

## Reflections on Forty Years of China's Reforms

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This conference is the first of undoubtedly many that will commemorate China's 40 years of reform and opening up. In December 2018, it will have been 40 years since Deng Xiaoping kicked off China's reforms with his famous speech "Emancipate the mind, seeking truth from fact, and unite as one to face the future," which concluded that year's Central Economic Work Conference and set the stage for the 3<sup>rd</sup> Plenum of the 11<sup>th</sup> Central Committee of the Communist Party of China. The speech brilliantly used Mao Zedong's own thoughts to depart from Maoism, rejected the "Two Whatevers" of Mao's successor Hua Guofeng ("Whatever Mao said, whatever Mao did"), and triggered decades of reforms that would bring China where it is now—the second largest economy in the world, and one of the few countries in the world that will soon<sup>2</sup> have made the journey from low income country to high income country.

This 40<sup>th</sup> anniversary is a good time to reflect on China's reforms. Understanding China's reforms is of importance first and foremost for getting the historical record right, and this record is still shifting despite many volumes that have already been devoted to the topic. Understanding China's past reforms and with it the basis for China's success is also important for China's future reforms—understanding the path traveled, the circumstances under which historical decisions were made and what their effects were on the course of China's economy will inform decision makers on where to go next. Increasingly, though, this reflection on China's reforms is important for the rest of the world. Because of China's economic success, more and more countries see China as an example to emulate, a model of development that could mean moving from rags to riches within a generation.

With the 19<sup>th</sup> party congress last October, for the first time as far as I know, China now also positions itself as such an example. One excerpt from General Secretary Xi Jinping's speech particularly signifies a departure from China's past ambitions and aspiration. In discussing the success of China, and by implication the Communist Party, Xi stated:

*"It means that the path, the theory, the system, and the culture of socialism with Chinese characteristics have kept developing, blazing a new trail for other developing countries to achieve modernization. It offers a new option for other countries and nations who want to speed up their development while preserving*

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<sup>1</sup> This paper reflects the personal opinions of the author and should in no way be attributed to the World Bank, its executive board or its member countries.

<sup>2</sup> By around 2024 in our estimates, sooner, if the RMB appreciates

*their independence; and it offers Chinese wisdom and a Chinese approach to solving the problems facing mankind.”*

Ten years ago, together with one of China’s great reformers, Wu Jinglian, I put down some thoughts on China’s reforms in a background paper to the Growth Commission (see [here](#)). I think the paper has held up pretty well, and I will use some of it in this speech, though China’s reform path has been changing in the past decade (Figure 1).

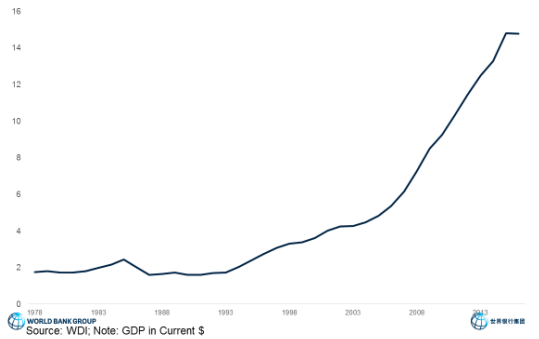
In some ways, China’s reforms followed many of the prescriptions mainstream economists would recommend. The country opened up for trade and foreign investment, gradually liberalized prices, diversified ownership, strengthened property rights, and kept inflation under control. Continued (relative) macroeconomic stability allowed high savings to be turned into high investment and rapid urbanization, which in turn triggered rapid structural transformation and productivity growth. But this is simplifying the reforms, and obfuscates the essence of China’s reforms: it was the unique way in which China went about in reforming its system that makes the country’s reform experience of interest. China’s gradual, experimental way to reform its economic system, especially in the early days, was in sharp contrast to the reforms in Eastern Europe and the Former Soviet Union. Although often compared, China and other transition countries were simply too different in terms of initial economic conditions, political development, and external environment to make comparison of much use. Similarly, comparison with much of the Latin American reforms seems out of place—the likes of Brazil, Mexico and Argentina were far closer to a market-based system than China was in 1978, and their reforms--liberalization and macroeconomic stability—were of a different order of complexity than China’s.

