Briefing Paper Series
No. 5

CHINA'S TRANSITIONAL ECONOMY

—Between Plan and Market

George Mina and Frances Perkins

DEPARTMENT OF FOREIGN AFFAIRS AND TRADE
AUSTRALIA

JULY 1997

ISBN 0 642 27012 0

ISSN 1321 2729

EAST ASIA ANALYTICAL UNIT: Working and Briefing Paper Series

Other Titles

- The Japanese Market for Manufactures Imports: the Door Opens Wider
- Links of Steel: The Australian and Chinese Steel Industries
- Shipping Services Between Australia and Indonesia: The Challenge of Logistics
- Tapping into China's Transport Infrastructure Market
- China's Infrastructure: Sectoral Plans, Reforms and Financing
- China's State Owned Enterprises - Nine Case Studies
- Measuring China's GDP
- Reform in China's Agriculture

See back page for EAAU report titles and order details

FOREWORD

The East Asia Analytical Unit's Working Paper Series is intended to promote discussion and inform policy making, assist with identifying and defining issues for future more detailed analysis and contribute to awareness of current issues affecting Australia's economic engagement with East Asia. As working papers, they represent the views of the individual authors and should not be interpreted as the views of the Department of Foreign Affairs and Trade or as statements of Australian Government policy.

The EAAU was commissioned to undertake this research project as part of a wider review of the status of the Chinese economy for the purpose of its treatment under the anti-dumping provisions of the *Customs Act 1901*. However the analysis herein should be of interest to a wider audience, as it provides a short assessment of China's progress in transition from a centrally planned to a market-oriented economy.

This paper should be seen as an introduction to China's progress in transition from plan to market, rather than a comprehensive or exhaustive treatment of this question. Within the constraints of this short exercise we have provided only an overview on the economy's status in 1997 and where it has come from in the past 19 years. A more comprehensive analysis of China's economic reform program is available in the East Asia Analytical Unit's latest publication, *China Embraces the Market*, which was released in April 1997.

The authors of this paper were George Mina and Frances Perkins of the East Asia Analytical Unit, Department of Foreign Affairs and Trade, although several others contributed their time and effort to the preparation of this paper. Thanks are due especially to Mr Ian Dickson, at the University of Adelaide's Department of Economics who was very generous in assisting our research on the commodity coverage of China's system of canalisation and also to Mrs Sue Begley, of the Department of Foreign Affairs and Trade's Statistical Services Section, who prepared estimates of the significance of canalisation to China's international trade.

An earlier draft of this paper benefited from comments from Professor Ross Garnaut and Dr Yang Yongzhen, both of the Australian National University and the Departments of Attorney General, Industry Science & Tourism, Primary Industries and Energy, Prime Minister and Cabinet and Treasury. Thanks are due especially to comments from several Australian businesses who participated in a seminar on the paper's findings in the Department of Foreign Affairs and Trade on 7 February, 1997.

CONTENTS

SUMMARY

Transition from Plan to Market

China can no longer be treated as a centrally-planned economy

This paper concludes that China can no longer be regarded as a centrally planned economy in which the Government substantially influences the domestic prices of goods or substantially monopolises international trade.

Nor can China be treated as a full market economy

- However, neither is it a fully market-oriented economy—as noted by Pieter Botellier, the head of the World Bank Mission in Beijing,

  > “China is perhaps about half way in its historic transition from a centrally planned to a market economic model” (Botellier 1996).

A gradual process of market-oriented reform is continuing in a range of policy domains.

- In relation to competition and the role of government intervention in the economy, in most sectors central planning has been dismantled, although there is still some way to go before other sectors can be considered fully market-oriented.
- While the legal and institutional framework necessary to underpin the operation of markets needs to be developed and that process is likely to take many years, it is nonetheless the case that the exchange of many goods and services are effected in accordance with market prices.

Market-orientation varies widely

Consequently, market-orientation varies widely across the economy and is more advanced in:

- some sectors (light industry, agriculture and services) than it is in others (mining, distribution, parts of heavy industry, and infrastructure services such as rail and telecommunications);
- coastal areas, than it is in central and inland regions; and
- private, foreign-owned, and township and village enterprises, than it is in urban collectives and state-owned enterprises, although in many state-owned enterprises market pricing is common.

INTRODUCTION

China's Transition to a Market

Reforms have been gradual and experimental

Since 1978, China has been undergoing a gradual process of transition from a centrally planned economy to an economy where resources are allocated primarily through the market-mechanism[1]. While economic reform has profoundly changed China's economic system over the past 18 years, the process of reform has been gradual and incremental in nature and is still incomplete. The Government's stated approach has been to implement policies on an experimental basis before adopting policies across the economy. New liberalisation initiatives were often trialed first in the coastal regions and special economic zones.

Reform commenced with the decollectivisation of agriculture in 1978 and advanced gradually throughout the first half of the 1980s to encompass much of Chinese industry. Reform measures included the introduction of a two-tier price system for most commodities, enterprise taxation, a revenue sharing system between central and local government, a wage system with a closer link between wages and productivity, and banking finance for enterprise investment. Reforms were expanded in scope and depth from 1986 to 1988, with the introduction of swap centres for the trading of foreign exchange earnings, the decentralisation of foreign trade through a rapid increase in the number of foreign trade corporations ad firms permitted to trade on their own account, and the adoption of a contract responsibility system for industrial enterprises. Between 1988 and 1991, reforms slowed during a period of retrenchment due to concerns about the social and economic costs of reform. Macroeconomic instability led to some re-centralisation of prices and to cooling the overheated economy through crude administrative controls.

Commitment to a socialist market economy in 1992

The period since 1992 and Deng's Southern Tour has seen a renewed political commitment to reform, enshrined in the Party's adoption in October of that year to the goal of establishing a "socialist market economy". Since this time, the market mechanism has been more extensively introduced throughout the economy. Developing a strong institutional framework to support this market economy has also emerged as a key priority. Of great importance have been measures to strengthen China's macroeconomic management capabilities. These include taxation and budgetary reforms and legal and regulatory measures to further the role of the central bank and measures to improve the operation of capital and foreign exchange markets.

What is a Market Economy?

[1] The following section is based on IMF 1993: 2-5.

