's unparalleled growth in the foreign trade sector between 1978 and 2009.

(insert here Table 2: China's Foreign Trade (1978-2009)

At the inception of reform, the paltry trade volume brings to light the near absence of China's interaction with external economies. Though export volume tripled during the 1978-1986 period, from $980 million to $2.74 billion, gains in exports were tentative during these earlier years of reform. Import gains for the same period were slightly more pronounced since China was in critical need of imports for basic technologies that had long been available in free markets. Negative trade balance for that same time period was inevitable. After 1985, as data in Table II indicate, growth in the export sector began soaring, resulting in rapidly accelerating trade surpluses as well as foreign reserves. Between 2000 and 2005, exports grew by 205.8% while that of imports by 193.2%. The dramatic increases in both imports and exports were the direct result of China's entry into the WTO in 2001. By 2010, China's exports climbed to $1.58 trillion while imports grew by 38.7 percent to $1.39 trillion.[5] China's meteoritic growth in imports and exports since reform began may well add a new chapter in the annals of the world's economic history.

China, the world's most populous nation, had a foreign reserve of only $1.6 billion in 1978. Ten years later, it grew to $18.5 billion. Another decade passed and China's foreign reserve soared to $149.2 billion. By 2008, China's foreign reserves had increased by another 1204% to $1.95 trillion. The latest available data indicated that China's foreign reserves reached a new height of $2.85 trillion by the end of the fourth quarter in 2010.[6]

Successes

China's gradualism approach to systemic transformation was tentative at the beginning. However, the scope kept widening and the pace hastening once the merits of reform in a designated realm became conclusive. The more fundamental reform fronts that proceeded simultaneously--though at differing speeds--comprised of the following: administrative decentralization, de-collectivization of the farm sector, rationalizing investment priorities, phased wage and price reform, privatization of state-owned enterprises, emergence of a labor market, and external economic relations that culminated in China's membership in the WTO.

Dismantling the centralized Command system resulted in revived entrepreneurial spirit and pervasive private initiatives. Commodity circulation channels multiplied, broadened and invigorated. Value-objectification via a market-based pricing system displaced a distorted value system that resulted from the Central Plan. Value maximization and waste minimization became the norm in the decision-making processes. Integration of China's economy into the global system has posed challenges as well as bountiful opportunities, keeping the spirit of entrepreneurial spirit alive on the one hand while helping mature administrative and managerial dexterity.

Concurrent with economic liberalization has been a significantly more relaxed societal atmosphere. Vivacity has displaced pessimism and "wants" has supplanted "needs." Three decades of reform has transformed China from a slumbering giant to a roaring force of influence. The day on which the People's Republic of China was officially founded, Mao declared to the world: "The people of China have stood up." However, the people of China did not. With reform, new life has been breathed into the life of the masses. The people of China, at least collectively, have now indeed been standing taller in tandem with sustained reform progressions.

Table III presents an overview of structural transformation and economic growth over the past three decades in China. Data in Table III wax eloquent in defense of economic liberalization. Economic successes are readily measurable. However, it must also be borne in mind that intangibles such economic freedom, improvement in individual freedom and fear could well be more meaningful to victims of ideological fanaticisms than improved living standards. Combine successes on the tangible and the intangible fronts can thereby yield a more telling account of the overall success in China since reform began in 1979.

(insert here Table III: Macro Indicators, 1979-2008)

Although 1978 is not indicated in data in Table III, production from the primary sector increased from 139.7 billion yuan in 1978 to 5.82 trillion yuan in 2008, a 4052% increase.[7] Growth in the primary sector was exceptional. Yet, GDP share from the primary sector had declined considerably from 31.3% to 11.3%. Growth of GDP share by the tertiary sector on the other hand nearly doubled during that same period. Significant and swift structural changes reveal the extent of investment distortions during the Mao era. They also evince eloquently the phenomenal successes of reform in structural realignment during the past three decades.

On another front, growth in GDP had risen from 406.3 billion yuan in 1979 to 30.1 trillion yuan in 2008, a 7300% upsurge. Taking population increase into account, the per capita income-increase was still an impressive climb of 5317%. Furthermore, taking inflation under consideration as well, the per capita real-income increased from 419 yuan to 4342.5 yuan, a notable increase of 936.4%.[8] In brief, reform has yielded bountiful dividends to China's vast population, both quantitatively and qualitatively. China's approach to systemic transformation has been distinctive and its successes unparalleled. Nevertheless, amidst glittering successes, anomalies have likewise been making their appearances alongside the get-rich–quick fever that has caught the people's imagination throughout China's vast terrains.