At the onset of reforms, China was among the poorest nations on earth and a predominantly rural, agricultural country. China had barely 25 years of history in central planning, marred by the failure of the Great Leap Forward and the political disruptions during the Great Proletarian Cultural Revolution. The country was neither integrated in the world economy nor in the Council for Mutual Economic Assistance (COMECON). Internally, in part due to Mao’s “Third Front” that required individual regions to survive economic isolation in case of a war, industry was inefficient, but also far less concentrated than in Eastern Europe and the former Soviet Union. When central planning relaxed, competition among regions and their enterprises became possible, and economic oligarchy was avoided. Perhaps most importantly, although political reforms were implemented over time, the state and the ruling party remained intact throughout the reforms, so China could focus on the economic and social transition.

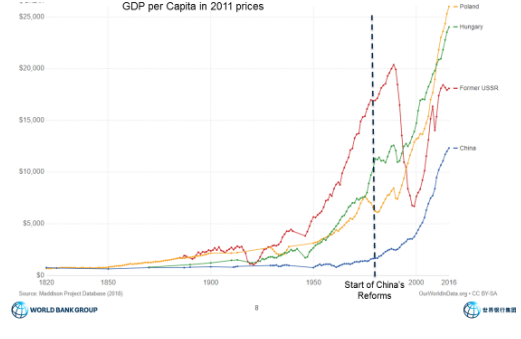
In contrast, most of the other transition countries were middle income, highly urbanized and industrialized, and had experienced more than 40 years and sometimes 70 years of collectivization and state planning. They were highly specialized in production structure

Figure 1: China's economic development 1978-2016

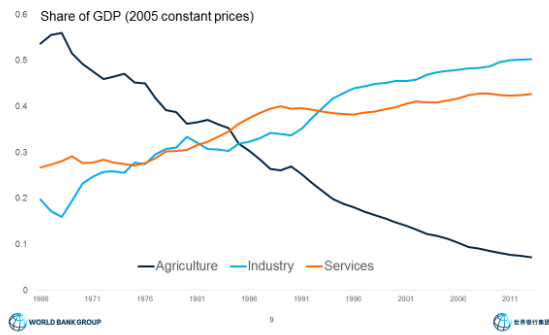
China's GDP as a share of World GDP 1978-2016



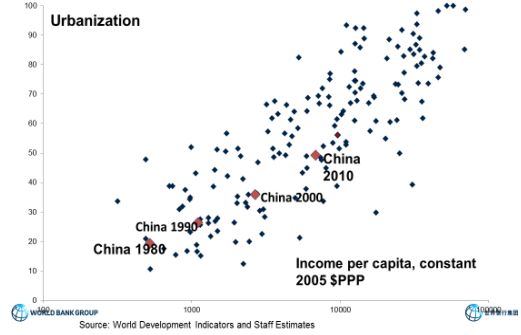
China compared with other transition countries