Core elements of a market economy

In considering China's progress in making the transition to a market economy, it is useful to outline some key elements or "threshold conditions" which define a market economy. An "idealised" model of a market economy could be characterised by the following elements:

- Price mechanisms operate freely, with prices set by the independent interaction of producers and consumers, in most or all sectors of the economy. Market-determined prices operate as signals to consumers and producers about the value of particular products
- All sectors of the economy are open to international trade, with minimal tariffs or non-tariff barriers (quotas, licensing, etc) or other forms of government trade control
- Competition is strong in all industry sectors of the domestic market, with no regulatory or legal barriers to the entry or exit of firms
- The state plays a minimal role in the domestic economy, mainly in providing public goods and collecting taxes necessary to finance these
- The institutional framework supporting market activities is well-developed, including an effective rule of law and an independent judiciary, well-developed regulatory standards and a responsive and transparent bureaucracy

While there are few, if any, economies which meet all of these core elements, we shall now consider China against each of these elements of a market-orientation.

1. PRICES

The Role of Prices under Central Planning

Prices in China's pre-reform economy (prior to 1978), operated mainly as instrument for the Government's redistribution policies, rather than as market signals.

- Prices of all major commodities were controlled by the Central Government, and those of virtually all less-important commodities were set by provincial and local governments. Price inflation barely existed prior to reform, many prices remaining fixed at the same level for decades.

- Prices also played little role in enterprises' (mainly state-owned enterprises') production decisions - they were merely a means of accounting for the flow of inputs and outputs within the planning system. The ultimate objective of state-owned enterprises was fulfilling output targets rather than cost efficiency or profitability.

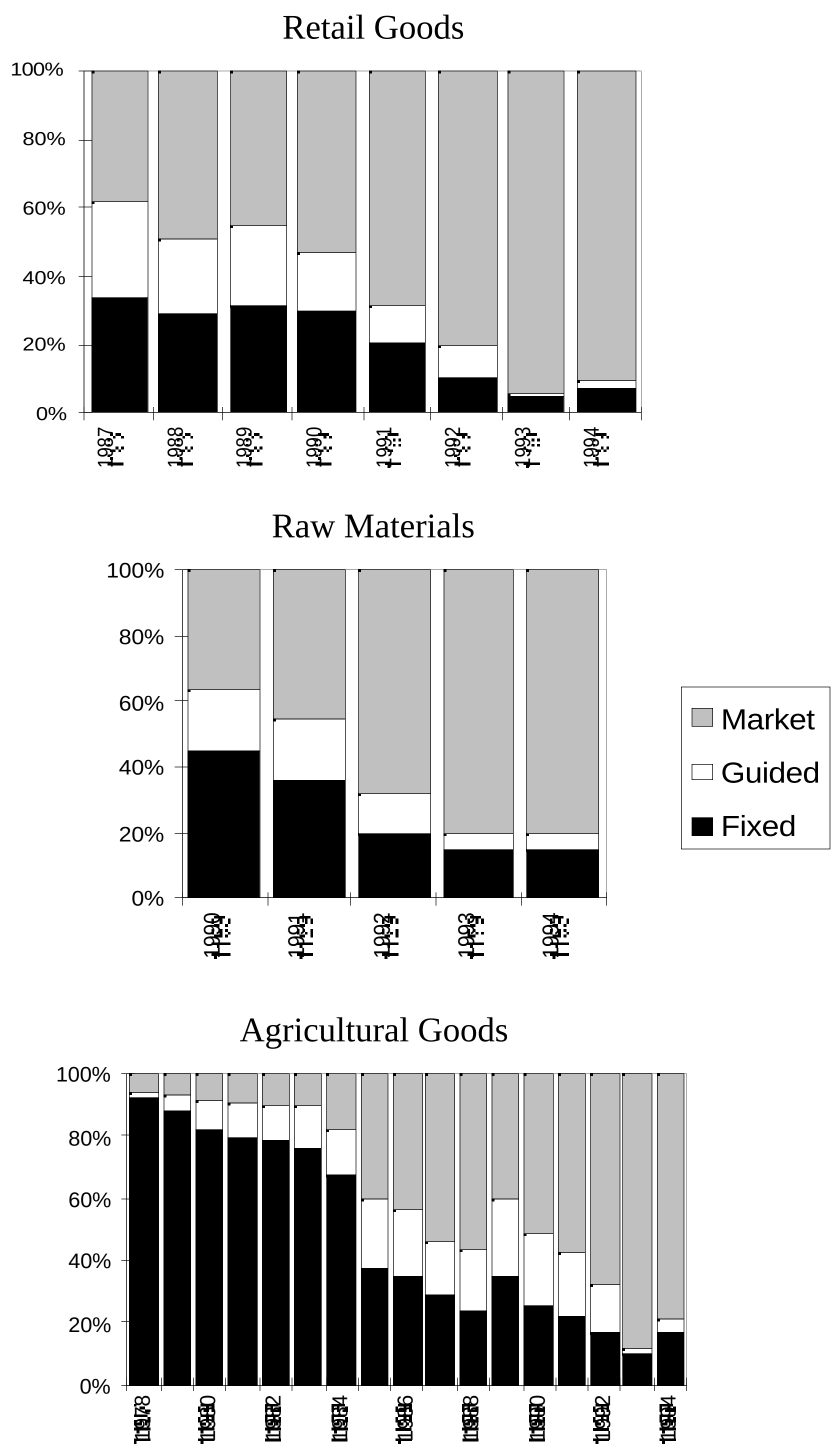
Price reform has allowed the introduction of freely-operating market signals in most sectors of the economy. Liberalising prices has allowed supply to be much more responsive to demand from consumers and downstream producers, encouraging greater allocative efficiency. Price reform is now almost complete as most prices have been substantially deregulated and the state's role in guiding or fixing prices is now minimal (Figure 1).

Over 90% of retail goods prices are determined in the market

According to China's Ministry of Internal Trade which is responsible for data collection on prices and publishes a yearbook on price deregulation[2], by 1994 over 90 per cent of retail prices and approximately 80 per cent of agricultural and producer goods prices (all as a proportion of output value) were determined by the market (Ministry of Internal Trade, 1995: 18-21). While these figures cover all Chinese goods prices, they do not cover service sector prices. Competition in producer and consumer products in China is intense; this is due to the impact of reforms on the activities of state-owned enterprises, the rapid growth of new foreign owned and joint venture enterprises and to the lowering of tariff barriers.