Anomalies and Challenges

Behind China's astounding successes are anomalies and challenges. As an evolving system, the successes often generate challenges both from within and from without. As China continues its path towards economic restructuring, it must address existing anomalies and future challenges. Since China has emerged as a major international economic powerhouse, China's economic well-being and stability is of interest to the world. The following sections highlight select anomalies which require ever heightened vigilance on the part of China's policy designers.

Anomalies on Farm. Although reform began on the farms, the scope of systemic transformation in non-farm sectors widened in the mid-1980s while the rural sector experience overall neglect. As a result of the grain surpluses, food prices and farm incomes declined while the factor costs and the cost of living kept rising. Since the local administration was responsible for providing basic services and making necessary infrastructural investments, excuses abounded for exacting charges, fees, taxes, levies, duties, fines and obligatory contribution of labor from farmers and rural residents.

Premier Li Peng outlined the need to "effectively control agricultural factor prices, resolutely end arbitrary imposition of fees or collecting unwarranted charges, (and) realistically reduce burdens borne by farm producers." He stated how "there have been pervasive practices of collecting unreasonable fees, generating unwarranted revenues and assigning uncalled-for obligations." He continued to call for implementing "effective measures and steadfastly help resolve the problem so that the burden on farmers is strictly limited to the parameters as defined by the state. [9] But it was not until March 5, 2008, that the current Premier Wen reported that taxes on agriculture, livestock and special produce had been eliminated.

Additionally, a system of farms subsidies had been established to strengthen the foundations of agriculture by directly subsidizing a variety of grain producers, quality products and purchasers of farm equipments.[10]

Official statistics for 2008 listed 54.3% of China's population as rural. This means that nearly 900 million Chinese reside in rural areas and townships.[11] The implication is that rural anomalies must be eradicated and that the living environment must be improved for more than half of China's population. Two points merit mentioning.

First, townships constitute the core consumer market for agricultural producers. Farmers' purchasing power directly affects the economies of townships. The financial burden totaling 133.5 billion yuan had been lifted from the farmers. However, the burden that was removed from the farmers were the taxes which urban and township populations never had to pay but which the farmers had been paying all along.[12]

Second, the farm subsidy programs were meant to improve the living standards of the farmers. Rural living conditions have improved in services such as irrigation, roads, and drinking water. Nevertheless, the goal to eliminate abuses by local officials has not been achieved.[13]

Investment and Demand Disparities. China's phenomenal Gross Domestic Product (GDP) growth has been fueled by even speedier growth in exports. Yet, growth in domestic consumption trails significantly behind that of GDP and export growth. Domestic consumer prices are higher than warranted. High relative prices help reduce consumption while generating more savings. Increased savings in turn fuels increases in investment in the export sector. However, excess investment in one sector usually produces sectoral imbalances.

While excess investment in heavy industry under Mao resulted in severe anomalies, the same pertains to excessive investment in the export sector. On average, domestic consumption ranges between 60 to 75% of a given economy's GDP. A study by Will Hutton reports that China's total consumption recently accounted for only 37% of its GDP.[14] The downward pressure on the worth of convertible currencies resulting from rising trade deficits in developed economies generates upward pressure for the Chinese yuan. Yuan revaluation increases relative factor costs that eventually will accompany episodes of decline in export growth. Excess investments in the export sector combined with a slow recovery of the worldwide recession will result in underutilized capital goods and parallel reduction in employment in the export sector. Since a one percent loss in China's GDP growth can lead to the loss of millions of jobs, China's GDP is dependent on increased domestic consumption. As such, the central government has embarked on massive budgetary outlays investing in infrastructural improvement and industries. The intention is through increased investment expenditures by the government, the rise in unemployment may be prevented or mitigated.

Select Incongruities. To prevent the rise in unemployment, budgetary expenditures were being poured into non-performing state enterprises. At the inception of reform, there was a budgetary surplus of 1.0 billion yuan. The first year of reform showed a deficit of 6.9 billion yuan. By 2008, the deficit was 126.2 billion yuan. Foreign debts exhibited the same negative tendency. In 2000, China's foreign debts were $145.7 billion. By 2005, it grew to $281.0 billion and in 2008, it climbed further to $374.7 billion.[15] Since rapidly growing aggregate debts helps fuel inflationary pressure, it will exact a heavy toll on future generations via increased tax burdens.

