CHINESE ECONOMIC REFORMS AND THEIR RELEVANCE TO INDIA*

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INTRODUCTION

China's stellar achievements in the economic field since it launched its reforms in 1978 have rightly evoked admiration around the world and ensured for it a unique position as a major world power today. Every visitor to China can see for himself the achievements over the last two decades in which China has lifted millions of men, women and children out of poverty, transformed their quality of life (the difference made to the *quality* of life for the masses can be gauged from the fact that **services available to the common man** - entertainment facilities, dineries, amusement parks for children, and tourist/ leisure spots are found all over China today, without compromising China's unique cultural ethos and heritage), and modernised its urban infrastructure on a scale and time-frame not attempted before.

The visual impact of the transformation is such that visitors have difficulty believing China is still a developing country. China has in fact to make strenuous efforts to convince its western partners in WTO negotiations to accord it developing country status. It argues that with 55-65 million people still below the poverty line, it continues to qualify as a developing country. However, the magnitude of the Chinese achievement can be gauged from some simple facts:

- Since introduction of economic reforms in 1978 GDP has grown at an average annual rate of **9%.** In the Eighth Five Year Plan (1991-95) growth averaged **12%.**
- Real GDP in 1995 was 4 times its 1978 level and real per capita GDP increased 250% between 1978 and 1994, or 6% a year despite a continuously increasing population. In 1949 - total value of industry and agriculture was RMB 46.6 billion. Per capita GNP increased from RMB 66 in 1949, RMB 379 in 1978 to RMB 4754 in 1995.
- Average annual growth rates for agriculture, industry and the service sector were much higher in the reforms period (1978-94) - as compared to the average rates in the period before the launching of reforms (1952-1977), thus changing the relative shares of the different sectors in the economy. During 1977-95, **agriculture's** share of GDP **declined** from 42% to 19%; **industry**'s share **rose** from 37% to 53%; the service sector from 21% to 29%.

Annual Rates of Growth	**1978-94**	**1952-77**
GDP	**9.25%**	**5.70%**
1. Agriculture	**5.23%**	**1.77%**
2. Industry	**11.68%**	**10.81%**
3. Services	**8.17%**	**4.45%**
International trade	**16.50%**	**n.a.**
Consumption	**7.40%**	**2.20%**

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Year	1992	1993	1994	1995	1996	1997
Rate of GDP growth	13.2%	13.4%	11.8%	10.2%	9.7%	8.8%

- **Reforms led to greater open-ness and liberalisation**: the share of the **non-state sector** today is over two-thirds of industrial output, while that of the state has declined from 78% in 1978 to 34% in 1994. Annual FDI inflows have crossed US$ 40 billion, contributing to greater openness in society in general.

- During 1978-94, international trade grew at an average annual rate of 16.5%, making China one of the top trading powers in the world and increasing its share of world trade to over 4%.

FOREIGN TRADE in US $ billion:

Year	1952	1978	1997
Foreign trade	**1.90**	**20.64**	**325.00**
Exports		**9.75**	**183.00**
Imports		**10.89**	**142.00**

- Foreign exchange reserves increased to US$ 140 billion at the end of 1997, thus confirming China's status as the world's second largest hard currency holder after Japan. FDI inflows reached US$ 43 billion.

- **All this had an enormous impact on poverty:** In human resources development and living standards, China achieved great improvements in over-all literacy particularly female education, nutritional standards and life expectancy. **Life expectancy in 1991 was 69 years compared to 55-57 years for low income developing countries**. According to China's State Statistical Bureau (SSB), the average annual growth rate of consumption was 7.4% in 1978-1994, more than three times the rate in 1952-77 of 2.2%. During the period 1978-94, per capita annual consumption of major foodstuffs including poultry, meat and eggs increased several times over its pre-reform levels. According to the Ministry of Health, the present average nutritional level in China has reached the level of middle-income countries.

- While the main consumer durables in the 1970s were watches, bicycles and sewing machines, main items in the '80s were TV sets, refrigerators and washing machines, and in the '90s - air conditioners, telephones, video recorders and video cameras.

Deng Xiaoping's contribution to the above achievements, is inestimable. It was not only the policies adopted under his direction, but the revolutionary philosophy at its core which transformed the ethos of the country. Briefly, he held that the ideological label of an economic policy was not important. The essential criterion of its worth was whether that policy promoted national wealth and productivity. *The colour of the cat was not important as long as it caught mice*. One of Deng's targets was *leftism*, pointing out that it had wreaked havoc on the economy and people's lives. He indicated that it was simplistic to equate market mechanisms with capitalist economics only and argued that both socialist and market economies had room for planning and the market. He also rejected the orthodoxy that the open-door policy was in contradiction to the principle of self-reliance. These injunctions were rapidly assimilated and transformed by farmers, workers and provincial leaders into actual results. The rapid increase in growth rates was in no small measure attributable to the change in mental attitudes initiated by Deng.

The Chinese model: Gradualism vs. Shock Therapy

In comparison with the East European models of reform, the Chinese are said to have adopted the gradualist as against the shock therapy approach in the transition from socialism to a market oriented economy. Deng Xiaoping set the tone with his apt description of crossing the river by groping for the stones underfoot. Deng's own experience as an apprentice in France unlike most of his colleagues who had studied in the Soviet Union, as well as his efforts to rein in the ultra-leftists under Mao, may have pre-disposed him towards a pragmatic approach.

China's reform process is therefore characterized by both experimentation and consolidation. In other words until a theory was tried and tested on the ground it was not generalized and applied to the entire economy. Dynamic change was accommodated without the existing structure being directly challenged. But this had its down-side as it implied that several characteristics of the earlier institutional arrangements were left intact. The attempt to cope with the new economic forces within the strait-jacket of the pre-reform institutional framework have created their own contradictions, as we shall see.

There are thus many who see in the 'gradualist approach' the seeds of the current dilemmas facing the leadership and of the controversies over the development model adopted by the Chinese. It is a fact that the rapid growth so far experienced in China has not solved all its problems. When discussing the Chinese economy, one could well apply to it the famous comment on India, that whatever statement you may make about India, almost exactly the opposite is also true. On the one hand, there has been obvious and significant development since the launch of China's economic reforms which led to a quadrupling of its national income between 1978 and 1995. On the other hand, it can be stated that some serious fault-lines have appeared in the quest for growth. Nevertheless the material well-being and welfare of the vast majority of China's population has been improved in the process. In view of the vast stocks of infrastructure, industrial assets, FDI and currency reserves which have been built up in the course of the reforms, China has the capacity to successfully solve its problems.

We have the privilege and opportunity to study a life-size model of development in our neighbourhood and draw parallels and lessons on various issues. Such a colossal experiment needs to be understood for anyone desiring similar levels of growth and prosperity in India. The purpose of the overview is therefore to understand the processes which have contributed to China's dynamism, and distinguish these from those which have held back its growth, in order to derive some conclusions for us in India.

PART I: PRE-REFORM SITUATION - 1949-78

The situation today is in stark contrast to that prevailing in 1949 when China emerged from decades of war and civil strife with a shattered economy at a very low level of development. Around 90% of the population lived in rural areas and industry accounted only for 12.6% of national income. The leaders of the People's Republic of China chose to develop heavy industry, influenced by the successes of the Soviet model and the prevailing intellectual wisdom which favored a heavy industry development strategy to ensure self-reliance. External pressure - the Korean War, the situation in Taiwan, and the hostility the young state encountered was an additional reason for choosing the heavy industry strategy.

In this China was not alone. Several developing countries, including ours, were to make a similar choice.

