

## Sustainability of Economic Growth in China

### Contribution to Shaping Factors in East Asia in the Year 2000 and Beyond

Geng Xiao  
School of Economics and Finance  
University of Hong Kong

In order to make clear assessment of the economic future for China, the following questions may need to be examined further:

- What are the major sources of rapid economic growth in China since 1978?
- What are the major barriers to future sustainable economic growth in China?
- What are the alternative economic reform policies open to the government?

Chinese official statistics show clearly that the rise of the non-state enterprises, including mainly the rural township and village enterprises and foreign invested enterprises, has contributed decisively to recent rapid economic growth in China. But, the statistics also show that the state-owned enterprises also experienced respectable growth at least in gross output if not in profit remittances to the government (see Singh, Ratha and Xiao 1994; Xiao and Gao 1994; Xiao 1991b). The growth of virtually all sectors in China, the shift towards producing labor-intensive products, and the surge in imports and exports and foreign direct investment have shown convincingly that the economic growth since 1978 is realized by taking China's comparative advantage in its abundant supply of labor (see Lardy 1994). The open-door policy and the decentralization of economic decision-making to the enterprises and farm households through various responsibility contracts are the new institutions which have facilitated the commercialization of the economy and the realization of its comparative advantage. The potential for sustained economic growth in the future lies in the fact that China's huge comparative advantage in labor relative to the West is likely to remain for next fifty years or longer and the current microeconomic institutions based on open-door policy and decentralized decision-making are not likely to be changed significantly by current or future leaders. Hence, at the micro level, market forces or the "invisible hand" seem able to lead China towards a sustained economic growth.

According to the "invisible hand" theory, many "problems" appeared after recent reform are rational responses guided by the markets.

- The migration from rural to urban areas clearly is consistent with the basic economics of comparative advantage. The “unemployed” farmers in the cities are simply looking actively for employment without asking the help of the government.
- The fluctuation in farm prices and supply, which are common even in market economies such as in the U.S. in the first half of this century, also show the working of incentives and markets in the agriculture production and distributions. Also, it seems economically wasteful for the Chinese farmers to worry about China’s self-sufficiency in grain supply instead of China’s industrialization. It would be better for the Chinese farmers to produce tractors for the American or Australian farmers in exchange for grain (which can then be used to fulfill the contracted quota set between the Chinese farmers and the Chinese government).
- The work unit (danwei) social security system, although reducing the profit remittance of the enterprises to the government, show how the enterprises are providing the services when both the government and the markets have failed to provide a better and cheaper alternative (see Xiao 1991a and Xiao 1995). The rural township and village enterprises have been playing the similar roles as the state-owned enterprises in providing rural community services.
- The bottlenecks in transportation, communication, and energy are the driving forces for the recent surge of foreign investment in these sectors. The recent sharp increase in freeway and air links between major Chinese cities and in the paging and mobile phones services show how the supply and demand forces can eliminate bottlenecks.
- The regional gaps in growth, productivity and income across China simply show the impact of introducing market institutions on the regional economic performance and welfare. The west and inland regions have been learning from the successful policies of coastal regions although they are asking for help from the central at the same time (see Xiao 1994a). The open door policy is bringing foreign investment into the coastal as well as the inland regions now.
- Even the widely spread corruption, which has serious macro economic consequences as will be discussed shortly, seems to have helped the flow of resources towards the highest bidders in the markets. Without it, how the non-state sector can access the capital that has been crucial for its rapid growth? (see Xiao 1994b)

In summary, the micro “problems” discussed above seem to signal a normal working of the growth engine or the “invisible hand” of the economy. However, the summation of these micro “problems” does present major macroeconomic crisis that may hinder sustained economic growth in China.

The macroeconomic imbalances, such as inflation, the potential national debt crisis, convertibility of RMB, and the unemployment, have become one of the major factors for political, social and economic instability since 1978. The government has not yet been able to make fundamental progress in macroeconomic management mainly because of the constraints at the micro level: the insistence by the authorities on the state ownership of large urban enterprises and on the collective ownership of farm land and rural enterprises. The widely spread public ownership of means of production discourages private enterprises and encourages rent-seeking activities at every corner of the economy (Sheng and Xiao 1995).

The rent-seeking behavior does not necessarily create major allocative inefficiency at the micro level since the parties involved have incentives to make the distribution or redistribution of economic rent at the lowest costs possible (Xiao 1995). Individuals and enterprises have to spend time and resources to lobby for loans and investment from the state banks and state economic administrations but they would minimize the lobbying costs. However, the macroeconomic consequences of the rent-seeking is serious and will lead to the asset-liability imbalances for the state sector of the economy.

The assets of the state are dissipated due to the rent-seeking. The rising social services to employees at the state-owned enterprises, the luxury life-styles of some managers at the rural enterprises, and the profits from speculation at the securities and real estate markets are consumed but not wasted. The benefits in the above cases are simply "privatized" while the costs are charged to the publicly owned enterprises, shrinking the net market value of the publicly owned assets.