The adverse effects of China's soaring growth, especially soaring foreign exchange reserves, is a serious concern for many developed economies with mounting trade deficits against China. The number of disputes over unfair trade practices against China continues to grow in number and intensity. Developed economies are less than willing to grant licenses for exports of advanced technology to China. Substantial portion of imports financed by resources borrowed from abroad theoretically could be developed and produced by domestic resources. Two positive outcomes could result if there is a reduction in foreign borrowing and an increase in expenditures on domestic research and development. Increased expenditures on domestic human resources increase aggregate demand. With the multiplier effect, the economy would then grow at a more sustainable level. Also, increased domestic expenditures on research and development help develop technological advances.

Another concern that can conceivably detract from the growth of the market system in China is that excess foreign reserves can pose serious threats to macro stability. A reduction in the supply of yuan is caused by an oversupply of foreign reserves in the central bank's holdings which reduces the bank's ability to more effectively implement monetary policies. Revaluation of the yuan renders Chinese exports relatively less competitive and imports more attractive. In time, increase in imports that could otherwise have been supplied by domestic sources applies pressure to reduce the domestic demand for labor. A rise in unemployment can occur.

Revaluation of the Chinese yuan relative to hard currencies had been anticipated since the late 1990s. The question was not whether but when the yuan's value would have to rise relative to foreign currencies. Demand for the Chinese yuan kept rising along with the supply for major convertible currencies. The central bank ended up with increasingly more foreign reserves while reducing the supply of Chinese yuan. Interest rates adjustments are usually needed to prevent rising unemployment, but the adjustments were less than adequate. Money supply exceeded GDP growth rates every single year for more than two decades. Low interest keeps fueling investments, causing excess productive capacity without corresponding increases in domestic demand. The central bank has raised reserve requirements more than a dozen times in recent years. No relief is in sight.

The macro stability may also be threatened by the excess money supply in the system in terms of investment opportunities by micro entities. Investments by the private sector have been a relatively novel experience with many who possess little knowledge or expertise. China still lacks a well-developed financial system as its stock and bond markets have only recently been introduced. Supervisory agencies to monitor financial markets' operations are still in their embryonic phase. Additionally, the excess money supply that is available to the private sector has been flooding the stock and bond markets. The expectation of continual upward movement in stock prices is leading to an ominous bubble in China's financial system. China must effectively prevent the bursting of the bubble to avoid the same experience as the near meltdown of the financial markets in the U.S. in 2008.

Administrative Decentralization and Social Unrest. Administrative decentralization in itself is an essential component of systemic transformation. However, with the administrative decentralization came the responsibility for budgetary disbursement. As such, immense disparities became inevitable in terms of population sizes, population densities, industry concentration, soil fertility, resource deposits, infrastructure, climatic and geographic amenities. The differences translate into fiscal potentials. From the perspective of what each of the municipality or province can accomplish with the revenues generated from their respective jurisdiction, the poor provinces or municipalities do not come even close to what the better endowed jurisdictions can do. Poorer provinces and jurisdictions do receive special budgetary allotments; however, even with considering the subsidies from the central administration, substantial disparities persist.

In addition to revenue collection, decentralization means each local jurisdiction is also responsible for providing social and economic needs of citizens. Serious inequalities exist among diverse administrative jurisdictions in terms of fiscal privileges and responsibilities. Revenue sources for many lower level administrations were inadequate while needs were more than considerable.

With unjustifiable and at times unexplainable financial burdens being placed on the masses in the form of fees, charges, taxes, and fines, complaints and petitions soared. Demonstrations and even violent confrontations with authorities occurred as security forces were often deployed to quell the demonstrations. The fabric of social calm keeps tearing.

Another consequence of administrative decentralization is that success is often defined as meeting and exceeding production quotas. The criterion leads to the proliferation of low-end manufactured or value added products. As competition for value added exports grow, especially from economies like India, Vietnam and other developing economies in the Pacific Basin, the excess capacity in China’s export sector will meet increasingly mounting challenges. Thus, the potential opportunity cost of the current investment trend in decentralized administrative regions would be high. If this materializes, pressure will mount in the labor market that could cause a chain reaction adversely impacting larger segments of the economy and society.