[2] As at January 1997, the latest available data are for 1994; which were published in Ministry of Internal Trade (1995).

Figure 1. Scope of Market-Determined Pricing in China



Source: IMF, 1996, Tables 26-28; and *China Price Yearbook* 1995.

Notes: Shares of market, guided and fixed prices are expressed as a proportion of that sector's output value. Agricultural goods prices represent farm-gate prices. "Guided" prices are determined via negotiation between the authorities and state enterprises and are generally closer to market prices than fixed prices.

Reliability of Price Data

The IMF and World Bank accept the accuracy of this data

The International Monetary Fund, which has reported this data on price liberalisation (IMF 1996a) has accepted them as accurate:

> *"We don't uncritically accept the Chinese estimates. By and large, however, we believe that the official estimate of a rising share of prices determined in the market provides a relatively good indication of the increasing role of market forces in the Chinese economy, and that the estimate of around 90 percent of retail sales occurring at market prices is in the right ballpark" (Charles Adams, Division Chief, Central Asia Department, IMF Washington , 12 December, 1996).*

The World Bank supports this assessment. It recently reported that by 1994, "price reform had led to the decontrol of more than 90 per cent of retail prices and between 80 and 90 per cent of agricultural and intermediate product prices, all of which are now market determined. Only a few prices remain fixed or negotiable within a band set by the state" (World Bank 1996a: 24). Questioned about the reliability of these statistics, a World Bank official (Lead Economist, China and Mongolia Department) commented that

> *"a figure of over 90 per cent market-set prices is consistent with what the World Bank has observed in the market, and we have no reason to doubt this number" (World Bank 1996b).*

Price liberalisation has, however, been uneven across China's regions (Table 1).

Table 1. Price Controls in Selected Provinces of China, 1994

Region	**Market**	**Guided**	**Fixed**
Shaanxi	97.4	-	2.6
Yunnan	93.6	-	6.4
Guangdong	92.6	-	7.4
Tianjin	89.0	6.9	4.1
Beijing	79.0	12.1	8.9
Qinghai	70.7	10.4	18.9

Source: Ministry of Internal Trade, 1995.

State Intervention in Pricing

The reimposition of some price controls in 1994, particularly targeting food grains, was an attempt to control prices in a period of rapid inflation. These controls have since largely been removed. As macroeconomic management has improved in 1995 and 1996, more indirect methods of controlling inflation have been employed, notably sales of government bonds to finance the budget deficit (rather than printing money) and tightening bank credit.

Controls apply to "strategically important" goods and raw materials

Price reform also has been slow for

- those commodities—such as food grains and oil—identified by China's leaders as "strategically important" and
- some key raw materials and energy sources required by state-owned enterprises.

Most price controls still in place apply to these goods and services (Table 2).

Table 2. Commodities Subject to Price Controls, 1996

Sector	*Commodity Groups*
Agriculture and resources	Cotton, tea, some timber, urea, salt. Grains including, wheat, indica rice, japonica rice, maize and soybean. 10% of all grain is subject to state price controls.
Energy and water	Crude oil, natural gas, petrol, diesel oil, heavy oil, some electric power (for domestic, not industrial users), irrigation and domestic water.
Chemicals	Ammonium nitrate.
Pharmaceuticals	Medicinal, veterinary-medicinal products.
Transport goods	Railway steel, aircraft and engines.
Infrastructure services	Telecommunications, public transport, urban housing.

Note: These sectors represent only those in which the Australian Department of Foreign Affairs and Trade is aware of controls operating. This list does not include prices over which local governments have jurisdiction, nor does it include those commodities which are subject to guidance pricing. However, most price controls have disappeared on minor commodities which are the responsibility of local governments.

In some cases, prices of final goods produced by some state-owned enterprises may be reduced as a result of price controls on some inputs. Examples include cotton textiles and processed foods based on grains, as both raw cotton and several major grains are subject to price controls. However, non-state firms do not receive any price-controlled inputs and they now produce over two-thirds of processed food, textiles and garments output. Furthermore, it is only in only few selected sectors that state enterprises still receive a proportion of their inputs at controlled prices[3]. The great bulk of inputs (85-90 per cent) are purchased by most state-owned and probably all non-state owned enterprises at market prices (see figure 1).

[3] In the case of cotton, controlled price supplies are apparently of poor quality and in short supply, because farmers resent having to produce and sell cotton at these low prices and avoid growing it if possible (see EAAU's forthcoming report on China, Chapter 9 on agriculture).

2. INTERNATIONAL TRADE

The Foreign Trade Regime under Central Planning

Prior to 1978, China aimed at self-sufficiency, importing only those goods it could not locally produce and exporting goods only to pay for essential imports.

- Trade was therefore only a small proportion of the economy.
- Trade was monopolised by 12 centrally controlled Foreign Trade Corporations, under the control of the central Government ministries. Other trade was not permitted.
- Export and import plans covered virtually all foreign trade, applying to around 3,000 commodities.
- Exports were compulsorily procured at state controlled prices by the Foreign Trade Corporations under the foreign trade plan. Similarly, imports were sold to domestic firms and consumers at state controlled prices.

The trade regime has been significantly liberalised

China's Open Door policy has dramatically reversed the autarkical position of pre-1978, welcoming foreign investment and trade. Increasingly China's imports and exports are determined by market forces and China's comparative advantage (Zhang 1995, World Bank 1994). The ratio of imports and exports to Gross Domestic Product is now 42 per cent and China is now the tenth biggest trading nation.

Non-state sector now dominates China's international trade

The non-state sector is particularly export-oriented. In fact much of China's trade is now being conducted by foreign funded enterprises. In the first eleven months of 1996, foreign funded enterprises (including joint ventures and wholly foreign owned firms) were responsible for 41 per cent of total export trade and 53 per cent of imports. Wholly foreign-owned enterprises alone undertook 16 and 18 per cent of export and import trade respectively (China Customs Statistics). The highly market-oriented township and village enterprises are also conducting a growing proportion of China's trade. For example, they have produced approximately 90 per cent of China's clothing exports in recent years (Yang 1997).

