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STRATEGIC ISSUES FOR CHINA'S ECONOMY

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1 Economic growth and living standards

1.1 Per capita income is key benchmark

Since initiating a programme of economic reform and trade liberalisation that has now spanned 25 years, China's economic growth has been extraordinary. Real GDP growth on an official basis has averaged almost 10 percent annually.[1] Even sceptics of Chinese statistics who discount official GDP growth statistics agree that the growth has been unprecedented, with the overall size of the economy likely at least doubling each decade.[2]

GDP growth continued at a very strong pace in 2003, reaching 9.1 percent, despite the impact of SARS at the beginning of the year. This growth was driven by domestic demand, in particular private consumption and fixed investment.

Table 1. OECD Forecast for China

	1990-2000*	2001	2002	2003e	2004f	2005f
Real GDP growth	**9.6**	**7.3**	**8.0**	**9.1**	**7.8**	**7.4**
Inflation (CPI)	7.1	0.7	-0.8	1.2	1.0	1.5
Fiscal balance (% of GDP)	-2.0	-2.6	-3.0	-2.9	-2.8	-2.7
Current account balance ($ billion)	13.3	17.4	35.4	16.3	8.01	15.6
Current account balance (% of GDP)	1.8	1.5	2.9	1.2	0.6	1.0

Sources: OECD Economic Outlook 2003, Chinese National Bureau of Statistics *Note: e-estimate f-forecast*

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1 While GDP growth is not an all-encompassing measure, it is probably the most comprehensive available from official statistics. Broader GDP measures that take account of resource depletion and pollution such as a 'green' GDP index have been proposed in many countries, and while discussed in China, they are a long way from adoption. Such measures have been discussed in the OECD dialogue with the China's State Environmental Protection Administration regarding environmental performance indicators.

2 Many inquiries have been made into the accuracy of Chinese GDP statistics (see Section 4). There are arguments that in the 1990s, official GDP growth rates may have been somewhat too high, but most recently the figures are argued to under-represent growth. These issues and the underlying methodology for their compilation have been discussed in an ongoing series of OECD workshops with the Chinese National Bureau of Statistics, who are increasingly adopting international standards for their statistics.

With population growth in the 1 to 2 percent range, such rapid economic growth translates into an increase in real per capita income of over 6 percent per year, or a doubling every dozen or so years, and a five-fold increase in the post-1978 period. On an international basis, Chinese *per capita* incomes have now reached 13 percent of the OECD average. Many key indicators of quality of life have risen in tandem with income. However, some indicators, such as distribution of income, have worsened.[3]

Table 2. Changes in China's living standards after beginning of reforms

Description of indicator	1980	1990	1995	2000	2002
Life expectancy at birth (years)	67	69	69	70	71
Infant mortality rate (per 1,000 live births)	42	38	37	32	31
Adult literacy rate (% of people Age 15 and above)	67	78	82	85	86
GDP per unit of energy use	0.703	1.694	2.824	4.135	
Gini coefficient	0.28	0.36	0.41	0.45	

Sources: UNDP World Development Report (2003), World Bank WDI (2003), NBS (2003)

1.2 Decomposition of growth shows priorities

A standard method of examining the sources of economic growth is to decompose growth into contributions by factor inputs, principally labour and capital, and total factor productivity. While data availability limits the accuracy of this exercise somewhat, one typical study finds that during the 1978–1999 period only 10% of GDP growth can be attributed to growth of labour input, while 62% can be attributed to capital accumulation.[4] Most other studies confirm this. Labour's relatively minor share in growth reflects its underutilisation to date. Analogously, the dominant role of capital demonstrates the importance of how investment is allocated for generating growth.

The remaining approximately 28% of Chinese growth is estimated to be total factor productivity. Productivity is considered the primary source of long-run economic growth, and it accelerated in China during the 1990s as structural reforms deepened. Higher productivity allows the same quantity of inputs to be combined to yield a greater quantity of output, so both labour and capital are utilised more effectively.