Banking, Housing, and Stock Bubbles. The Bank of China became the central bank in 1983. Instead of functioning as a clearing house for the state’s financial transactions, it began assuming the traditional role of a central bank. In theory, the special purpose banks became independent commercial banks, reaping successes or bearing loss on their own. Also in theory, most SOEs became financially independent from the state budget. Predicaments arise when many SOEs incurred losses. Allowing the insolvent SOEs to bankrupt would mean further increases in unemployment. The articulated objective in decentralization was the separation of the state from enterprises. It nevertheless was easier envisioned than realizable. SOEs incurring losses turned to state-owned financial-institutions for budgetary assistance. The unrecoverable loans from state banks to state-owned enterprises may be credited as losses but they nevertheless help fuel financial bubbles. For the near future, bank insolvency can be cushioned by China’s immense foreign reserves. However, if and when the bubble does burst, then macro disturbances would quickly follow financial chaos. The current momentum of growth and restructuring efforts could suffer an incalculable setback.

During the early stage of reform, no real estate existed. Money or capital markets and bank rates were low, investment opportunities for mounting savings had limited opportunities. The social class that became rich quick recognized a potential gold mine. For example, in "1978 there were only 3.6 square meters of living space per inhabitant… By 1981, living space in urban housing had increased to 5.3 square meters per person, and by 1985 the figure was 6.7 square meters.[16] Yet, the supply of housing was still significantly short of demand. As on other fronts, real estate development had to resort to the state's exercising its power, in this case, eminent domain rights. Similar to other major reform measures, experimental sites for the housing industry included several southern cities such as Hainan, Beihai, Guanzhou and Shenzhen. A mortgage system was established in these experimental cities. Housing bubbles quickly formed. However, Premier Zhu Rongji's recognized the nearly bursting housing bubble in Hainan. He ordered an immediate cessation to bank lending.[17] As real estate industry has been an integral and pivotal ingredient in economic growth, a nationwide mortgage system came into existence by 1997 as the Central Bank of China issued a communiqué granting permission to commercial banks to extend mortgage loans to credit worthy patrons. It was through state intervention from 1998 onward that the growth in the housing market accelerated.[18]

The government's role in creating the housing market is apparent. A 585 billion yuan stimulus package was used to build shopping malls, apartment buildings, office towers, condo towers and even entire cities that have since been left unoccupied.[19] Another report estimates that 64.5 million apartments and houses in urban areas have been left vacant.[20] Added to this is that since the central administration announced property tax reform, sales of real estate fell by 70% in Beijing and Shanghai in 2010.[21]

The 2008 meltdown of the financial system in the U.S. that was caused by massive mortgage defaults and operational irregularities in the system sent tremors around the world. A similar meltdown in China could be comparably seismic. It was announced that China surpassed Japan as the worlds' second largest economy (U.S. first) on August 15, 2010.[22]

China's financial market is still in its budding stage. The primary investment outlets for average household savers include banks, stock and bond markets, insurance and trust funds. No commodity market has yet evolved in China. Nor have money markets, derivatives, futures and foreign exchange markets. Two stock exchanges were established in 1990: Shanghai Stock Exchange and Shenzhen Stock Exchange. Within a year there were a total of 1625 listed companies, with 864 in the Shanghai Exchange and 761 companies in Shenzhen Exchange.[23]

Relative stability in the stock market has been absent. Soaring and plummeting market led to a fear that the bubble could burst. Although the government intervened to temper the fever, it also caused violent fluctuations.[24] The market reached a historical high of 6124 points on October 16, 2007. Shanghai's Composite Index then plunged by 65% in 2008. And, the moving average for the month of August was 2627 points for 2010.[25] The volatility of the China's stock market may be viewed from yet another perspective. The P/E (price/earning) ratios for shares in the two Exchanges in 2007 were 59.2 and 69.7, respectively. Severe down turns were experienced in subsequent years.[26] Yet another factor contributing to the market's flaw is the government's role in the stock market. As of 2007, the seven state banks whose shares are listed on the stock market account for nearly one third of total market value of the entire stock exchange. Yet at the same time, these banks carry combined unrecoverable loans totaling in excess of 600 billion Yuan.[27] The government holds a controlling interest in listed shares and there has been no indication that the government intends to privatize.[28] The stock market, therefore, is unable to fulfill its broad function of efficiently allocating resources for value maximization.[29]

Another relevant concern over stock and housing market bubbles is the central bank's monetary policy. In China, the supply of M2 consistently exceeds that of GDP growth by a significant margin. The GDP growth for 1994 was 13.1%. The money supply increased by 34.5% and the stock market gain went from 333 points on August 1, 1994 to 1053 points by September 13 that same year. Yet another instance was that M2 inexplicably grew by 47% within a 20-month period between yearend 2008 and early August 2010, far exceeding the GDP growth.[30] That such a monetary policy is based on sound economic rationality is questionable at best.