Trade is now undertaken by thousands of enterprises on the basis of market decisions

While MOFTEC still controls the issue of foreign trade licences to foreign trade corporations or enterprises, by 1996 there were over 5,000 foreign trade corporations and over 200,000 foreign and large state-owned production enterprises which had the right to trade internationally on their own account (MOFTEC 1996a). Foreign trade corporations now pay market prices for the exports they procure from domestic firms, and firms can sell to any corporation they choose. Competition between corporations and traders is intense and is not controlled by the Chinese Government.

All foreign funded enterprises can automatically trade on their own account. Foreign firms were also allowed to form joint venture foreign trade corporations for the first time in 1996.

Foreign trade planning was formally eliminated in 1994 but many controls remain

However, the process of moving away from total control of trade to free trade is still incomplete, as is the transition in the domestic economy. The foreign trade plan was formally eliminated in 1994 (IMF 1994: 10), but many controls, some less transparent than others, remain on a range of imports (but to a much lesser extent on exports). Direct import controls still continue on a number of major items of importance to Australia such as wheat, wool, and other agricultural and raw materials (see Table 3).

Trade Policy Instruments

[4] Calculated by Statistical Services Section, Department of Foreign Affairs and Trade, January 1997.

Aside from state control over a proportion of China's trade through 'canalisation' (see below), a number of other policy instruments are employed by the Government to manage the trade regime. These instruments include tariffs, licences and quotas, restricted trading rights, subsidies and foreign exchange controls.

Canalisation

State retains control over trade in some strategic commodities through 'canalisation'

While formal trade planning has been abolished, a number of central foreign trade corporations and large state-owned enterprises have been given selective monopoly powers to import and export strategic commodities (Bach et al 1996: 410). This process has been termed 'canalisation' by the World Bank (1994).

By 1996, canalisation applied to those commodities listed in Table 3. Together, these commodities represented approximately 4.6 per cent of China's exports and 19.4 per cent of imports in 1995[4].

Table 3. Commodities Subject to Canalisation

	Imports[a]	**Exports**[b]
Primary Products	Cereals, tobacco, logs and plywoods, wool, cotton, rubber, petroleum, sugar, vegetable oils, crude oil, refined oil.	Crude and refined oil, tea, coal, rice, silk, cotton, tobacco, maize, soybean.
Manufactures	Cigarettes, acrylic, iron, steel, and articles fabricated from iron and steel, chemical fertiliser.	Tungsten, tungstates, antimony, selected textiles.

Sources:[a] Compiled from Dickson 1996: 31 and advice from the Trade Negotiations and Organisations Division, DFAT [b] Information on exports subject to canalisation was compiled from the *MOFTEC Gazette* by Ian Dickson at University of Adelaide, January 1997 and advice from the Trade Negotiations and Organisations Division, DFAT.

Tariffs

Tariffs have been substantially reduced

While average import tariff rates are still high by international standards, at the end of 1995 the Chinese Government announced a significant trade liberalisation package reducing the weighted average import tariff rate to 19.4 per cent (see Table 4). This represents a rapid reduction from an average rate of 32 per cent in 1992 (World Bank 1994: 48). The Chinese Government also announced that it intended to reduce import tariff rates further to 15 per cent by 2000 (MOFTEC 1996b: 2). Due to an extensive duty draw back scheme for exporters as well as weak and inconsistent tariff collection procedures, tariff revenue in fact only represented 4 per cent of the value of imports in 1994—down from 9.7 per cent in 1986 (Naughton 1996). A small number of export taxes are still in place.

Licensing and Quotas

Licensing and quotas have been wound back

While import and export licensing is still significant, it has been substantially reduced. In 1996 licensing covered 25.3 per cent of all trade, down from 43.5 per cent of trade in 1992 (MOFTEC 1996a). Table 4 shows the liberalisation of licensing and quotas.

However, a range of other important non-tariff barriers remain in place, including import tendering, local content and other import substitution arrangements, export performance requirements, product registration restrictions and statutory inspection arrangements.

Table 4. Liberalisation of Tariff and Non-Tariff Barriers*

Date	*Unweighted average tariff*	*Weighted average tariff*	*Non-tariff barriers*
Early 1992	43.0	32.0	Applied to 1530 tariff lines
End-1992	39.9	32.7	..
End-1993	36.4	30.7	Eliminated on 283 tariff lines
End-1994	35.9	..	Eliminated on 206 tariff lines
End-1995	35.7	26.8	Eliminated on 367 tariff lines
Mid-1996	22-23[a]	19.4%[c]	Eliminated on 170 tariff lines
Target, 2000	15.0[b]	..	

* Non-tariff barriers in this table comprise licences and quotas.

Source: World Bank (1996c: 8) and (c) obtained from Department of Foreign Affairs and Trade, Trade Analysis and Reporting System.

(a) President Jiang Zemin's speech at APEC summit, Osaka, Japan, 21 November 1995.

(b) Statement by Vice Premier Zhu Rongji in November 1995.

Export Subsidies

Export subsidies abolished, but operating subsidies continue

Export subsidies were abolished in 1991 and foreign trade corporations were forced to become commercial operations responsible for their own profits and losses.

However, about half state-owned enterprises were making a loss in 1996 (up from a third in 1995) and some are permitted to keep rolling over debts to the state banks. Subsidies are provided in a variety of forms, including direct budget transfers, access to concessional credit, technology upgrade assistance, and favourable access to inputs in "high-priority" sectors such as automobiles. However, direct budget subsidies have been falling significantly in yuan terms in recent years, as have the availability of price controlled inputs (Figure 1).

Although some of these loss-making state-owned industries would be exporters, in the main they would tend to be domestically oriented as they are typically unable to compete in domestic markets, let alone export markets. The exception would be enterprises which are producing outputs which are still subject to price controls, like oil refineries and grain millers. However, many such exports are typically subject to monopoly export rights precisely to ensure that they are exported at international prices, rather than low domestic prices, so China does not incur a loss from these transactions.

Nevertheless, the continued existence of such firms, and controlled price inputs and subsidies would make it necessary to undertake careful assessments of data provided to determine "normal values" in these particular industries,

Trading Rights

Trading rights are gradually being extended

As discussed above, trading rights are restricted by licence from MOFTEC, although they are now extended quite widely. The extension of permission to foreign firms to establish joint venture foreign trade corporations will have a dramatic effect on the dynamism of these organisations.