However, neither capital nor labour can be allocated efficiently if markets are not well developed enough to allow them to be priced and allocated efficiently. And well-functioning markets require well-functioning institutions to support them.[5] Much of China's productivity gains can be directly traced to structural adjustments that are closely linked to institutional developments. Similarly, China's future growth will likely be determined by its ability to mobilise not only labour and capital, but also to progressively improve its institutional framework.

2 Key issues/problems/challenges for growth

2.1 Mobilising labour: creating jobs

Mobilising labour is a fundamental challenge for the Chinese economy and policy makers. While labour is potentially China's greatest resource, it is underutilised and inefficiently allocated. This is in part due to the current sectoral structure of China's economy and in part due to barriers in the reallocation of

[3] Distribution of income in China has become increasingly uneven over the past two decades. However, China's present level of inequality does not exceed the levels of many other countries' at similar stages of development. Comparisons with OECD countries were made in a workshop organised in 2003, with China's National Reform and Development Commission, using a variety of different methods.

[4] Refer to Table 6 for a summary of recent estimates of contributions to China's GDP growth.

[5] A growing body of literature supports the primacy of institutions in guiding economic development.

labour across regions, urban boundaries, and industry sectors. Human capital capacity-building is important as well.

2.1a Generating employment in labour-intensive services

China's ongoing transition to a market economy has involved substantial reallocation of employment out of agriculture and industry and into the service sector. The service sector is most able to absorb labour as shown in Table 3.[6] Its growth has been driven over the past several years by the rapidly growing private economy, which now represents 19% of formal employment. Informal private employment is also important, in part because barriers to the entry of private firms have limited their ability to expand and create jobs (see Section 2.3d).

Nevertheless, while the wholly private sector represented only 4.4% of employment in 1996, it generated over 26% of new jobs from 1997 to 2001. Moreover, by 2002, the private sector was generating 3 out of 4 new employment opportunities, and is increasingly seen as the most important solution to swelling unemployment in many cities created by the ongoing restructuring of state-owned enterprises.

Table 3. China's service sector has highest employment elasticity and most able to absorb labor

	Growth of GDP [1]			Employment (millions)			Empl. growth [1]			Empl. elasticity [2]/[1]		
Year	I: primary	II: secondary	III: tertiary	I	II	III	I	II	III	I	II	III
1995	5.0%	14%	8.4%	355	157	169	-3.0%	2.2%	8.8%	-60%	16%	105%
1996	5.1%	12%	7.9%	348	162	179	-2.0%	3.5%	6.2%	-39%	29%	79%
1997	3.5%	11%	9.1%	348	165	184	0.1%	2.1%	2.8%	2%	20%	31%
1998	3.5%	9%	8.3%	352	166	189	1.0%	0.3%	2.3%	28%	4%	28%
1999	2.8%	8%	7.7%	358	164	192	1.7%	-1.1%	1.8%	60%	-13%	24%
2000	2.4%	9%	8.1%	360	162	198	0.8%	-1.2%	3.2%	32%	-13%	40%
2001	2.8%	8%	8.4%	365	163	202	1.3%	0.4%	2.0%	47%	5%	24%
2002	2.9%	10%	7.5%	369	158	211	1.0%	-3.1%	4.3%	34%	-32%	57%
Mean	3.5%	10%	8.2%				0.1%	0.4%	3.9%	13%	2.0%	48%

Source: Lu et al. (2001) and China Statistical Yearbook (2003)

2.1b Facilitating managed urbanisation

One of the major restraints on the reallocation of labour from agriculture to services is the system of controls on urban residency which restricts the ability of the rural population to move to cities, and prevents residents of smaller cities to move to larger cities. Although urbanisation has occurred both illegally and through liberalisation of the "*hukou*" system, with the urban population rising from 21% to 38% over the past 20 years, restraints on internal migration in China continue to play an important role in restricting efficient allocation of labour.