A more dynamic issue concerning stable economic growth and social well-being is whether macro policies based on political decisions is to the best overall long-term interest of the nation. The issue of price stability aside, if monetary policy is being implemented primarily for influencing housing and/or stock market activities, then the average household investors are being preyed upon . In a time when augmented domestic consumption is a crucial factor for sustained economic growth in China, such macro policies merit reconsideration.

World Trade Organization China's membership into the WTO organization meant accelerated systemic reform. A time table was established for implementing the required changes. Two primary domains become immediately challenged. On the political front, the WTO may challenge China's policies pertaining to foreign trade and domestic commerce and laws for foreign and domestic economic relations must be in sync with accepted international norms, mitigating the influence of political decisions on economic affairs. If not, then challenges may be filed with the WTO against China for unfair trade practices. Thus, China has agreed for the first time to be subjected to WTO arbitration. On the economic front, numerous challenges face China as a member of the WTO. China is required to remove trade barriers or restrictions including restrictions on foreign communication equipment imports, mass media, and internet services. Not only has the media been the tool for promoting government causes and ideology, the entry of foreign capital, foreign technology, foreign organizational and operational expertise in communication and mass media industries, the established communication industry in China will face severe challenges.

Although China has made significant technological strides since reform began, it still pales to those of developed economies. While there has been strong growth in exports of China's manufactured goods such as colored TV sets and computing equipments, many key components of these products have either to be imported or licensed by foreign patent holders.[31] China's R&D capacity also pales in comparison with that in the developed economies, especially when contrasted with research facilities in the U.S., Japan and some of the EU countries. Moreover, mergers, acquisitions and similar tactics on the part of foreign capital can slice deeply into China's intent of fostering a high tech research force that can compete more effectively with other economies. The pace of China's drive for fostering a viable R&D foundation is likely to be slowed down as a result.

Another front that can expect serious challenges from injection of foreign interest is China's banking and insurance industries. According to agreements with the WTO, China promised to permit financial institutions including banks, insurance and investment firms wholly owned by foreign interests to freely enter the country by 2005. Foreign banks are now permitted to conduct business in local currency, servicing domestic businesses and consumers. Entry of foreign banks and insurance companies which are well organized, experienced and efficient, can pose serious challenges to state-owned domestic banks.[32] The challenge is whether the state is prepared to oblige the less efficient SOEs to undergo the test of market forces by having them either privatized or be eliminated from the market by competing forces. This really poses the question of whether the state is intent on deepening reform for improved efficiency or be more concerned with the rise of unemployment consequent upon reorganization of non-performing SOEs. That is, entry in the WTO questions whether economic rationale can prevail over political predilections.

Entry into the WTO also required a reduction in farm subsidy, a reduction in tariffs, and, as a result, significant increases in agricultural imports. China, therefore, will need to learn how to protect and improve the productive efficiency of its farm sector within the prescribed rules of the WTO. Challenges are bountiful. China's agricultural exports are mostly routine items and instances of unsafe agricultural exports from China have raised the level of apprehension on the part of importing economies.

In brief, China's entry into the WTO does bring with it a host of practical challenges. The five-year transitional period granted to China by the WTO ended five years ago. The long term benefits hold vast promises. Short and medium term complications arising from WTO membership are manifold. Managed well, stability and sustained growth will prevail. Otherwise serious disorder and disruptions can either help delay or derail the state's current drive for continual reform and development.

Conclusion

More than a decade before the collapse of the Communist regimes in Eastern Europe, the world's most populous nation began experimenting with systemic and structural transformation. Paralleling institutional reforms on the domestic front, China concomitantly initiated reforms in the external sectors. On the domestic frontier, reform successes may be attributed to administrative decentralization, to restoring rights to private ownership, to privatization of state-owned enterprises and the rapid emergence of the private sector. The most pronounced catalysts of China's meteoritic growth, however, may be duly attributed to reform successes in the realms of foreign investment and foreign trade. China has transited from a foreign-reserve deficient economy to one that has been awash in reserves. The predictable consequence is China's ability and readiness to search for investment opportunities abroad. Three decades of sustained reform has transformed China from a closed and unpretentious economy to one whose performance is capable of impacting the economic well being of world economies. China's reform experience richly merits a chapter in the annals of world development history.