The Liberal Export Processing Regime

Nearly one-half of China's total trade flows operate under very liberal conditions

Nearly half of China's total trade flows — its export-processing trade — operates under a very liberal set of policy conditions. Export processing trade, representing 50 per cent of exports and 44 per cent of imports in 1995 (Naughton 1996: Table 4) enables foreign-funded enterprises engaged in export processing to import and export directly, import duty-free raw materials, access concessionary income and corporate tax rates, obtain preferential access to foreign exchange and sometimes access subsidised land, utilities and other production inputs (Naughton 1996: 5).

3. THE ROLE OF GOVERNMENT INTERVENTION

Government Intervention under Central Planning

The role of government in the economy was all-pervasive prior to reform. The state produced, planned and distributed practically all output.

- The bulk of resources; land, labour, raw materials and final output were allocated under the Government's planning system.
- Production and distribution plans were determined by the central and lower levels of government and implemented by state-owned production or distribution enterprises. Most inputs were supplied by the plan and most outputs were purchased and distributed under it.
- Private enterprises were generally not permitted. Well over three quarters of industrial output was produced by state-owned enterprises. All of the rest was produced by urban and rural collectives. There were no foreign owned or private sectors.

Scope of Planning

The Government's role in the economy has changed considerably over the reform period as a more market-based economy has gradually been allowed to grow "out of the plan" (Naughton 1995). What planning that remains is usually more indicative in nature, representing projections of current trends, and designed to avoid bottlenecks and shortfalls, particularly of infrastructure services, utilities, heavy industry outputs and controlled inputs and imports.

Planning has been wound back and is now loose in nature

Hence in most industries planning has disappeared completely. Most enterprises produce and sell on the basis of market prices signals and the desire to maximise profits. The *Ninth Five Year Plan (1996-2000)* focuses more on the policy reforms appropriate for indirect economic management than on administrative targets for Chinese industry.

Production and Allocation Plans

Only a few commodities remain under direct planning

Only 18 industrial commodities were covered by state allocation or compulsory contracts in 1993 and compulsory output plans assigned for only 36 industrial commodities (Naughton 1995: 290) and the scope of planning has continued to fall significantly since this time. Energy is one of the few sectors where plan controls still remain. Even in these industries however, only a small proportion of output is produced for the plan - the majority of output is sold at market prices in free markets (see Figure 1). Most plan-priced inputs are allocated to defence industries, priority infrastructure projects and key heavy industries, such as iron and steel.

Credit

Capital remains subject to pervasive planning

China's credit plan is still the most important means of allocating capital through the state-controlled banks, and only indirectly affects the fast-growing non-bank, non-state financial sector. Non-state financial institutions accounted for over one third of all deposits and loans in 1995 (People's Bank of China 1996). The credit plan, compiled annually by the Ministry of Finance, State Planning Commission and the People's Bank of China, attempts to control aggregate credit creation to determine overall levels of growth, investment and inflation (Montes-Negret 1995: 29). While this quantitative control is still in place, credit management is also effected by a managed interest rate regime based increasingly on market-determined rates.

Investment

State investment is reorienting to social and public infrastructure

While the State's share of direct fixed asset investment is quite significant, in recent years its structure has shifted heavily towards public goods.

In 1995 the State accounted for 43 per cent of total new fixed asset

4. COMPETITION IN INDUSTRY

Competition Under Central Planning

Competition was virtually non-existent prior to the commencement of economic reform. China's industry was dominated by state-ownership and a rigid regulatory regime.

- Production and investment by state-owned enterprises were controlled through a system of governing authorities, usually the industrial ministries at the central and provincial level.
- Profits made by state-owned enterprises were surrendered to the Government through their governing authorities and investment funds were allocated by the Government from the budget.
- Regional comparative advantage was ignored and regional self-sufficiency became an overriding policy goal.
- Heavy and military industries were given priority; light, consumer goods industries were neglected.

Competition in the domestic economy has increased considerably

As a result of significant relaxation of government restrictions on the non-state sector, competition has increased considerably since 1978. Entry barriers for domestic and foreign firms to most industries and sectors, with some notable exceptions, have been considerably reduced. In the consumer products sector, for instance, the Economist Intelligence Unit points out that competition from both foreign and local players is intense—and in many areas is rapidly accelerating (EIU 1996:18).

State Ownership

Although falling, state ownership still accounts for a third of industrial output

Although the state's share of the industrial economy has been steadily declining since the commencement of reform in 1978, state-owned enterprises still account for 33 per cent of industrial output in 1995 (China Statistical Yearbook 1996: 401). In addition, some urban collectives, which together produced around 10 per cent of industrial output in 1995 (China Statistical Yearbook 1996), are still subject to significant government intervention. Furthermore, many important sectors remain dominated by state-ownership, such as the distribution sector, and heavy industries such as chemicals and steel production and utilities.

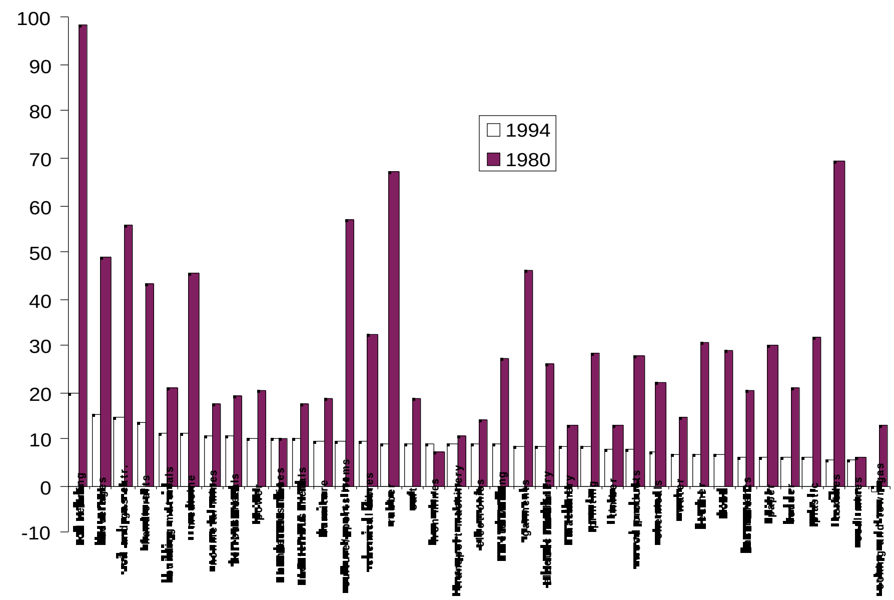
Lower Entry Barriers in Industry

One means of judging the effectiveness of reforms in increasing competition in the domestic market is to measure the freedom of products and raw materials to move throughout the economy. In a well-functioning market economy, profit rates in different sectors will converge as entrepreneurs move into high-return sectors and out of low-return ones.