Restricted reallocation of labour not only limits the potential gains from restructuring but also leads to insufficient agglomeration of economic activity in both rural industrial and urban areas. These inefficiencies could be addressed through greater flexibility in inter-village and urban-rural movement of resources.

2.1c Creating land markets and strengthening property rights

A closely related constraint on inter-regional and urban/rural movement of resources are limits on the ability of farmers to sell their land. A range of informal use arrangements have emerged in the place of

[6] Difficulties in measuring the service sector were addressed during a workshop by the OECD Statistics Directorate with the Chinese National Bureau of Statistics.

formal transfers, some of which do not guarantee effective ownership rights. Constitutional reforms planned for March 2004 should strengthen these rights but it may still be some time before the rural populations can fully exercise property ownership rights.

In part because land serves in place of a social security system, there has been great reluctance to enable rural residents to sell their land freely. In turn, farmers have difficulty in relocating without giving up their land and to use it as collateral for loans. The latter problem is magnified since rural areas are not served well by the formal financial system (see Section 2.2b).

2.1d Building more human capital

Access to primary education in China has provided an important resource for its development. Although standard measures of labour input place labour as a relatively small contributor to economic growth, once quality is taken into account, its contribution is much higher. Still, access to higher education has grown more slowly than primary or secondary school enrolment and it now reaches just under 15 percent of the population.

The relatively low provision of higher education suggests that considerable potential for future gains exist. A review of China's higher education system in 2003 concluded that a number of fiscal and structural reforms to the education system could result in broadened access to higher education.[7] Labour market reforms that raise returns to educational investments act to reinforce such gains.

2.2 Mobilising capital: efficient investment

Given the large role that capital accumulation has had in economic growth, the location and sectoral focus of investment is an important determinant of the regional and urban/rural distribution of development. Allocation and misallocation of capital can have long-term consequences on its social rate of return and substantially affect where and how subsequent growth occurs.

2.2a Improving infrastructure in underdeveloped areas

Growing disparities in economic performance in the western (and north eastern) regions relative to the coastal areas in China has led to a concerted effort by the central government to direct greater resources to these under-capitalised regions. These efforts have met with some success, as the growth of infrastructure and recently even output has begun to even out. Still, north eastern regions have lagged considerably, and they are now the target of a new policy effort. One major challenge that China increasingly faces as it meets its World Trade Organisation (WTO) obligations for policy consistency is that its ability to redirect foreign and non-state domestic investment will become increasingly limited. On the one hand this will be advantageous to regions that previously lacked policy preferences, but on the other hand, since private investment becomes increasingly important, it will be harder to manage development. Difficulties in managing private investment were observed recently in the past year as the government has found it difficult to rein in a post-SARS investment boom, as noted in the OECD Economic Outlook.

2.2b Reducing constrains on rural investment

A variety of institutional factors lead to under-capitalisation of rural areas, limiting their ability to increase growth.[8] Combined with restrictions on urban-rural migration, many opportunities for increasing productivity remain unexploited. In particular, there is significant potential to increase economies of scale

[7] OECD Review of Financing and Quality Assurance Reforms in Higher Education in the People's Republic of China, CCNM/EDU(2003)2.

[8] See the paper "The Role of Agricultural and Other Policies in Raising Rural Incomes in China, in OECD (2002), *China in the Global Economy: Agricultural Policies in China after WTO Accession*.

in rural investment. Rural areas are underserved by the formal financial system, so informal credit provides over 70% of rural finance. An OECD-China workshop on rural finance, in 2003 considered the various policy options for addressing this financing gap with Chinese policy makers.

2.2c Improving sectoral allocation of investment

The sectoral composition of investment does not reflect its marginal productivity in many industries, and may in part explain why the production share of capital is so large relative to labour. With more than two-thirds of the economy controlled by non-state owners, market mechanisms and growing competition should increasingly improve the allocation of capital. Still, the service sector appears to be relatively small relative to other countries at similar stages of development.[9] Private firms in particular are affected strongly by the continuing presence of entry barriers in many industries.