The Communist Party of China proclaimed the goal of rapid industrialization and establishment of a socialist economy. Given the economic structure at the time and China's resource endowment (capital scarcity, a scattered agricultural surplus, low levels of foreign exchange, low technological levels and weak industrial and export base) development of a heavy industrial complex required that market forces be suppressed, since without direction resources would spontaneously flow only into areas in which the economy enjoyed a natural comparative advantage.

China's leadership chose central planning, through which resources could be mobilised administratively to enable speedy industrialisation. The major part of the resources was allocated to heavy industry, ignoring China's comparative advantages in the labour intensive sectors of light industry and agriculture. Estimates are that anything upto 80% of investment was directed to heavy industry between 1953-85. Private farms were fully collectivized by 1958 to be replaced by state procurement and distribution according to centrally fixed targets. All private firms were also nationalised by the end of 1957. Foreign investment was prohibited and the private sector phased out of existence. The Government set production targets and allocated raw materials and inputs to each sector according to a national plan. Revenues of State-owned Enterprises (SOEs) were surrendered to the government and funds for expenditure allocated to them. Banks were nationalised and became an extension of the State budget. Interest rates were fixed at a very low level. Consumer goods sectors were neglected while the heavy and military industries received priority. Labour markets were replaced by a centrally planned job allocation system, while allotments of food supply, housing, education and health care were made through a strict household registration system. This enabled control of migration between urban and rural areas, essentially locking the rural population out of urban employment opportunities and the social security system available to urban workers.

International trade was monopolised by 12 national Foreign Trade Corporations (FTCs). Other trade was not permitted. An overvalued exchange rate was maintained in order to artificially depress the cost of imported capital equipment which was primarily for the heavy industrial sector. From an exchange rate in 1950 of RMB 4.2 to the US Dollar, it rose to RMB 1.72 in 1978. Thereafter the rate began to fall as dual exchange rates came into existence following the reforms, until their unification in 1994 at the rate of RMB 8.6 to the Dollar. Foreign exchange was surrendered at the official exchange rate. However, these measures penalised exports. By 1978, the total value of foreign trade was only 10% of GDP, little above its 1949 level. Foreign investment was prohibited. China became an inward looking economy with low rates of growth throughout this period.

Evaluation

During this period, the rate of growth of the economy was increased and a comprehensive industrial sector was established. By 1978, the share of industry in national income had increased from 12.6% to 46.8% while that of agriculture had fallen from 68.4% to 35.4%. These achievements however masked serious failures.

Since planning and administrative controls replaced the market mechanism for allocation of resources now entirely owned by the State, enterprises lost not only their autonomy but also any incentives for better performance. Central planning in China resulted in overstaffing, overstocking of inventory, low worker productivity and low technological

innovation. This ensured a negative growth of total factor productivity in this period and declining international competitiveness.

A combination of low interest rates, low input prices, low wages and an overvalued exchange rate meant that heavy industry obtained its inputs at relatively low cost. In terms of welfare levels however, chronic food and other shortages and poor quality of consumer goods were a fact of life. Living standards throughout this period improved very slowly.

Outwardly, elements of a socialist welfare state with low prices for food, essential consumer goods, housing, medical care, education, and fuel for domestic use mandated by a benevolent State seemed to have been established. In fact, the wage rate of urban workers was suppressed to ensure maximum returns from the enterprise to the State budget. Also, the social security net available to urban workers did not extend to rural areas, and migration of labour from rural to urban areas was strictly controlled by the household registration system. Hence there was little multiplier effect in the rural areas where productivity continued to remain at primitive levels as state investment was directed to heavy industry.

Added to this suppression of living standards were the U-turns in policy embodied in the Great Leap Forward launched in 1958, and the Cultural Revolution, both of which had disastrous effects on the economy. During the Great Leap Forward, the forced withdrawal from agricultural activities of China's farmers in order to produce steel in backyard furnaces, led to severe famine and economic ruin. Without waiting for agriculture to fully recover, Mao launched the Cultural Revolution, which caused further set-backs. The Great Leap Forward, which carried the emphasis on development of heavy industry, in this case specifically steel production, to an extreme, was a tragic real-life demonstration of the Law of Diminishing Returns, which implies that concentrating resources in only one sector can lead only to economic disaster.

Theory suggests that returns on investment diminish when resources are deployed to a single sector beyond an optimal level, so that first the rate of growth and then production itself declines. An economy which could have produced at a higher level if it had optimally used its resources, was instead reduced to a much lower Production Possibility Frontier as resources were diverted with ever diminishing returns into areas where the economy enjoyed low comparative advantage. The net loss of not exploiting China's comparative advantage in the light industrial and agricultural sectors has not been quantified to my knowledge. But some measure of their opportunity cost can be gauged from the rapid growth rates unleashed with the onset of reforms.[1]

<u>PART II: REFORMS: THE FIRST PHASE</u>

In 1978, recognizing the need for radical economic transformation, Deng Xiaoping launched reforms in economic policy. There is so far consensus that Deng did not follow any pre-determined blueprint, but rather felt his way forward. However his goals were clear - to improve the state of the economy with pragmatism as the new slogan. The revolution he effected was in people's attitudes, *with wealth generation no longer treated as a pariah activity*. It is not precisely known who coined the *"To get Rich is Glorious*" slogan but it is popularly attributed to him. The importance of the change in mental attitudes which

[1] In India's case Dr. Rakesh Mohan has estimated in his essay "Industrial Policy and Controls" that per capita levels could have reached US$500 - 550 instead of the then current US$300, if the right industrial policy mix had been followed.

followed cannot be overestimated. The *Economist* commented that "no matter where you go in China today, the most emphatic sensation you get is the intensity of the desire to modernise and grow. Governors, party secretaries, party representatives on boards of directors: their only interest seems to be foreign investment, trade and economic reform."

Reforms in agriculture started and underpinned the whole reform process. The economy was opened up to foreign trade and investment, and industrial sector reform began with the introduction of various incentives for production. Prof. Justin Yifu Lin describes in fascinating detail how the micro changes led to the need for progressive relaxation of the system of centralised controls, as reforms seeped vertically up and horizontally.

AGRICULTURE

The reforms which began in 1978 were simple: incentives were introduced in the agricultural and industrial sectors in order to stimulate individual effort and therefore production. Agricultural reforms were spontaneous, with the Government approving the household responsibility system after it was adopted by farmers. Peasants were assigned a lease over a plot of land (gradually increased from 3 to 15, and then a 30 year period). The farmer could now retain a surplus for sale on the market over and above the state purchase quota. By the end of 1983 almost all collectives had adopted the new system, which led to improved crop productivity and diversification into high value items, eliminating China's chronic food shortages. Per capita consumption of meat, eggs, poultry and other high value items increased and life expectancy improved dramatically to 69 years in 1991. Production of cotton and oilseeds increased by 17-19% per year between 1978 and 1984. Grain production increased over three times from 1950s levels, with the largest increase registered by corn, cotton increased nearly 5 times, while growth in some other items was even greater.

TOWNSHIP AND VILLAGE ENTERPRISES (TVES)

Growth created a huge rural market for consumer goods, which led to the proliferation of township and village enterprises. TVEs absorbed increasing numbers of rural labour and accounted for 38% of China's industrial output by 1993. During 1981-91 output of TVEs grew by 29.6% annually, 3 times the rate achieved by state firms. According to the State Statistical Year Book of PRC, employment by TVEs at 28.2 million in 1978 had risen to 106.25 million in 1992 and 135 million in 1996. TVEs are owned by urban and rural collectives, and are not considered a formal part of the State sector. They thus enjoyed relative autonomy from the beginning. At the same time, they lacked priority access to credit and social security provided to SOE employees. Since they had to compete to survive in the tough market conditions in China, their utilisation of resources was more efficient. Studies have shown the total factor productivity (TFP) in this sector have been higher than in any other sector.