On the other hand, the government has to commit more and more hard liabilities resulting from the transition from a centrally plan system to a market economy. Pensions to retirees of the state-owned enterprises have to be paid. In the state banking sector, bad loans imply losses of the state assets while rising household savings deposits are hard state liabilities. The market economy also needs strong tax collection agencies, costly legal and regulatory institutions, extra police and civil services, basic social safety net, and extensive infrastructures. All of them are hard liabilities of the government (see Sheng and Xiao 1995).

The imbalance in the assets and liabilities of the state sector is hidden under the balance sheets before it is revealed by price reforms, privatization or bankruptcy of loss-making enterprises. When the liabilities are exposed, they need immediate financing. The government can print money or borrow to pay the liabilities but it would lead to inflation or rapid rise in domestic and external debts. Temporary measures such as an austerity program may reduce inflation by keeping the liabilities unpaid for a while. The fundamental problem of asset-liability imbalance can only be solved by increasing

the net value of the state asset, net of the liabilities. The challenges to the Chinese government are:

- How to control the losses of net state assets due to rent-seeking activities?
- How to increase the net value of the currently owned state asset?
- How to capture the capital gains and use it to pay the liabilities the government already committed or has to commit in the future?

An optimistic scenario is that the government would diversify its ownership of state-owned assets by partially privatizing the individual state-owned enterprises so that most of them would become joint-ventures with non-major (less than 50% or better less than 30%) ownership by the state and also delegate management to the private investors. Since few enterprises would then have more than 50% shares owned by the state, the traditional state-owned enterprises will no longer exist. A level playing field for all enterprises could then be built by allowing the market to determine interest rates and allocation of capital. The rent-seeking activities would then be eliminated when the public ownership is no longer dominating. The government then can free-ride the effort of the private investors in the management and control of the state-owned assets. The increase in productivity of the privatized enterprises would generate capital gains to pay past liabilities of the state so that to close the asset-liability gap once and for all (see Xiao 1994c).

A pessimistic scenario is that the government would gamble on the state owned enterprises to generate revenues for paying mounting liabilities. It can mobilize the expensive private household savings and inject them into a few thousand large state-owned enterprises. This would not only drive other non-priority enterprises out of the formal capital markets but also create rent-seeking opportunities for informal diversion of capital from priority to non-priority enterprises. When the state-owned enterprises fail to deliver the needed revenues to the government, the asset-liability gap of the state would widen and generate inflation and debt crisis and potential political, social and economic instabilities.

In the near future, the pessimistic scenario is likely since the inflation of 15% to 25%, the domestic and external debt of about 20% to 25% of GDP, and urban unemployment rate of 2% to 5% are not really threatening to political, social and economic stability in China. The economic potentials as well as people's living standards in China have never been as good as they are now since 1949. It simply does not pay to current leaderships to risk a fundamental reform of the Chinese economic system. However, as the inflation or unemployment problems deteriorate into potential crisis in the near future, the leaderships and the society would have to make decisions on the fundamental reform of the Chinese economy, gradually or radically.

## References

- Lardy, Nicholas R. (1994), *China in the World Economy*, Washington, D.C.: Institute for International Economics, 1994.
- Sheng, Andrew and Xiao, Geng (1995), "Property Rights and Economic Transition Revisited: The Case of China," manuscript, June 10, 1995, the Hong Kong Monetary Authority and the University of Hong Kong.
- Singh, Inderjit; Ratha, Dilip and Xiao, Geng (1994), "Non-State Enterprises as an Engine of Growth: An Analysis of Provincial Industrial Growth in Post-Reform China," manuscript, February 16, 1994, the World Bank and the University of Hong Kong.
- Xiao, Geng (1991a), "Managerial Autonomy, Fringe Benefits, and Ownership Structure," *China Economic Review*, Volume 2, Number 1, Page 47-73, Spring 1991.
- (1991b), "State Enterprises in China: Dealing with Loss-Makers," *Transition*, the World Bank, Volume 2, Number 11, Page 1-3, December 1991.
- (1994a), "Central-Local Relations from the Perspective of State and Non-State Industries," in *Reforms and the State Capacity: Changing Central-Local Relations in China*, edited by Jia Hao and Lin Zhimin, Oxford: Westview Press, page 135-152, 1994.
- (1994b), "Financial Reform in China: Evolution, Theory, and Policy," *International Financial Market in the North-East Asia: Assessment and Prospect*, edited by Sang-Woo Nam and Hak Kil Pyo, Seoul: Korea Development Institute and Seoul National University, 1994, page 129-156.
- (1994c), "Privatization or Inflation," *Asian Wall Street Journal*, November 15, 1994.
- (1995), "The Nature of the State-Owned Enterprises and their Reform: The Case of China's Industrial Contract Responsibility System," manuscript, August 9, 1995, the University of Hong Kong.
- Xiao, Geng and Gao, Haiyan (1994), "The Engine of Growth and the Root of Inflation for the Chinese Economy," *China Review 1994*, Chapter 9, Hong Kong: The Chinese University Press, 1994.

\*This note is drawn primarily from Sheng and Xiao 1995 and Xiao 1995. August 21, 1995, Hong Kong