Evidence suggests lower entry barriers and higher resource mobility

Evidence from an analysis of China's profit rates over the past decade and a half suggests a significant growth of competition and a reduction of entry barriers across Chinese industry (Mina and Wu: 1996). Industrial sector profit rates in China have converged significantly since 1980 (Figure 3), indicating that resources are now much freer to move in the Chinese economy. The only industries to show profit rates higher than 15 per cent in 1994 were oil and gas extraction, oil refining, and beverages, where entry restrictions still apply. There has also been a marked fall in absolute profit rates, indicating a significant growth in the amount of capital available for profitable projects and the extent of competition from new entrants.

Figure 3. Variation in Chinese Industrial Profit Rates (%), 1980 and 1994



Source: *China Industrial Economic Statistical Yearbook*, various years; Naughton 1995, 237.
Note: Profit rates measured here represent [profit plus tax]/total fixed capital. "Total fixed capital" is defined as depreciated fixed capital plus working capital. Statistics do not include tobacco industry profits, which were around 326% in 1980 and 72% in 1994.

Exit—The Bankruptcy Mechanism

No rigorous bankruptcy mechanism has yet emerged

Competition in the domestic economy has grown despite the absence of a rigorous bankruptcy mechanism. While the Enterprise Bankruptcy Law (Trial Implementation) took effect from November 1988 and several provinces have bankruptcy legislation, these laws have been very unevenly applied around China. The Government fears that a large number of declared bankruptcies would have a destabilising effect on the economy, given that so many state-owned enterprises technically are bankrupt.

Although the permanent Bankruptcy Law was drafted in May 1994 (Law Annual Report 1995: 23), it is yet to be promulgated. Rather, the Government has demonstrated a preference for mergers and acquisitions, only dissolving enterprises as a final resort. This approach is borne out by the relatively small number of bankruptcies proceeding to the courts. In 1994 there were 478 bankruptcy cases adjudicated by the court, of which 171 were related to state-owned enterprises. Nevertheless, some observers believe that the national bankruptcy law will be promulgated by the end of 1997.

5. INSTITUTIONAL FRAMEWORK OF THE MARKET

Economic Institutions under Central Planning

- *Capital and Labour Markets:* Financial intermediation played a very limited role in China's pre-reform economy. Prior to 1978 the People's Bank of China was the only bank and merely performed the roles of transferring approved budget funds into the relevant state-owned enterprises and government authority accounts and with providing these entities and households deposit facilities. Loans were not made unless approved by the plan. Interest rates were set by the Government and remained fixed at very low levels for decades. Labour allocation was tightly controlled prior to reform - labour markets did not exist.

- *Legal System*: All existing laws were repealed in 1949 with only a few replaced by a series of regulations and policy directives. Most discretion remained with the political authorities. Laws and regulations were relevant only for as long as the policies that produced them. The legal profession virtually disappeared during the Cultural Revolution. Under central planning, courts had no independence but functioned under the direct control of the Party's legal committees. The courts had only a minimal part to play in resolving economic disputes.

- *Administrative System*: The main functions of the bureaucracy were ensuring social and economic control and achieving the targets embodied in state plans. The bureaucracy was almost immune to scrutiny and had a high level of discretion to make decisions as it saw fit, subject to Party approval.

- *Accounting Standards:* Accounting was used simply as a mechanism of control the flow of resources through state-owned enterprises, and was not concerned with the profit performance of an enterprise.

While the market mechanism has been introduced extensively throughout the economy, reform of China’s market-based economic institutions is not as far advanced. The next phase of reforms will need to concentrate on the development of key economic institutions required for a stable macroeconomic environment and efficient, diversified economic growth.

Capital and Labour Markets

Capital markets are developing rapidly but are still embryonic

The financial sector is developing rapidly, from a low base, but is still embryonic. Stock exchanges have been established in Shanghai and Shenzhen, and a bond market in Wuhan. A growing cooperative credit system has developed in rural and urban areas and many new banks have been established including recently a domestically owned private bank. While by the end of 1995, a total of 137 foreign bank branches and 519 offices had been approved only a few in Shanghai’s Pudong area have been given permission to undertake yuan business, on an experimental basis (United States Trade Representative 1996). Three foreign insurance licences have been issued and the insurance industry is growing rapidly. However, there is no nationally-organised short-term money market (IMF 1996b: 6), and the payments and clearing system is under-utilised, with most transactions based on cash (IMF 1996b: 37).

Some controls exist on the mobility of labour

Some controls still exist on the mobility of labour and the flexibility with which it is deployed, particularly in state-owned enterprises. There is now considerably less intervention in wages and other conditions in the state enterprise sector but there are still definite limits to the ability to dismiss workers without official approval. This results in considerable inefficiency in state-owned enterprises.

Although China's household registration (*hukou*) system has been significantly relaxed, allowing massive migration to urban areas, some elements of it still persist, preventing permanent migration for most rural workers.

Legal System

A large volume of commercial and civil laws have been passed by the National and Provincial People’s Congresses since 1978, covering many aspects of commercial operations. The legal profession is growing rapidly and foreign legal firms have been established. The central Government’s arbitration system[5] is well regarded by foreign investors (Graham and James 1996), although obtaining redress through the local courts or tribunal systems can be very difficult.

Government

The nascent rule of law is the weakest element of China’s institutional

[5] China International Economic and Trade Arbitration Commission (CIETAC).

working to improve legal framework, but still weak

structure. The Chairman of the National People's Congress, Qiao Shi, has recently observed that "the neglect of law and even overriding laws with administrative power, are relatively serious in some localities and departments" (FEER 96: 7). A number of companies doing business in China, including Australian companies, have encountered difficulties due to the under-developed legal infrastructure. Some have encountered difficulties obtaining payment; others have found their technology and intellectual property has been copied. The Chinese Government is still working to improve the transparency and effectiveness of the legal and regulatory framework for foreign investment and business activity, but there is inconsistency in the system and concern by foreigners that the system sometimes discriminates against them.