The private sector also received a boost and growth rates averaged higher than in the state sector, with successive party plenums recognising co-existence of different forms of ownership.

STATE OWNED ENTERPRISES (SOES)

The inconsistency between the rigid macro economic policy and liberalised situation on the ground gradually pushed the government towards more reforms. SOEs were forced to face an entirely new scenario. In SOEs there was gradual delegation of authority and increase in autonomy. Increasing competition from TVEs forced the State sector to adapt to,

and adopt some of the elements of a market economy. The State formally approved dual pricing in 1984 to permit SOEs to sell their above quota production at market rates. Not surprisingly market pricing became the dominant norm soon. Eventually the contract responsibility system which permitted profit retention and performance related bonuses combined with the permission to produce outside the mandatory State plan - led to a marked increase in productivity and expansion in production. Foreign trade enterprises were also permitted to retain part of their foreign exchange earnings for their own use, and an informal and legally permissible foreign exchange market called the swap centres evolved.

OPENING THE ECONOMY TO FOREIGN TRADE

The FTCs were in 1979 permitted to retain a portion of their forex earnings. Swap centres, in which forex could be traded and renminbi purchased at higher than official rates, began to proliferate, thus effectively creating a dual exchange rate. The exchange rate against the dollar was RMB 1.7 in 1981, rising gradually to RMB 5.76 in 1983 and RMB 8.6 by 1994. Total foreign trade in China in 1952 was US$ 1.9 billion which rose to US$ 325 billion in 1997 with exports of US$ 182.7 billion and imports of US$142 billion (in 1978, foreign trade had been US$20.6 billion).

OPENING THE ECONOMY TO FOREIGN DIRECT INVESTMENT (FDI)

One of the most striking aspects of China's economic reforms has been its success in attracting foreign direct investment (FDI), particularly the exponential rise in the last 5 years. Between 1978-96, official figures indicate that China received US$462 bn in contracted and by 1997, US$220 bn in actually utilised investment. In 1996 China received US$ 42.35 billion in FDI, up 12.2% from the US$ 37.7 billion received in '95. It thus became the second largest destination for foreign investors after the US, confounding conventional wisdom that FDI flows are mainly between developed countries. However, FDI inflows have begun to peak (in '97 growth was only 3% to US$ 43 billion). Figures for FDI utilised are as follows:

(Figures in US$ billion, Source: China Statistical Yearbook):

YEAR	1990	1991	1992	1993	1994	1995	1996	1997
DFI	3.49	4.37	11.29	27.77	33.95	37.38	42.35	43

In 1996 the foreign trade of Foreign Invested Enterprises (FIEs) grew by 25% to US$ 137.1 billion or 47% of China's total trade. A total of 17 million workers were directly employed by FIEs in 1996 and FIEs accounted for 14.5% of China's industrial output. Over 70% of FDI was from overseas Chinese, mostly in **labour-intensive export processing** sectors (shoes, toys, electronics sub-assemblies, food processing, textiles, christmas decorations and other items in demand in export markets), and real estate. **By exploiting China's comparative advantages in abundant, skilled and cheap labour and light industry, FDI led to enormous increases in productivity. FDI in the consumer goods sector catalysed a vibrant domestic market in food processing and domestic electrical appliances as well as exports in these sectors**. **Today China's consumer goods sectors are vibrant. China's retail sector was transformed accordingly.**

The presence of newly foreign invested enterprises stimulated the growth of local component suppliers and service providers, and led to introduction of new concepts of doing business, new product and quality standards, and new services. This also resulted in an increase in employment, as the local industries expanded and took in more workers. This multiplier effect could be seen in other sectors in which foreign investment was relatively low or absent altogether. The presence of large numbers of managerial and lower level

expatriates stimulated a booming demand for local and FIEs' products, tourism infrastructure and other modern living amenities. **Influx of tourists, businessmen and visitors (over 40 million a year!) led to expansion and upgradation of China's tourism and services infrastructure, which showed off its unique historical and natural treasures to stunning effect.**

1. POLICY AND INCENTIVES

In 1979 FDI was permitted for the first time with the passage of the Law on Joint Ventures. Investor-friendly policies were adopted under the Open Door Policy. The pace of opening up was accelerated and the incentives significantly expanded and deepened following Deng Xiaoping's tour of southern provinces in 1992. **Approvals under and implementation of the policy were both delegated to the provinces and localities.** Foreign firms were promised and delivered some of the world's most favourable tax rates. Local provinces and municipalities vied with each other to court foreign investors, with ready assurances of preferential tax policies, priority supply of land, water and electricity, and expeditious clearances. Tax breaks and holidays, concessional tax rates, duty free import of capital and office equipment, duty free import of all inputs for the processing trade (these are available for all enterprises and not just Foreign Invested Enterprises, or FIE*s*), were the main perquisites enjoyed by foreign investors in China.

At the same time the Government embarked on a policy of massive investment in infrastructure to create favourable conditions for foreign investment. By 1993, investment in infrastructure was 6.5% of GDP, as compared to a 4% average for developing countries, and the World Bank's recommendation of 7%. The pace especially picked up from the mid-80s onwards.

China also established 5 Special Economic Zones (SEZs), in which it developed world class infrastructure - Shenzhen, Zhuhai, Shantou, Xiamen (in 1980) and Hainan Island (in 1988), the Pudong New Development Area in 1991, and Economic and Technological Development Zones, open coastal cities, High Tech Parks, Open Economic Areas (OEAs), Bonded or Free Trade Zones, Border Zone and Privately-invested zones, which could offer preferential treatment for foreign investment. Overseas Chinese from Hong Kong in particular also created a number of vehicles to invest in property and real estate development in the coastal areas of China, leading to a construction boom and rapidly changing urban landscapes. Indian visitors are left speechless at the impressive development of infrastructure they see not only in cities like Shanghai, Beijing, and the SEZs and the entire coastal area, but in cities of the interior. China has made impressive strides in urban infrastructure. Though it is heavily concentrated in urban and coastal areas, most visiting Indian businessmen say, it is better to have world class infrastructure in some areas, than to have none at all in the entire country. SEZs now account for a disproportionate share of manufacturing, foreign investment and foreign trade in China, infrastructure is the most developed, and average per capita incomes are the highest in China.

2. CONTROVERSY OVER FDI - BACKGROUND:

FDI IN THE FIRST WAVE

The policies described in the section above, and proximity to the booming economies of Hong Kong, Macau, Taiwan, Singapore and South Korea, led these countries to shift significant *but low-technology* manufacturing/assembly/export processing operations to the

mainland. These inflows were followed by overseas Chinese based in South-East Asia and were responsible for the export boom.

THE SECOND "WAVE" (1994 ONWARDS)

The second wave of investment, more recent, was led by multinationals from the West (including Japan), which sought a share of one of the world's growing and potentially largest markets, prompting competitors and component suppliers to follow suit. In fact, as the domestic market became more and more important, FDI became a, if not the, crucial component in entry strategies into the market.