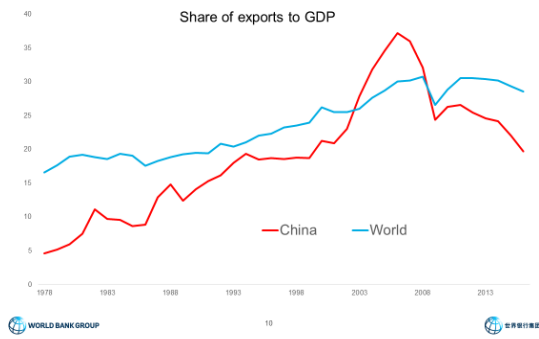
Rapid Structural Transformation



Rapid Urbanization



A great leap outward



Opening up for foreign investment

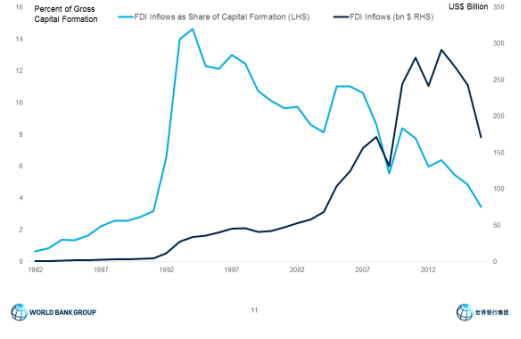
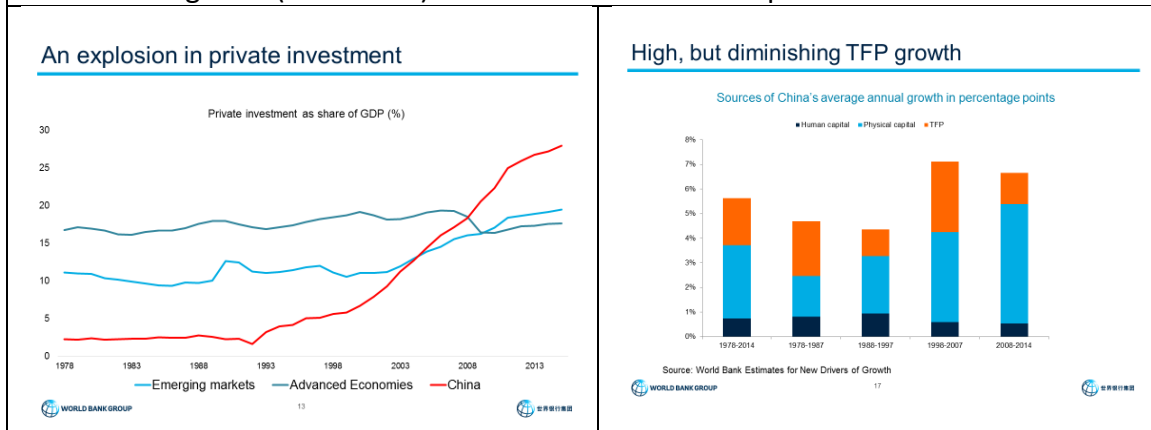


Figure 1 (Continued): China's economic development 1978-2016



and integrated in the COMECON, with heavy concentration of industry in often monopolistic enterprises. The gradual reforms initiated in the system, first in Hungary and later in the Soviet Union had met with only limited success, especially in the latter country. Reforms started under conditions of large macroeconomic imbalances and a large monetary overhang so price liberalization led to an almost immediate and disruptive jump in inflation, which eroded people's savings. But the biggest difference with China was undoubtedly the collapse of the political systems throughout much of the former Soviet Union and Eastern Europe, which made a gradual transition of the economic system, if at all feasible, virtually impossible for most. And for some, notably countries in eastern Europe, a new economic system was swiftly found in the EU, to which most of them have now acceded. This adoption of a ready-made economic system eliminated the need for a search for institutions that fit the individual country. Though perhaps less than fully suited for the middle-income transition countries, the EU framework offered stability and a clearly specified reform path. As a result, the transition recession for those that aspired to accede the EU was short, and most are now thriving high income countries.

### How did China Reform?

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

rather than comprehensively. I recall one of my first visits to Chongqing (then a municipality in Sichuan province) to study the pilot implementation of the Value Added Tax, something which World Bank staff (including yours truly) could hardly imagine being possible. But it worked and helped prepare for nationwide roll-out.