Administrative System

Performance of bureaucracy uneven

While there is marked improvement in the administrative capacity of the core central ministries, some local government administrative bodies are considerably less efficient and transparent. Many officials of such bodies retain considerable discretionary authority over economic decisions.

Accounting standards are in transition

Accounting System

China’s accounting standards also are in transition between systems used in planned and market economies. Important differences remain between Chinese and Western accounting standards and also in the treatment of Chinese enterprises and foreign-invested enterprises. These differences cover a wide variety of issues including the treatment of bad debts, inventories, long-term equity investments, plant and equipment, land, non-profit facilities, intangible assets and pensions.

CONCLUSIONS

While it is difficult to generalise about the nature of the Chinese economy due to its considerable regional and sectoral variation, China has obviously progressed a considerable distance from central planning towards a market economy.

A Market with "Chinese Characteristics"

China aims for a socialist market economy with Chinese characteristics

China has indicated that its goal is to create a "socialist market economy with Chinese characteristics". While it is unclear how these Chinese characteristics will be expressed in practice, there are indications that this model envisages a strong role for the state and continued close cooperation between the state and the business sector. Singapore and the Republic of Korea are often cited by Chinese officials as appropriate models of state intervention for China. The leadership's commitment to preserving the "socialist character" of the economy is likely to preclude privatisation of the sort experienced in some transitional economies of Eastern Europe and the Former Soviet Union, especially in key pillar industries (IMF 1993: 4). However, corporatisation is proceeding in those industries and forms of privatisation, through sales to workers of the assets of small and medium state enterprises, and joint ventures with foreign firms, are ongoing.

No single model exists for the state's role in the economy

Among those economies that rely primarily on the market mechanism to allocate resources—including the OECD economies—there is no single definitive model of the appropriate role for the state in economic management. Rather, a wide variety of selective interventions in the economy can occur. For instance, in the area of prices, many governments influence, cap, determine or otherwise control prices in the economy. In the area of international trade all economies impose some restrictions. Most economies reserve some sectors for the state, establishing regulatory barriers to entry (electricity, telecommunications, aviation, railways or postal services are common examples)[6]. Subsidies in a variety of forms are common, particularly in agriculture, but also for energy. Several OECD economies, such as France and Sweden also have a relatively large state-owned sector.

Generalising About China's Status

Market orientation varies across industries, regions and ownership forms

Given the enormous scale of China's economy—an economy of 1.2 billion people, it is not surprising that considerable variations in market-orientation occur across industrial sectors, geographic regions and ownership forms. Much of the reason for the high degree of variability in the extent of market-orientation is due to the considerable decentralisation of authority to provincial and local government. This needs to be borne in mind in any attempt to generalise about the status of the Chinese

[6] Even Hong Kong, one of the most open economies in the world, maintains some regulatory barriers to entry

economy.

Sectoral Variation
The majority of prices are market-determined and most foreign trade is undertaken by independent trading corporations and enterprises attempting to maximise returns. While the great majority of industrial sectors are now unplanned, some heavy industry sectors still have significant government involvement. While there has been rapid development of the non-state financial sector, planned reforms of the state banking system have been delayed by their obligation to finance loss-making state-owned enterprises.

Geographic Variation
Market-orientation is most advanced in the coastal regions and in the south, whereas north-east, central and western China—while also developing rapidly—lag, having for example a higher proportion of output produced by state-owned enterprises and prices subject to controls.

Ownership-Related Variations
Most of the non-state sector, which represents two thirds of industrial output is highly market-oriented, and exposed to market disciplines, including bankruptcy. Non-state enterprises have been responsible for three quarters of the growth in exports in recent years. Despite considerable efforts to change the operation of state-owned enterprises, many still continue to operate although they make losses and have been much less successful in domestic and international markets.

Decline of Central Planning

Resources are allocated primarily by the market

China has come a long way from central planning and resources are now allocated primarily by the market. However, as mentioned above, residual element of planning does operate in some sectors of the economy. Rather than intervening pervasively to allocate resources economy-wide, the Government now intervenes only selectively to achieve specific policy goals, such as macroeconomic management, energy and food security and assistance to ailing state-owned enterprises. As such, China more closely resembles many mixed economies whose governments also pursue a similar range of social and economic objectives.

Government no longer substantially monopolises

China therefore can no longer be treated as a centrally-planned economy. In particular, it can no longer be described as an economy in which the Government substantially influences domestic prices of goods or substantially monopolises trade. In each of these areas and others

into certain sectors (such as banking).

trade or prices

considered by this paper government planning and control have been largely dismantled.

Transition to Market

China is in transition between plan and market

On the basis of the five criteria of a free market in the introduction to this paper, China is an economy in transition between plan and market.

While the market mechanism now has been introduced throughout most of the economy, the complex task of establishing the necessary institutional framework to underpin and facilitate the operations of a market-based system is still in progress. However, it is clear that China's transition to a market is advancing strongly, and that this process is irreversible.

REFERENCES

Asiamoney 1996, *Currency Guide*, November.

Bach, Christian et al 1996, "China and the WTO: Tariff Offers, Exemptions, and Welfare Implications" in *Weltwirtschaftliches Archiv* Vol. 132, No. 3, 409-431.

Botellier, Pieter 1996, "China's Economic Reforms Since 1978 and the Role of the World Bank", *Background Paper for Seminars Sponsored by Austrade in Perth, Sydney, Melbourne, and Canberra*, February.

China Statistical Yearbook 1996, China Statistical Publishing House, Beijing.

China Customs Statistics, Monthly.

Dickson, Ian 1996, "China's Steel Imports: An Outline of Recent Trade Barriers", *Chinese Economy Research Unit Working Paper*, Department of Economics University of Adelaide.

East Asia Analytical Unit, 1997, *China Embraces the Market: Achievements, Challenges and Opportunities*, Department of Foreign Affairs and Trade, Canberra

Economist Intelligence Unit 1996, *Consumer Marketing in China*, Second Edition, April.

Far Eastern Economic Review (FEER) 1996 "China Rules: Liberalism with Chinese Characteristics", November 7.

Graham and James Beijing 1996, "Reform to the Legal System", consultancy to the East Asia Analytical Unit, unpublished.

International Monetary Fund (IMF) 1996a, *People's Republic of China - Recent Economic Developments*, 8 March, Internal Board Document.