Foreign firms with manufacturing operations on the mainland circumvented high tariff and non-tariff barriers, while obtaining direct access to distribution networks. T**his was crucial as foreign firms are forbidden from directly selling products including imports other than those manufactured by their mainland operations.**

Official circles welcomed MNCs initially as they were bringing in bigger lump-sum and high-tech investment in greater accordance with Chinese priorities. But investments by multinationals were targeted at the domestic market, while the first wave of investment was in line with China's export orientation. Gradually and then with increasing frequency official dissatisfaction began to be openly expressed at the quality of foreign investment received in the first wave (i.e., up to 1994), and need for greater selectivity emphasised. Thus the second wave provoked an open debate on the pros and cons of FDI, particularly the consequences for the beleaguered state sector.

This gave rise to China's own version of the "**Bombay Club"**, as MNCs on the one hand were commended for bringing in investment, technology, better managerial skills, training, increasing employment and higher levels of remuneration, wider choice of goods and improved quality, price competition which benefited consumers - in addition to providing linkages to world markets through their service and trade networks, but on the other were seen as a threat to national economic sovereignty. This view-point was criticised in turn by liberal economists as throw-backs to the mentality of central planning. The debate was exhaustive and is pertinent for our own experience, with the main arguments summarised below.

Proponents of the benefits of FDI pointed out that far from monopolising the domestic market - with the coming of more and more foreign enterprises, **competition** between them actually **drove down prices,** and led to **offers of better technologies**. Net domestic sales of foreign enterprises were RMB 112.8 billion or only 2.66% of total sales in 1994. **Chinese domestic electric appliances accounted for 80% of the local market**. There were several success stories in China's consumer, domestic appliances and electronics industries which showed that competition led to the emergence of stronger Chinese companies, specially amongst TVEs. Thus the state-owned colour TV maker Changhong through aggressive marketing tactics expanded its market share to 27% following a decrease in tariffs. Similarly several domestic companies such as Konka in color TVs, Haeir, Rungsheng, Meiling, Xinfei in refrigerators, Little Swan, Haeir, Little Duck in washing machines, and Haeir, Kelon etc. in air-conditioners had won dominant market shares. The benefits of FDI were clearly demonstrated as Chinese companies mastered the technology obtained through licencing agreements and by reverse engineering. While many local

manufacturers did not survive foreign competition, some flourished and even expanded abroad[2].

It was also pointed out that most of the investments by multinationals were in new and high technology industries and in machine building, electronics, textiles, chemical and building materials industries. Investment size per project had also increased. Multinationals were followed by investments by other companies to supply parts and services. Aiming at long-term cooperation in China, such companies actively pursued "localisation", using local managerial personnel, components and raw materials. Foreign investment was also showing a welcome geographical shift to central and western regions, which was State policy, and FDI was coming more from developed countries. Finally, China had become an important pillar of multinationals' global, long-term strategy, meriting independent regional headquarters at par with those in America, Europe and the Asia-Pacific region. Thus, on all counts, quality and source of investment, size per investment, sectors, and geographical trends, the new trends accorded with official policy. While it was readily conceded that there would be contradictions between their interests and China's own development priorities, **it was concluded that the positive impact out-weighed the negative**.

CURRENT POLICY

The debate over FDI was natural following the initial honey-moon. While its export prowess was based initially on labour-intensive relatively low-technology FDI funded factories, **China recognized the need to switch strategy to develop a high technology industrial base. For this it needed a different kind of partnership**, and hence the shift in policy which accompanied this debate. **Fresh guidelines were framed in 1994 for directing foreign investment into high-technology and capital intensive sectors, and to the relatively backward interior areas. An attempt was also made to progressively withdraw preferential treatment for foreign investors.**

The Chinese however avoided the tendency to demonize FDI. There are as yet no signs that FDI is unwelcome, with the authorities even taking steps to restore some privileges withdrawn earlier[3]. The trend towards greater selectivity and control is tempered typically by Chinese pragmatism. The Chinese response has **not been to shut out foreign investment, but to seek ways to direct it to priority sectors through policy instruments (auto, chemicals, pharmaceuticals).**

Examples of new policy: The Ministry of Chemical Industry announced that foreign investment **had to conform with priorities laid down by the State**. It targeted US$ 12 billion in foreign investment in the industry by 2000, bringing the ratio to overall investment to around 17% and specified key areas where it would be welcomed. In the auto sector, FDI was restricted as China's priority has been to develop a strong indigenous car industry, with synchronous development of the parts industry, to world standards. At least 40% of parts must be domestically procured/produced by any new car joint venture, with progressive localization. Hard bargaining by the Chinese led to an announcement of a US$ 1 billion pledged by General Motors for production of a Chinese car. Similar developments took place in other high-tech sectors, pharmaceuticals, materials building industry etc.. Chinese pragmatism was however apparent when one glances at retail, hardly a strategic but still

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[2] [2]Imports were subject to customs tariffs and regulations which prevented foreign companies from importing and distributing goods. More than tariffs which did not cover a sizable proportion of imports, these regulations provided substantial protection to domestic industry.
[3] This could be because China's dependence on foreign capital for sustaining its growth rate will continue till it manages to turn around its loss making state sector.

classified as a "restricted" sector (due to forex outgo concerns), in which hundreds of foreign-owned or joint venture department stores with world class facilities nevertheless came up all over urban China in response to demand.

FDI IN INFRASTRUCTURE

Contrary to general impression, China is following a cautious policy for FDI in infrastructure. China itself has invested heavily in infrastructure and taken the primary responsibility for its development. In power, China has installed more than 12,000 MW of generating capacity per year over the last 10 years, and has made it clear that it will invite foreign investment largely on its own terms (generating capacity is planned to reach GW 300 by 2000. 1995 capacity was 214 GW compared to India's 83 GW). FDI will account for only 20% of funds, with the rest supplied through domestic resources. Concerns regarding the rate of return, foreign exchange outgo and control over power tariffs in a system still burdened with subsidies are partly behind this approach.

The telecommunications and civil aviation sectors have undergone the greatest internal restructuring and are consequently expanding at breathtaking rates. However recently a decision has been taken to open the civil aviation sector more to foreign investment. In telecommunications, foreign investment has boosted production capacity, and technological upgradation, but FDI is still prohibited in the telecom services sector. In areas such as aviation and ports, ceilings have been placed on FDI, but foreign investment has been attracted nevertheless. Roads are primarily funded by wealthier local and provincial Governments. While western companies prefer the power and telecom sectors, overseas Chinese have flooded into real estate and property development, and department retail stores through different investment vehicles, changing the urban landscape beyond recognition. Growth engenders more growth. Today's China is completely unrecognizable from the China of even 10 years ago.

CONCLUSIONS

FDI has clearly supplemented the level of domestic savings and imparted a powerful momentum to the second wave of economic growth in China as the impulses from the first began to subside. FIEs have driven China's trade and economic growth over the past decade, with some estimates that foreign trade has contributed 80% of China's growth rate. China also derived the benefits of international competition through FDI, a superior strategy to the one which only emphasizes imports. Thus the positive effects of FDI are indisputable.