There were several reasons for this gradual approach to reforms. First, gradualism was a means to circumvent political resistance against reforms (Wu 2005). While, as mentioned, the political ideology of class struggle of the Cultural Revolution had been put to rest after Mao's death, many in the communist party retained a deep suspicion against the market, and instead trusted the "administrative" system (including the Party) more. Gewirtz (2017) provides a lively account of these ideological battles in the early days of reform and how foreign advisors (including the World Bank) played a role in this. Second, gradual, experimental reform was a pragmatic approach in a heavily distorted environment in which "first best" solutions were unlikely to apply. Experimental reforms, confined to specific regions or sectors, allowed the authorities to gather information on the effects of reforms that could not be anticipated. They were also necessary to develop and test the administrative procedures and complementary policies needed to implement the reforms. With proven success, the experiment could be expanded to other regions and sectors. Third, experimental reform may have suited the Chinese culture well as a means to avoid loss of face: if an experiment did not work, it could be abandoned as an experiment, rather than considered a policy failure. China's gradual strategy reinforced the credibility of reform over time. By making reforms one step at a time, and starting with those most likely to deliver results, the government built up its reputation for delivering on reform. With every successful reform, the likelihood that the next one would be a success as well undoubtedly increased. It also gradually built up the experience and skills for the design and implementation of reforms. Thus, by gradually reforming, China built up its "reform" capital.

***Decentralization and Incentives.*** Decentralization to local government became a powerful tool for progress within the confines of central political guidance. The provinces and local governments received increasing authority over investment approvals, fiscal resources, and policies. Provinces, municipalities and even counties were allowed, even encouraged, to experiment with reforms in specific areas, and successful experiments then became official policy and were quickly adopted throughout the country. In a way, by decentralizing, China turned the country into a laboratory for reforms. The fiscal system and the political organization within the party were key in aligning subnational government incentives with that of the center. The fiscal reforms introduced in 1980, which became known as "Eating from Separate Kitchens," formed a de facto tax contracting system, with high revenue retention rates for local governments, in particular for those local governments that were set for growth. For instance, Guangdong province only had to pay a lump sum in revenues to the central government, and could retain 100 percent of the rest. This distributed the benefits of reforms to a large part of the

population as well as to local government and party officials, who therefore had strong incentives to pursue growth and promote a market economy (Qian and Weingast 1997).

Within the party, the personnel promotion system was largely based on achieving growth. The dominant criteria for promotion were growth itself, creation of employment, attraction of Foreign Direct Investment (FDI), control of social unrest, and achievement of birth control targets. Four out of these five were closely aligned with GDP growth. Experience in the regions also counted heavily in the promotion to higher-level party posts, which provided the most talented with the incentives to gain that experience, and to demonstrate their capacity to reform and spur growth. Taken together, this environment provided a strong incentive for growth. A disadvantage was imperfect macroeconomic control and repeated bouts of inflation driven by local government loosening of investment and credit controls. Further, these conditions gave rise to local protectionism, which threatened to undermine China's unified market and competition among domestic firms. When in 1992 reforms regained momentum after the 1989-91 retrenchment, and inflation reemerged, the agenda became one of centralization of policies, with major effects on macroeconomic conditions. The fiscal and financial reforms that followed were aimed at creating the tools for macroeconomic management in a market economy.

***Pragmatism and Transitional Institutions.*** China's approach to reforms provided the room for the country's own particular institutions to emerge, which suited the country's purposes well at any given point on its reform path. The "dual track" system for growing out of the planned economy was the preeminent of all transitional institutions. It allowed a continuation of the planning system at planned prices, which avoided the collapse of production, but at the margin the system allowed a nonplanned economy to emerge. This also provided the information needed to gradually reform within-plan prices in such a way that by the time of the abolition of most material planning in the mid-1990s, plan and outside-plan prices had been largely aligned. Similarly, the de facto fiscal contracting system installed after 1980 gave strong incentives for growth to subnational governments by leaving much of the incremental revenues in the provinces. The growing control over resources by local officials provided them with the incentives to pursue the reforms and attract the investments needed to promote growth. The price, though, was a growing loss of macroeconomic control, and when inflation became the dominant concern in the early 1990s, the system was replaced by a more mainstream tax sharing system, although not without a considerable political struggle led by then-Vice Premier Zhu Rongji.