Much has been accomplished. Nevertheless, the burgeoning capitalist spirit in China has concurrently revealed institutional flaws and critical financial anomalies. As discussed in this paper, acute irregularities in the real estate and in the financial markets are only two of the more serious aberrations faced by China's policy designers and decision makers. Alternately stated, amidst bountiful accomplishments are also copious flaws that require pressing mindfulness of the central government to ensure China's continual path towards improved well being of its growing population.

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[1] During the height of the "Cultural Revolution," it was made clear that Mao was the embodiment of absolute truth and ideological purity. The Party's resolution in 1978 was a veiled rebuke of the cult that Mao had carefully cultivated for himself through the fear that he had instilled.

[2] Shenzen was the first SEZ. Six months later, Zhuhai and Shantou were added. Two months thereafter, Xiamen was the forth; and, in April of 1988, Hainan became the fifth.

[3] The fourteen cities had been declared open were Qinhuangdao, Dalian, Yantai, Tianjin, Qingdao, Lianyungang, Nanton, Shanghai, Ningbo, Wenzhou, Fuzhou, Guangzhou, Zhanjiang and Beihai. Victoria Mantzopoulos and Raphael Shen, "China's Economic Restructuring through Induced Capital Inflows." Journal of International Business and Cultural Studies. Vol. 4, 2011. p. 104

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[32]Other than the entry of foreign financial institutions include other foreign service industries such as entertainment, tourism and restaurants will all pose compelling challenges to domestic concerns consequent upon China's entry into the WTO.

Table I: Capital Inflows (1979-2008)

Utilization of Foreign Capital Unite USD, 100 Million		
Year	Foreign Loans (I)	Foreign Direct Investments (II)

		Number of Projects	Value
1979-1984	169.78	3724	97.50
1985	35.34	3073	63.33
1986	84.07	1498	33.30
1987	78.17	2233	37.09
1988	98.13	5945	52.97
1989	51.85	5779	56.00
1990	50.99	7273	65.96
1991	71.61	12978	119.77
1992	107.03	48764	581.24
1993	113.06	83437	1114.36
1994	106.68	47549	826.80
1995	112.88	37011	912.82
1996	79.62	24556	732.76
1997	58.72	21001	510.03
1998	83.85	19799	521.02
1999	83.60	16918	412.23
2000		22347	623.80
2001		26140	691.95
2002		34171	827.68
2003		41081	1150.69
2004		43664	1534.79
2005		44001	1890.65
2006		41473	1937.27
2007		37871	
2008		27514	

Source: National Bureau of Statistics of China. China Statistical Yearbook, 2009. Beijing: China Statistics Press, September 2009.

Table II: China's Foreign Trade 1978–2009 (Select Years)

	Billion U.S. $

Year	Total Exports	Total Imports	Balance
1978	9.8	10.9	–1.1
1985	27.4	42.3	–14.9
1990	62.1	53.4	8.7
1995	148.8	132.1	16.7
2000	249.2	225.1	24.1
2005	762.0	660.0	102.0
2006	968.9	791.5	177.4
2007	1217.8	956.0	261.8
2008	1430.7	1132.6	298.1
2009*	1200.0	1010.0	190.0

Source: *Statistical Yearbook of China 2007, p. 724* and *Statistical Yearbook of China 2009*
*Source: www.chinaview.cn and http://www.gov.cn/english/2010-02/25/content_1541738.htm

Table III: Macro Indicators, 1979-2008 (Select Years)

		Composition of Gross Domestic Product	

	[billion Yuan]	Primary Industry (%)	Secondary Industry (%)	Tertiary Industry (%)	GDP (Yuan)
1979	406.3	31.3	47.1	21.6	419
1985	901.6	28.4	42.9	28.7	858
1990	1866.8	27.1	41.3	31.6	1644
1995	6079.4	19.9	47.2	32.9	5046
2000	9921.5	15.1	45.9	39.0	7858
2005	18321.7	12.2	47.7	40.1	14053
2006	21192.4	11.3	48.7	40.0	16165
2007	25730.6	11.1	48.5	40.4	19524
2008	30067.0	11.3	48.6	40.1	22698

Source: National Bureau of Statistics of China. 2009. China's Statistical Yearbook 2009. Beijing: China Statistics Press. P.37.38. (7-1 National Government Revenue and Expenditure and Their Increase Rates)