While China followed an open door policy with respect to FDI, it continued to protect its domestic market through high tariff and non-tariff barriers, restricting access through FDI only. While China is also suffering the consequences of shutting out imports, this policy did create an additional incentive to invest,[4] **whereas in India we combined restrictive FDI policies with high barriers to imports till 1991. Thus, we lost out both on FDI and the benefits of relatively open international trade, with well documented consequences.**

The issue of FDI's effects on domestic industry also needs to be understood in a broader framework. It is known that two-thirds of FDI flows are between developed countries, whose domestic sectors are not threatened by such flows. The issue is of having a

[4] The effectiveness of China's high tariff protection has however been questioned, as due to various tax-breaks and grey-area operations a relatively small proportion of China's imports are taxed.

strong domestic economy. The debate is interestingly analysed in a *Foreign Affairs* article on "The Unraveling of Japan Inc" which points out that even Japanese multinationals shun investments in their home base as competitiveness declines there. Money made from profitable operations outside is also not necessarily repatriated to the mother company and is instead re-invested in expanding local operations in the host country. They are generally seen to act in accordance with the host country's priorities in terms of increasing employment, bringing in know-how, and re-investing profits if the domestic economic situation is conducive to expansion. Japanese multinationals are now identifying their interests with those of the areas where their investment is located. Similarly, in the annual MFN debate in the US Congress, US multinationals with a stake in China were similarly seen to vociferously take up China's case more effectively than any combination of Capitol Hill lobbyists.

The Chinese State sector's unprecedented losses are more due to its lack of competitiveness than because of FDI. In a **way China is paying the price of maintaining high entry barriers to foreign imports while slowing down the pace of internal restructuring and reform unleashed in 1978. One indirect adverse effect of FDI could be the fact that huge inflows have masked the gathering inefficiencies in China's domestic sector and enabled it to postpone decisions regarding privatisation and other restructuring measures it needed to upgrade economic efficiency in its state-owned sector**. However FDI per se can hardly be blamed for this. **India should derive an important lesson from this, that is, not to slow down the pace of internal restructuring and reform even while welcoming FDI.**

The picture is therefore not all rosy for China. Contracted investment has fallen and growth rates for FDI are expected to decline. Withdrawals of privileges, restrictive policies, controls on pricing on the one hand and price wars on the other, over-supply, over-capacity, higher labour costs and a host of other problems facing foreign investors are coming to the fore. Representatives of foreign investors report an increasing level of dissatisfaction with actual results as compared to expectations. Moreover, Hong Kong, Macau and Taiwan have basically completed the transfer of their labour intensive industries to the mainland, and FDI inflows from this major source should decline in future. Taiwan has in any case taken steps to limit FDI on the mainland. The current Asian crisis will affect FDI inflows from Thailand, Indonesia and Malaysia. Lower inflows should in fact satisfy the nationalist lobby!

To sum up, China's requirements of FDI have changed following the changes in its own economic development. However, continued ability to attract high fund inflows will depend on China's ability to surmount problems in other sectors of its economy and maintain a high growth rate.

FINANCIAL DEREGULATION AND EXPLOSION OF "HOT" MONEY

The reforms led to an explosion in liquidity. Unrestricted growth in the long suppressed sectors of the economy combined with financial deregulation as provincial branches of banks channeled the new and increasing stream of resources into speculative activity and dubious commercial and real estate deals laid the bases for the boom and bust cycles characteristic of Chinese economic growth in the reforms period. Growth was also relatively unhampered by stringent licensing and other conditions which were imposed on India's private sector, since China lacked a regulatory framework for a market economy. The exponential expansion of the government apparatus which mirrored the increasing complexity of the economy and which doubtless imposed a high degree of inefficiency have to be dealt with in a separate category. Decentralisation of administration accompanied the

reforms, with delegation of power to lower levels. Thus for some time the new economic activities took place in a free-wheeling and dealing atmosphere in conditions approaching *chaos*. This term was used in the Peoples' Bank of China Annual Report on the financial system to describe the anarchic conditions prevailing in China's financial markets prior to 1994 and continued to be used in official reports tabled at the National People's Congress. American commentators also were fond of commenting that conditions were reminiscent of the wild-west. Sources of hot money were:

- Personal savings increased after 1978 to 35% of GDP and above. Consumption was restricted beyond a point due to lack of heavy duty spending options like housing or automobiles. Savings, which were deposited in banks, were diverted by the banks themselves into speculative activity. Savings were also recycled as working capital for loss-making SOEs, another form of sub-optimal utilisation.

- SOEs were also known to indulge in investment activities unrelated to their sphere of production. Despite the spread of the market economy, the government persisted with preferential policies for state enterprises. Real interests rates continued to be very low and even negative in periods of high inflation. This encouraged SOEs to expand recklessly on the basis of availability of cheap credit, itself a consequence of delegation of credit approvals to local branches of banks and the relaxation of supervision on them.

- Fixed Asset Investment (FAI) grew in the early 1980s with the only significant dip in 1989-90, at (-) 7.2% and (-) 2.4% respectively, picking up to 61.8% in 1993 and coinciding with the peak of the financial chaos in the system. The proportion contributed by bank loans increased as appropriations from the State budget decreased.

- The growth in output outside the confines of the centrally planned system following liberalisation in state enterprises and in agriculture stimulated the need for parallel channels of distribution, marketing and allocation of resources for the newly freed sectors of the economy. The co-existence of essentially different economic systems inevitably led to opportunities for rent seeking, as the state and non-state sectors were now competitors for the same resources, raw materials and other inputs, "creating" a new stream of resources available for speculative activity.

The explosion of credit found its way into speculative investments or investments of dubious quality, with consequent increase in money supply and inflation. The government periodically reimposed administrative controls on credit and investment which led the bubbles to collapse. The embryonic stock exchanges especially suffered from wild fluctuations due to the "hot" nature of the funds.

The Chinese economy persisted in this boom and bust cycle which became increasingly unhealthy as reckless expansion meant investments of doubtful commercial viability and huge increases in indebtedness of state enterprises to the banks. The banks were becoming increasingly vulnerable as loan portfolios consisted of bad and non performing loans and the massive savings of the Chinese population were not utilised efficiently. **The genesis of the current problems afflicting the Chinese economy, loss-making enterprises, bank indebtedness, the difficulty in restructuring the financial and industrial system, was laid in this period.**

Achievements: However by 1995, China's real GDP was four times its 1978 figure having grown at an average rate of 10%. Per capita GNP had reached RMB 4754 from RMB 379 in 1978. From 1977-95, agriculture's share of total GDP declined from 42% to 19% while

industry's share rose from 37% to 53%, of the service sector from 21% to 29%. The share of the non-state sector has now become over two-thirds of industrial output, while that of the state has declined from 78% in 1978 to 34% in 1994. These years also witnessed a shift from agriculture to the light manufacturing sector. Annual employment growth was 1% higher on average since the reforms began. However, despite the shift of labour to tertiary and secondary industry sectors, around 55% of the population is still employed in agriculture, which shows that controls on movement still exist.

PART III: SECOND PHASE OF REFORMS - 1993-TO DATE:

The transition from a centrally planned, heavy industry oriented model of development - to one which encouraged private initiative, unleashed an initial wave of growth which characterised China's economic "miracle". The preferential treatment given to foreign investment, and the development of infrastructure in key coastal areas and Special Economic Zones, attracted a new stream of resources and imparted fresh momentum to the economy. But the initial dynamism was followed by a prolonged interregnum, during which the situation of SOEs began to deteriorate at an alarming rate. China had undergone several sharp boom-and-bust economic cycles. The last such cycle initiated by Deng Xiaoping's *nanxun,* or tour of the southern provinces in 1992 to revive growth - led to renewed overheating of the economy.

A serious attempt at deepening reform through macro-economic tools, rather than direct controls was spear-headed by Zhu Rongji in mid-1993 but was scaled back by the November Plenum in the face of mounting contradictions. At the November 1993 Third Plenum of the Fourteenth Central Committee of the Party, decisions were taken to effect the following - financial system reforms; currency reforms; taxation reforms; SOE reforms and price liberalisation. In fact reining in inflation, SOE reform, and agriculture were 3 priority areas identified by all Party Plenums and Congresses between 1994-97.