Perhaps the most successful example of a transitional institution was the Township and Village Enterprise (TVE), an enterprise form that operated outside the plan, but which was owned and to some extent managed by local governments across rural China. Born out of the Collective Production Brigades, these enterprises were highly successful in expanding production and creating employment, even though their ownership form was far from the private ownership that standard theory predicted would work best. However, as argued in Qian and Wu (2003), in an environment where private property was in many

circles frowned upon and hardly protected by law, creating an ownership form that aligned the interests of the local government with that of the enterprise was crucial for its emergence and survival. Although perhaps not the most efficient ownership form imaginable, it was a feasible one, one that was more efficient than the prevailing State Enterprises, and as such it increased the efficiency of the economy as a whole. As protection of property rights improved, the success of the TVEs started to falter, and in the last decade they have been overtaken by private and foreign-invested companies as the main source of growth and job creations. Increasingly, TVEs are being turned into private companies.

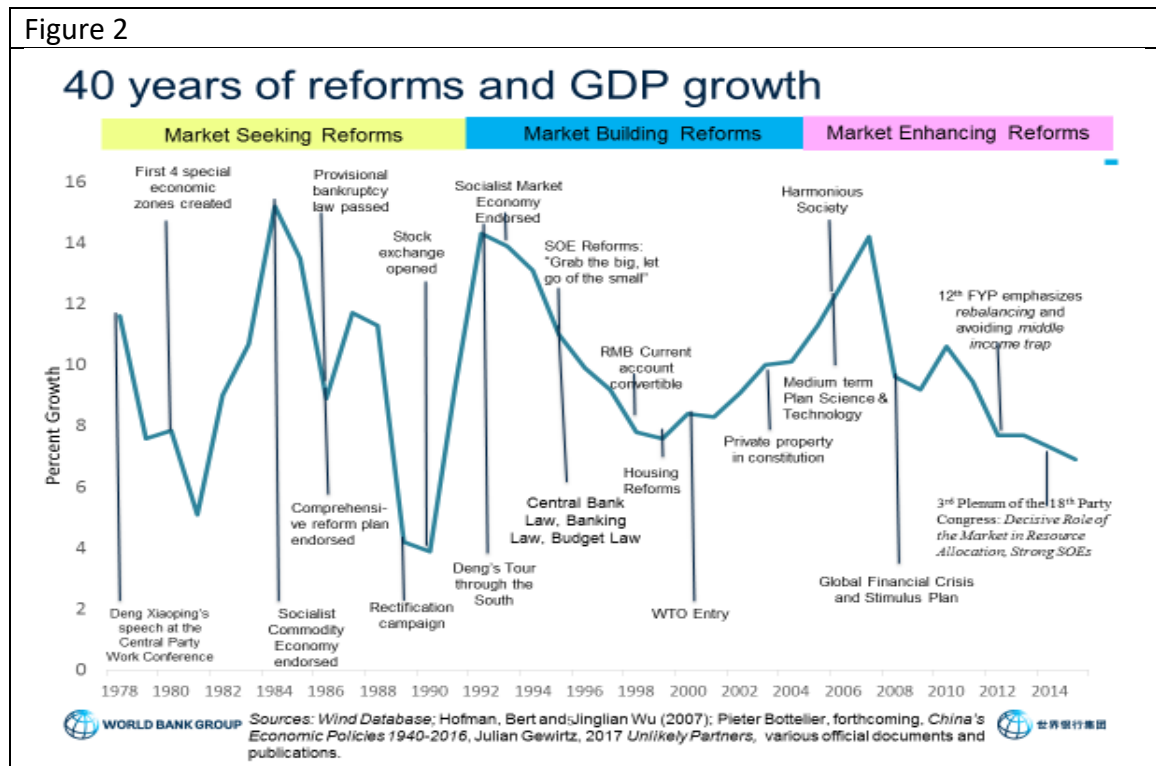
***Institutionalization of Reforms.*** Of importance to other countries that aspire to reform, in China the study and formulation of reforms and new policies was institutionalized itself. Starting with the China Academy of Social Sciences in the early days of reforms—the only place in which the study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

### **Where next?**

I think it is helpful to analytically distinguish three phases of reforms. At Fudan University, I called them: Market *Seeking* reforms, roughly from 1978 to 1993; Market *Building* reforms from 1993 to around 2003; and Market *Enhancing* reforms from about 2003 onwards.