International Monetary Fund (IMF) 1996b, Communication to EAAU from Mr Charles Adams, Division Chief, Central Asia Department, IMF Washington D.C., 12 December.

International Monetary Fund (IMF) 1994, *Economic Reform in China: A New Phase*, November, IMF Washington D.C., Occasional Paper 114.

International Monetary Fund (IMF) 1993, *China at the Threshold of a Market Economy*, IMF Washington D.C., September.

KPMG Peat Marwick 1993, *Investment in the People's Republic of China*, Hong Kong.

Law Annual Report of China 1995, Law Annual Report of China Press 1996.

Lu, Weigo 1995, "Reform of *China's* Foreign Trade Policy", *1995-1996 Parliamentary Research Paper No. 19*, November.

Mina, George and Wu, Harry 1996, "Internal Market Development in Transitional China", *Paper Presented to the 25th Australian Conference of Economists*, Canberra, September.

Ministry of Internal Trade, *China Price Yearbook 1995*, Beijing.

MOFTEC 1996a, Communication to Australian Department of Foreign Affairs and Trade, Letter from Department of American and Oceanic Affairs, October 24.

MOFTEC 1996b, Individual Action Plan of the People's Republic of China on Trade and Investment Facilitation in APEC, Manila, October. Prices Surveillance Authority (PSA)—Australia 1990, Annual Report 1989-90.

Naughton, Barry 1996, "China: from export promotion to an open economy?", paper delivered at *Conference on International Trade Policy and the Pacific Rim*, Sydney, July.

Naughton, Barry 1995, *Growing Out of the Plan: Chinese Economic Reform 1978-1993*, Cambridge University Press, New York.

People's Bank of China 1996, *China Financial Outlook*, China Financial Publishing House, Beijing.

Prices Surveillance Authority, 1990, *Annual Report 1989-90*, Beijing.

State Statistical Bureau, 1988-1995, *China Industrial Economic Statistical Yearbook*, China Economic Statistical Publishing House, Beijing.

State Statistical Bureau, 1996 and previous years, *China Statistical Yearbook*, China Statistical Publishing House, Beijing.

United States Trade Representative 1996, *National Trade Estimate: People's Republic of China*, Internet address http://www.ustr.gov/reports/nte/1996/china.html.

World Bank 1996a, *World Development Report: From Plan to Market*, Oxford University Press, New York.

World Bank 1996b, Communication to EAAU from Mr Richard Newfarmer, Lead Economist, China and Mongolia Department, 31 December.

World Bank 1996c, *The Chinese Economy: Fighting Inflation, Deepening Reforms*, World Bank Country Study, Washington D.C.

World Bank 1994, *Internal Market Development and Regulation*, World Bank Country Study, Washington D.C., December.

Yang, Yongzheng 1997, Communication to the EAAU, National Centre for Development Studies, Australian National University.

Zhang, Xiaoguang 1995, "Trade Reform and Resource Allocation Efficiency in China", Asian Business Centre Working Paper 1/95, Institute of Applied Economic and Social Research, University of Melbourne, Melbourne.

ALSO BY THE
EAST ASIA ANALYTICAL UNIT

Australia and North-East Asia in the 1990s: Accelerating Change

Published February 1992 (ISBN No. 0 644 24376 7), 318 pages, A$29.95

Korea to the Year 2000: Implications for Australia

Published November 1992 (ISBN No. 0 644 27819 5), 150 pages, A$19.95

Grain in China

Published December 1992 (ISBN No. 0 644 25813 6), 150 pages, A$19.95

Southern China in Transition

Published December 1992 (ISBN No. 0 644 25814 4), 150 pages, A$19.95

Australia's Business Challenge: South-East Asia in the 1990s

Published December 1992 (ISBN No. 0 644 25852 7), 380 pages, A$34.95

Changing Tack: Australian Investment in South-East Asia

Published March 1994 (ISBN No. 0 644 33075 9), 110 pages, A$19.95

ASEAN Free Trade Area: Trading Bloc or Building Block?

Published April 1994 (ISBN No. 0 644 33325 1), 180 pages, A$26.95

India's Economy at the Midnight Hour: Australia's India Strategy

Published April 1994 (ISBN No. 0 644 33328 6), 260 pages, A$34.95

Expanding Horizons: Australia and Indonesia into the 21st Century

Published June 1994 (ISBN No. 0 644 33514 9), 350 pages, A$34.95

Subsistence To Supermarket:

Food and Agricultural Transformation in South-East Asia

Published August 1994 (ISBN No. 0 644 35093 8), 376 pages, A$37.95

Overseas Chinese Business Networks in Asia

Published August 1995 (ISBN No. 0 642 22960 0), 362 pages, A$39.95

Growth Triangles of South East Asia

Published November 1995 (ISBN No. 0 642 23571 6), 136 pages, A$26.95

Iron and Steel in China and Australia

Published November 1995 (ISBN No. 0 642 24404 9), 110 pages, A$26.95

Pacific Russia: Risks and Rewards

Published April 1996 (ISBN No. 0 642 24521 5), 119 pages, A$26.95

Asia's Global Powers: China - Japan Relations in the 21st Century

Published April 1996 (ISBN No. 0 642 24525 8), 158 pages, A$26.95

China Embraces the Market Achievements, Constraints and Opportunities

Published April 1997 (ISBN No. 0 642 26952 1), 448 pages, A$39.95

A New Japan? Change in Asiaís Megamarket

Published June 1997 (ISBN No. 0 642 27131 3), 420 pages, A$39.95

The New ASEANS: Vietnam, Burma, Cambodia & Laos

Published June 1997 (ISBN No. 0 642 27148 8), 380 pages, A$39.95

Reports can be obtained from the Statistical Services Section

Department of Foreign Affairs and Trade

Fax: 61 2 6261 3321 **Tel: 61 2 6261 3114**

One John McEwen Crescent, ACT 0221 Australia.

They can also be obtained from major bookstores and Commonwealth Government Bookshops Australia-wide.
Trade enquiries, contact Gary Allen Pty Ltd. Telephone 02 9725 2933, Facsimile 02 9609 6155

Internet: http:/www.dfat.gov.au/bookshelf/
(provides access to Executive Summaries and Order form)

EAAU Working and Briefing Papers listed at the beginning of this paper

are available from above contact numbers - A$15 each