However the reforms, though in many ways revolutionary in the Chinese context, were not intended to effect structural change. They were designed to create institutional umbrellas for containing the adverse effects of the first phase, mitigate the excesses in the financial system, correct imbalances which had developed in the economy because of the State enterprises problem, and reform taxation, and monetary and fiscal systems to approximate them to the more recognizable structures in a modern economy. The first stock exchanges were created around this time on an "experimental basis". Agricultural reform remained frozen, with continued state control over procurement and marketing in what are considered strategic crops such as grains and cotton, and there was no further movement on the issue of property rights for the peasantry. There continued to be stasis on the issue of SOE restructuring, with various reform programmes based on the principle of "gradualism" launched. The consequences of restructuring in terms of mass redundancies also brought about a re-think.

Attention in 1994-96 was also focused on the external sectors - restructuring the foreign exchange and foreign trade systems, and the foreign investment sector. The unification of the exchange rate at a more realistic market rate and expansion of the right to conduct foreign trade to more parties led to a boom in exports. A very important reform thrust was in taxation in order to increase the central Government's financial powers. In 1995 VAT rebates for exports and tax privileges for FFE projects were reduced. But one of the immediate results of these measures was a decline in export performance. Several export incentives and concessions for foreign investment were hastily restored. Talk of withdrawal

of some of the privileges enjoyed by SEZs similarly receded following a wave of opposition from SEZ leaders to this proposal. New guidelines for foreign investment were adopted.

One of the qualitative changes that foreign investors from western countries including Japan effected was a demand for a regulatory environment more suited to their requirements, as China lacked a regulatory environment for the operation of the non-State sector. The government introduced new legislation through 1994-97 to institute a recognizable legal framework for doing business in China, including corporate tax laws, banking laws, an urban real estate law, a company law, and a new labour law.[5] Some of these came in response to the demands of the FIEs. These developments will not be dealt with in detail here. At the same time the Chinese non-State sector continued to exist in legal limbo (by our standards at least) with little progress towards redefining their property rights or to reflect the changes which took place in the direction of de facto privatisation.

Financial system reforms: As noted earlier, since launching of economic reform, China experienced several sharp cyclical contractions. Financial system reform was accordingly identified as one of the essential components of managing economic reform and a transition to the "socialist market economy", and concrete measures outlined at the November 1993 Plenum. The intention was to introduce the more sophisticated tools used in market economies for macro-economic management, in an economy undergoing rapid, but as yet incomplete, transition from a centrally planned system and State control. Measures to bring order to the financial chaos included creation of a genuine central bank - the People's Bank of China (PBOC), transformation of state-owned banks into commercial banks, curbing of stock and real estate speculation and other extra-legal activities by State-owned entities, development of monetary instruments, currency convertibility, taxation reform, expenditure reform, and formulation of a tight credit and monetary supply policy.

The People's Bank of China (PBOC) Law passed in 1995, confirmed the PBOC as the country's central bank with the responsibility of formulating and implementing monetary policy and supervising the country's banking system, but under the "leadership" of the State Council. The law sought to address some of the major inadequacies of the old system, in which PBC branches were forced to give out unrecoverable loans to influential entities, and provide overdrawal facilities to cover financial budget deficits. The Commercial Banking Law passed shortly thereafter sought to ensure that state commercial banks were freed from making policy loans to SOEs. This was henceforth to the responsibility of the Policy Banks.

While there has been genuine progress, China's financial system reform has still a long way to go. One of the most serious obstacles is the problem of the problem-ridden State-owned sector, a legacy of the centrally planned economy. China's banking system bears the brunt of SOEs' losses, as SOEs are no longer supported through the Govt. Budget. Any steep contraction in bank lending crucial for SOEs, could lead to widespread closedowns. In periods of high inflation funds were lent at real negative interest rates to the enterprises. When interest rates became positive, it created an additional strain on loss-making SOEs. The dilemma was to choose between the viability of the banks or continued support to the SOEs. It was therefore widely recognised that banking reform was dependent on measures to tackle the problems of the state sector. Decisions on credit allocation and interest rate policy could not be taken independently of the problems of the state sector. The new policy was therefore implemented very selectively.

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[5] To a certain extent, the free-wheeling dealing atmosphere and the culture that "everything is negotiable" had been to the liking of foreign investors, particularly one suspects, the lack of clarity in labour laws. For example, the new labour laws adopted for joint ventures led to significant increase in the responsibilities of employers and in the costs of labour employed. Still, beyond a point it became difficult to do business in a legal vacuum.

China's opening up in the financial sector to foreign investment has therefore been more limited than India's. This could unleash forces of competition which would place the already embattled State sector, including the State banks, under further stress. The system of financial intermediation is poorer in China than in India, and doubtless China's extremely high savings rate in comparison to India's accounts for the appearance of normality.

2. **Currency reform:** The old system of dual exchange rates was formally abolished in January 1994. The Governor of the PBC announced in June 1996 that China would make the yuan convertible under the current account by the end of 1996, 4 years ahead of schedule.

3. **Taxation reform:** The Central Government took several measures to reverse the decline in its taxation power, its share in total revenue having fallen inexorably over the years and by 1994 reaching its lowest levels in China's post-1949 history. Lack of funds left the Government unable to implement an effective monetary policy and address the issues of growing financial chaos. Domestic taxation reform carried out in January 1994, was aimed at institutionalising and demarcating the central and provincial governments' respective tax bases and doing away with the earlier contract financial responsibility system in which funds surrendered to the central government varied from region to region. The old Consolidated Industrial and Commercial Tax (CICT) was replaced by three different taxes for both foreign and domestic companies - the Value Added Tax, a business tax, and a consumption tax, and several other taxes. The corporate tax for foreign and domestic firms was equalized to 33%[6]. Domestic corporations had earlier paid at the rate of 55%. The Government withdrew various customs duty exemptions, such as on items imported by foreign enterprises, then on equipment imported by foreign-funded enterprises from 1.4.96, and reduced VAT rebates on exports. It also clamped down on unauthorized zones offering special incentives and tax breaks to foreign investors, and announced withdrawal of SEZs' special privileges over a time-frame. The above moves were also interpreted as a sign of a conservative revival, since foreign investment and SEZs were the lynchpins of Deng's modernisation strategy. Some of these measures were reversed later.

4. **SOE reform - Background:** China has 118,000 State-owned enterprises employing 112 million people. SOEs account for over 70% of fixed assets, 75% of industrial investment while healthier firms are starved of funds, but produce less than 35% of industrial output. Productivity and rate of employment creation lag behind the non-State sector. Though SOEs are beneficiaries of numerous preferential policies, subsidies and low interest rates, the percentage of SOEs making losses was estimated at over 50% at the beginning of 1998. The debt-asset ratio is officially estimated at 85%. Official estimates of inventory carried by SOEs upto end-October 1994 were RMB 500 billion (US$ 58.8 billion), or more than one-tenth of GDP, and these have only increased since then. Poor sales in turn led to payment deafults to suppliers, creating a debt chain through the economy and an acute shortage of working capital for healthy suppliers and loss-making producers alike. There are varying estimates of triangular debt but some place it at RMB 800 billion, or more than US$96 billion.