In the first phase, there was a genuine search for the right economic institutions for China. In part driven by politics, experiments and decentralized initiative, China was searching for ways to allow more market into its system. Informed by reforms in Eastern Europe under communism, reforms concentrated largely on microeconomics, to some extent with a neglect of macroeconomics, and the highly volatile growth rate in the 1980s bears witness to that. After the retrenchment, Deng Xiaoping’s tour through the south makes clear that market reforms were there to stay.

The *Decisions* of the 3<sup>rd</sup> Plenum of the 14<sup>th</sup> Party Congress in 1993 triggered the second phase by laying out a comprehensive plan to build the institutions for a market-driven economy—including a modern tax system, enterprise reforms, and a financial system that separated policy banks from commercial banking. The start of serious SOE reforms in the mid-1990s allowed those commercial banks to indeed become commercial, and housing and (urban) social security reforms followed. Entry in the WTO not only served as a lever for those domestic reforms, but also ensured much greater competition on the goods market. The slashing of import tariffs made China far more competitive in exports, as well as a viable platform for final assembly for much of the Asia-based exports hitherto produced elsewhere.



In my view, the inclusion of private property in the constitutions concluded the market building phase. This phase—the Zhu Rongji years if you like—can be seen as years in which the state retrenched and left increasing room for the market. Perhaps the best indicator for this was the explosion of private investment in the economy, which increased its share in the economy from less than 2 percent in 1992 to some 15 percent by 2003 (granted, some of this was due to a reclassification of collective enterprises as private). In 1999, government also consolidated all the industry-related ministries into the Ministry of Commerce and the Ministry of Industry and Information Technology.

Since then, reforms have focused on what I would call *enhancing* the market. The two main ingredients of this are a gradual expansion (or, if you want rebuilding) of the social



safety net (pensions, health care, welfare), notably after the *Harmonious Society* became the goal of State Policy after 2006. Second, we have seen a return of Industrial policy as noted by Ling and Naughton (2016). As Ling and Naughton argued, “techno-industrial policy” never left, but had been on the defense after 1978, only to re-emerge after Zhu Rongji left office. Perhaps to signify a new phase, the Systems Reform Commission was merged with the State Development Planning Commission in 2003, to form the National Development and Reform Commission. With the publication of the Medium-Term Strategy for Science and Technology and initiation of the 16 Megaprojects (both 2006), industrial policy returned to the forefront. This has since then been amplified with the 5<sup>th</sup> plenum of the 14<sup>th</sup> Party Congress (on productivity and innovation), the 13<sup>th</sup> Five Year Plan and the Manufacturing 2025 Strategy (2015). This return of industrial policy in the economy was supercharged by the global financial crisis, which China countered with a large domestic stimulus, and which gave ample resources for central and local government to pursue those policies. State banks and SOEs were called to task to serve as instruments to implement this policy. Though the 3<sup>rd</sup> Plenum of the 18<sup>th</sup> Party Congress in 2014 assured that the market should play a “decisive role” in the allocation of production factors, it also pledges adherence to the “basic economic system” with public ownership playing a dominant role in the economy.

The 19<sup>th</sup> Party Congress and General Secretary Xi Jinping’s report confirms these policy directions: market-based allocation, a dominant role for public ownership, and a strong emphasis on industrial policies and science and technology to achieve the goals of the “first phase of the New Era (2020-2035)” namely socialist modernization. Interestingly, “Socialist Modernization” was also what Deng Xiaoping envisioned when he set out for reforms in 1978—and he saw the “Four Modernizations” (of industry, agriculture, national defense and science and technology), which go back to Zhou Enlai, who formulated these first in 1963. With the New Era, China seems to have found its distinct own economic system, with markets and state ownership living side by side, and with industrial policies guiding the market. No doubt did the global financial crisis contribute to the idea that a western model of market economy was not the panacea for China’s economic development. China’s current economic system has its own complexities and issues—both internal to China and in the international arena. It also is too early to tell whether this system will best serve China in achieving its 2 centennial goals, and how the balance between state and market will shape up in the years to come. Irrespective, those who believed that by “crossing the river” China would reach a familiar river bank on the other side—a market economy not that different from the many varieties found in OECD countries—would need to think again.