China's banking system bears the brunt of these debts, as SOEs are no longer supported through the Govt. Budget. The estimated outstanding bank loans to SOEs are over RMB 1 trillion. Since SOEs also rely on bank loans for 80% of their working capital, while private savings make up 53% of total bank, individual savings are therefore funding the continued operations of loss-making enterprises, and individuals therefore would face the

[6] However many exemptions for FIEs were retained which decreased the effective tax rate.

worst consequences of enterprise bankruptcy if the banks are unable to recover their loans. China's leadership were therefore unwilling to adopt the new Bankruptcy Law for fear of the consequences. Confidence in the banking system keeps the system going. If there was a call on the money, panic would ensue unless the State undertook a massive bail-out or enforced administrative controls on withdrawals.

Attempts at SOE Reform

Parameters for reform were laid down in 1993. These consisted of - introduction of a modern enterprise system, or the separation of management from ownership and increase in enterprise autonomy; reduction of state subsidies and bank credit in order to increase fiscal discipline, removing social welfare liabilities from enterprises while elaborating an alternative social security net for workers, recapitalisation of enterprise debt, incentives for technological upgradation and changes in ownership forms such as share listings, joint stock, mergers and bankruptcies. Some of the projects adopted as pilot experiments to implement these ideas were as follows:

- 100 enterprise project on a modern enterprise system: at the end of 1994, 100 State-owned enterprises were selected as pilot firms to be changed into modern corporations.
- Enterprise restructuring in 58 cities: the State would support enterprise restructuring through encouraging mergers and bankruptcy.
- Concentration on 1000 key enterprises -"Seizing the Big and letting go of the Small", and "selection of the superior while eliminating the inferior" slogan.

Despite two years of experimentation (1994-96) with a "modern corporate system" - declining industrial growth rates in 1996, mounting inventories, reports on mounting labour unrest due to unpaid wages and unemployment[7], and World Bank estimates reported in the Hong Kong press which placed actual growth in 1996 at 7% prompted a reappraisal of the options available[8]. Meanwhile, asset-stripping and "privatization" was whittling down the state share of the economy. A large proportion of the assets in coastal provinces like Guangdong and Jiangsu had changed hands.

At the macro-economic level, the growth rate target was therefore increased, fixed asset investment and credit for enterprises expanded. Other measures in 1996 were taken to stimulate growth - adoption of interest rate cuts by the central bank, identification of new "growth poles" such as the mass housing sector and the information technology industries, etc. At the same time the Chinese leadership itself acknowledged that high growth rates in a pattern of "extensive development" were undesirable unless accompanied by improvements in efficiency.

Outlines of the following policy began to emerge following the acknowledgement of the impossibility of the task of reforming the hundreds and thousands of loss-making enterprises:

1. The State would concentrate on reform and development of **1000 large state-owned enterprises and groups in key sectors**, transforming them into independent corporate entities and the **backbone of the economy**. The state would set up a special fund in the 9th FYP to encourage mergers, offset debts of bankrupt enterprises, and lower

[7] The Vice-Minister for Labour estimated total surplus labour at 210 million in 2010.

[8] The World Bank also reduced its estimate of the size of the Chinese economy measured on a purchasing power parity basis, by over 25%, and also estimated the proportion of population living in poverty at closer to a third, rather than the official 7%.

enterprises' liability-asset ratios through debt conversion. Thus, since the role of the state sector would be preserved in strategic industries, it would continue to play the dominant role in the economy.
2. Reform of smaller state-owned enterprises, of which there are over 200,000, was to be stepped up in 1997. Options could be merger, joint stock partnership, leasing, contract operation, or sale. The hopeless cases would be allowed to go bankrupt.
3. Redundant workers would be the responsibility of the local governments, thus taking them off the balance sheets of SOEs. The reform of the social security system would be an important component of economic structural reform.

Common development of all economic sectors with public ownership[9] as the mainstay was adopted as the basic principle for the long term. Emphasis was on helping the stronger and more efficient of the key state enterprises to survive, while lowering the exit barriers to the weaker, under-performing ones. In addition, corporatisation of the Ministries would be accelerated.

The policy is to reinvigorate only the biggest and most important state enterprises. **A credit squeeze on the small loss-making SOEs has forced several of these to close down and thrown several million out of work (some estimates are that 12 million workers were retrenched in 1996 alone), leading observers to conclude that China has quietly taken the decision to implement the "shock therapy" approach in SOE reforms.**

RECENT DEVELOPMENTS

The decisions taken at the First session of China's Ninth National Peoples' Congress in March 1998 are in line with the above trends and policy evolution, although they bear the clear imprint of one of China's most determined reformers. China today faces a problem of flagging growth because of a slow-down in the pace of internal restructuring and reform, accompanied by over-investment and over-capacity. In the agricultural sector, despite tremendous growth in the past, falling rates of growth are a real prospect as the small-holdings reach the limits of their productivity. Traditional strategies of pumping up the economy may only stoke inflation and lead to a further increase of inventory. The intensification of SOE reform on the ground, measures to reduce the size of the government apparatus, downsize bureaucracy including eliminating 4 million posts, recapitalise the banking sector, boost domestic spending on infrastructure (reportedly to the tune of US$ 1 trillion over 3 years) and eliminate subsidies on housing, which should stimulate growth, are the right medium-term policy choices for China.

PART IV: RELEVANCE FOR INDIA

IS THE CHINESE EXPERIMENT NON-REPLICABLE:

Some argue that China's success in achieving such high economic growth is due to the huge investments of overseas Chinese, an advantage that India does not have as our NRIs are mostly professionals. This ignores the fact that it took so long for China to attract sizable amounts of this 'patriotic' FDI. **In fact, it was the provision of generous incentives and infrastructure** (coupled no doubt with greater familiarity with China's cultural ethos and business environment) **which attracted overseas Chinese investment.** Moreover, the

[9] Publicly owned companies comprise both state-owned and collective companies.

Chinese themselves were unhappy with the quality of investment in the 'first phase', and actively courted investment from western, mainly multinational companies.

Skeptics have also often tried to explain away China's success by attributing it to certain aspects of the Chinese system which promote discipline. However, it is clear that it was the economic reforms which led to this growth, as the 'discipline' remained before and after reforms. Also, the Chinese people *supported* the reforms process and participated whole-heartedly in it as it made a demonstrable difference to their quality of life. Hence the Chinese case is not *sui generis* and can be drawn on while considering options and strategies for economic development in other countries.

LESSONS FOR INDIA

What should be the lessons that India can derive? It is clear that China enjoys the international prestige that it does today mainly because of its economic performance and clout and the obvious material well being enjoyed by its population. The reform process in China therefore has relevance for India which is also trying to attain high economic growth rates, eliminate poverty and improve the standard of living of its peoples. At the same time, growth in China has not solved the problems of unemployment, a loss-making public sector, and an inefficient banking sector. It is essential to separate the processes which contributed to China's success from those which held it back, in order to derive some relevant conclusions for us in India.

Reasons for China's economic success:

◊ First is the attitude of the leadership and the people**. Economic development became a national creed imbibed by all layers of society**, reinforced with the emphasis placed on pragmatism and results above ideological debate.

◊ The attitudes of bureaucrats and party functionaries especially at the local and provincial levels were different from their counterparts elsewhere. Officials welcomed proposals for increasing investment, and actively facilitated their implementation by expediting the approvals process, which itself was decentralised.

◊ In terms of policy, the agricultural reforms, which restored the right of the peasant to market his produce, and effected an equitable land distribution throughout the country, created the basis for relative prosperity in the countryside, and provided the initial momentum for development of township and village enterprises.

◊ This was accompanied by a complete turn-around in China's philosophy of self-reliance. The Open Door Policy to foreign investment, creation of SEZs, and a determined drive to make China a great trading power were its results.