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**Annex 1: 40 Major Reform Steps in China 1978-2017**

<i>Year</i>	<i>Reform Step</i>
1978	Deng Xiaoping's speech at the Central Party Work Conference " <i>Emancipate the Mind, Seek Truth from Facts and Unite as One in Looking to the Future</i> "
1978	<i>Communiqué</i> " of the third central party Committee (CPC) plenum of the 11 <sup>th</sup> party congress confirming "four modernizations" as the major goal for reforms
1979	"Open door" policy initiated, foreign trade and investment reforms begin. Law on Joint Venture Companies passed.
1979	Limited official encouragement of household responsibility system, informally initiated in 1976
1979	Three specialized banks separated from the People's Bank (the central bank).
1980	First 4 special economic zones created
1980	"Eating from Separate Kitchens" reforms in intergovernmental fiscal relations
1984	Socialist Commodity Economy endorsed at the 3 <sup>rd</sup> Plenum of the 12 <sup>th</sup> Party Congress
1984	Individual enterprises with less than 8 employees officially allowed
1984	Tax for Profit reforms of SOEs
1986	Provisional bankruptcy law passed for SOEs
1986	CPC approved a <i>comprehensive</i> "Economic System Reform Implementation Plan"
1987	Contract responsibility system introduced in SOEs
1989	Retrenchment policy, halt on reforms
1990	Stock exchange started in Shenzhen, Shanghai
1992	Deng Xiaoping's "Tour through the South" reignites reforms
1993	16 point program introduced to fight inflation
1993	Decision of the third plenum of the 14 <sup>th</sup> party congress to establish a "socialist market economy" paving way for fiscal, financial, SOE reforms
1994	RMB convertible for current account transactions announced
1994	Tax Sharing System Reforms introduced,
1994	Policy banks established, commercialization of banking system announced
1995	Central Bank Law, Banking Law, Budget Law enacted
1995	5 <sup>th</sup> Plenum of the 13 <sup>th</sup> Party Congress confirms SOEs reform plans to "grab the big, let go of the small"
1996	China in compliance with IMF Article VIII (current account convertibility).
1999	Urban housing reforms initiated. Practically all of the housing stock privatized.
1999	Government reforms consolidate industry-related ministries and institutes.
2001	China's accession to WTO
2001	10 <sup>th</sup> Five year plan emphasizes efficiency, structural change, industrial upgrading
2003	State Commission for the Restructuring of the Economic System merged with SPC to create NDRC.
2003	3 <sup>rd</sup> CPC plenum of the 16 <sup>th</sup> party congress, decision to "perfect" the socialist market economy
2004	Constitution amended to guarantee private property rights
2005	Construction Bank, Bank of China Initial Public Offerings
2006	6 <sup>th</sup> CPC plenum of the 16 <sup>th</sup> party congress establishes the goal of "Harmonious Society"
2006	Medium Term Plan for Science and Technology approved
2008	Stimulus program launched in reaction to the bankruptcy of Lehman brothers, Global Financial Crisis
2013	12 <sup>th</sup> Five Year Plan launched, emphasizing <i>rebalancing</i> and avoiding <i>middle income trap</i>
2014	3 <sup>rd</sup> Plenum of the 18 <sup>th</sup> Party Congress decides on <i>Decisive Role of the Market in Resource Allocation, Adherence to the "Basic Economic System (Dominance of SOEs)</i>
2015	4 <sup>th</sup> Plenum of the 18 <sup>th</sup> Party Congress decides on Rule of Law with Chinese characteristics
2016	13 <sup>th</sup> Five Year Plan Launched emphasizing innovation and productivity as drivers of growth
2017	19 <sup>th</sup> Party Congress defines "New Era" and China's new long term goals for Modernization

*Sources:* Hofman, Bert and Jinglian Wu (2007); Pieter Bottelier, forthcoming, *China's Economic Policies 1940-2016*, Jonathan Gewirtz, 2017 *Unlikely Partners*, Government of China official documents and publications.