◊ Internally also, private initiative was permitted both within and outside the public sector which contributed to the doubling of growth rates in the reforms period.

Imperfections in China's model:

◊ While high growth rates were achieved, private initiative flourished in the interstices of the centrally planned economy. This, in common with similar models in other countries, created opportunities for rent-seeking as the two sectors co-existed and competed for the same stock of resources.

◊ After the first phase of reforms, China slowed the pace of structural and institutional reform. It did not replace the institutional structures of a centrally planned economy -- a huge bureaucracy, an outmoded banking and creaking financial sector, the dominance of a relatively inefficient and loss-making public sector, the lack of market responsive

institutional structures, etc., although bold attempts have been made recently to tackle these problems head-on. Further land reform was also stalled.

◊ The result has been a hybrid economy, poised half-way between the market and state control, and therefore struggling with as yet unresolved ambiguities. Even the Chinese widely apprehended that traditional strategies to pump up the economy would only stoke inflation, lead to a further increase in inventory, and continue to encourage "extensive' rather than 'intensive' growth (a Chinese euphemism for technology-led, energy & resource-efficient, rational economic growth). Unless the reforms package unveiled recently are implemented, China will continue to face uncretain economic scenarios.

Options for India:

Our conclusion is that **reforms should be accelerated** as they will (i) ensure Indian industry is strong enough to withstand foreign competition; (ii) meet the demands of the long-suffering domestic consumer; (iii) ensure a stable, long-term institutional and legal foundation for dynamic growth**.** Reforms should **benefit as wide a spectrum of society as possible instead of benefiting only powerful lobbies and entrenched vested interests.** Sheer economic growth is not always enough to deal with political and social imbalances. Economies in which excessive controls have been prevalent, are unfortunately classified amongst the most rent-seeking societies in the world. Opportunities for rent-seeking multiply with faster growth - as vested interests feel the need to reinforce their control over the lucrative levers of power. **Hence deep and thoroughgoing structural reforms is a *sine qua non* of fast economic growth, to liberate the innovativeness which is inherent in the people, and improve economic efficiency and morality**.

Secondly, FDI should be actively facilitated and allowed in all sectors, with suitable but flexible export obligations to meet our concerns over short-term foreign exchange outgo if necessary. China welcomed FDI in all sectors initially without prioritisation. Domestic liberalisation and the Open Door Policy were launched at the same time - no time was lost in *ideological* debate. *An export boom followed and moreover domestic industry reaped the benefits of competition on home soil, which strengthened its capacity to compete abroad.* In our case, **FDI need not be feared if the domestic sector has been made strong through ongoing reform.** Studies have shown that foreign companies prefer to re-invest profits in host countries with better business environments rather than in their home countries if business conditions are deteriorating there. FDI will lead to upgradation of *domestic manufacturing **and services*** industry, employment and competitiveness. **Foreign-invested companies also create a burgeoning demand for services, a competitive advantage in which has become the key to some nations' economic success.** If excesses are perceived, the State should reserve some policy instruments through which it can help domestic industry. It should however immediately start to support its domestic industry through pro-active measures, adopting a more industry-friendly regulatory environment and taxation structure, reducing the interest rate burden and improving infrastructure and general governance. It is therefore imperative to:

◊ **Identify fast economic growth as a national priority.**

◊ **End time-consuming debates on ideology**, pros and cons *(the colour of the cat*) etc. and shift accent to implementation.

◊ **Implement reforms as per an action plan**. If doubts remain, **adopt China's experimental approach**: adopt a pilot project to test the theory on the ground; if results are found satisfactory, the 'experiment' can be replicated in other parts of the country.

◊ **Implement rational economic policies** to help domestic industry (b) continue to put in place **strong and transparent regulatory frameworks which can enforce the law**

without conflict of interest (c) institute a business friendly environment with tariff and tax rationalisation. For e.g., it has been proposed that rationalisation of the national centre/ state tax structure would benefit economic activity.

- ◊ **Invest heavily and immediately in infrastructure (including Special Economic Zones for domestic and foreign investors).** China invested heavily in infrastructure and SEZs, recognising this as an absolute pre-condition for growth.
- ◊ **Implement real economic federalism. Adopt the three D's - Decentralisation, Deregulation and Devolution.** China's experience shows that growth results from local initiative and inter-provincial competition for investment.
- ◊ **Implement genuine and well considered land reform.** China's experience in land reform was that it was the first step towards economic boom.
- ◊ **Downsize bureaucracy.** This has become a vested interest in itself. China is planning to cut 4 million posts and has already rationalised its central government structures, drastically cutting down the number of ministries while envisaging regulatory roles for the remaining ones.
- ◊ **Launch a mass literacy campaign,** which has created a sustainable basis for economic growth in China. Give every district magistrate a time-bound target and link promotions with their fulfillment.
- ◊ **Recognise that special efforts need to be made to attract FDI.** Create **Special Economic Zones for FDI**, like China, and **provide world class infrastructure, hygienic and pleasant living environment, tax incentives**, and encouragement to FDI. It cannot be denied that lack of proper telephones, roads, congenial living environment, all act as dampeners to significant FDI inflows. Indian industry should also be allowed to establish base in these world class enclaves.

COMMON GOALS OF INDIA AND CHINA AND WHERE THEY CAN SHARE CONCRETE EXPERIENCES AND RESEARCH FINDINGS:

Though China's economic development has created an economy which differs in important respects from India's, problems and issues that China faces are uncannily similar to those of India. **Common goals are**:

- ◊ Elimination of poverty and participation of masses in economic growth
- ◊ Improved living standards
- ◊ Increased and sustainable growth rates
- ◊ Addressing problem of unemployment

The measures which could be adopted to achieve them are:

- ◊ Deep structural reform, including down-sizing the State apparatus
- ◊ Removing obstacles to growth, ensuring optimum deployment of resources, and correcting earlier misallocations
- ◊ State sector reform
- ◊ Eliminating waste, bureaucratic inefficiency and stagnation
- ◊ Appropriate policy framework for foreign investment

Greater cooperation with China could help us understand our problems and seek their solutions better. Future options may be different both because of systemic differences and because resource endowments of the two countries are now different. But both countries face the same task of removing obstacles to growth, ensuring optimum deployment of resources, and correcting the earlier misallocations. Consequently both have a lot to learn from each other. Exchanges of ideas and comparisons of development experiences in

different sectors have taken place, generating mutual good-will. These are of immense mutual benefit as well as implications for growing cooperation between the two Asian giants and should be increased. We can imbibe Chinese pragmatism and dynamism in the process, and the Chinese can study our institutional structure and reforms.

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"The book traces in considerable depth the developments in South Asia and its eastern neighbourhood in the context of the emerging mega-trends in the international economic order. It brings out clearly the imperative need to focus on the longterm challenges of globalization in order to cope with them effectively. The far reaching implications of liberalization, deregulation and privatization in the developing world on the one hand, and the emergence of powerful mega-groupings in the developed world on the other, would have to be addressed squarely both by the South Asian countries as also their eastern neighbours.

"The study highlights the inevitable need for greater cooperation between South Asia and the major countries of South -East Asia. It details some important guidelines for the South Asian countries. Given the geographical proximity and resource endowments of these countries, the excellent suggestions made in the volume deserve series attention." (jacket)

[Muchkund Dubey is currently President of the Council for Social Development New Delhi. His books include **An Unequal Treaty : World Trading Order After GATT.**

Nancy Jetly's books include India-China Relations, 1947-1977: A Study of Parliament's Role in the Making of Foreign Policy and **Democratization and Regional Cooperation in South Asia.**]