Table 4. Changing sectoral composition of output

Value added (GDP)	1980	1990	1995	2001	2002
Agriculture	30%	27%	21%	16%	15%
Industry	49%	42%	49%	50%	51%
Services	21%	31%	31%	34%	34%
Employment					
Agriculture	69%	60%	52%	50%	50%
Industry	18%	21%	23%	23%	21%
Services	13%	19%	25%	27%	29%

Sources: OECD (2002) and NBS (2003)

An OECD investment policy review of China that was completed in 2003 found a number of sectors where obstacles to both domestic and foreign investment remain. While foreign investment plays a relatively modest role compared with domestic investment (as a proportion of gross capital formation, foreign investment it is about 10%), it serves as an important source of new technology and business practices.

2.3 Increasing productivity: further structural reforms

Improving China's utilisation of resources through specific sectoral reforms will confer considerable gains for its economy, but many of these challenges are structural and thus require multi-sector and economy-wide reforms to be addressed adequately.

2.3a Intensive growth – sustainable, innovation-fostering

A debate has emerged about whether China has relied more upon extensive vs. intensive growth over the past two decades. This question depends on the relative contribution of factor accumulation vs. productivity in GDP growth. China's post-1978 development experience has relied on both contributors to important degrees (see appendix), with indications that growth has become more "intensive" – reliant on productivity – as reforms have deepened.

China's R&D intensity has already risen to over one percent of GDP making China not only an important adopter of technology, but increasingly an innovator as well.[10] Such benefits can be seen in many areas, including such rapid improvements in energy efficiency in some sectors that energy utilisation has actually declined despite rapid growth.

[9] See the OECD study *China in the World Economy: The Domestic Policy Challenges* (2002).

[10] OECD's *Science and Technology Scoreboard* for 2003 includes a section on China.

Intensive growth has the particularly advantageous feature that it has less detrimental negative externalities or social consequences and may sustainably improve living standards. Environmental problems in particular have been a source of great concern in China. In some regions there have been reports of environmental degradation severe enough to impede future growth. As a result of these concerns, China's environmental authorities have been working with the OECD to develop improved indicators and monitoring systems, and are now preparing for an environmental policy review.

2.3b Improving domestic integration, creating a common market, increasing competition

China's economic reform programme has been characterised by a process of progressive deregulation, beginning initially in the special economic areas in the eastern coastal provinces. At the same time, a countervailing tendency has also existed where trade and investment barriers between provinces grew, inhibiting inter-provincial competition. This potential balkanisation could be observed at times during the late 1980s and early 1990s as the dual-track pricing system gradually phased out price controls.[11]

Table 5. Most transactions in China are now at market prices (by transaction volume)

	Retail commodities			Agricultural commodities			Producer goods		
Year	Market	State-guided	State-fixed	Market	State-guided	State-fixed	Market	State-guided	State-fixed
1978	**0%**	3%	97%	6%	2%	93%	0%	0%	100%
1985	**34**	19	47	40	23	37			
1991	**69**	10	21	58	20	22	46	18	36
1995	**89**	2	9	79	4	17	78	6	16
1999	**95**	1	4	83	7	9	86	4	10
2001	**96**	1	3	94	3	3	88	3	10

Source: Lardy (2002); China Development Report (2003)

Yet by the late 1990s, the level of regional integration had advanced significantly. This integration has been reinforced by China's ongoing efforts to abide by its WTO commitments. However, monopoly industries continue to dominate in some industries because state-owned enterprises are often favoured by government policy and China lacks an appropriate competition law.

In its ongoing dialogue with China, the OECD has highlighted the importance of passing such a law in order to create an effective market environment. One sign of progress is that regulatory reform has become a priority in several network industries. To support these efforts, a report on railroad reform was published in 2003 and a workshop was held to share the experiences of OECD countries on deregulation in various sectors.

2.3c Adjusting to greater international integration

China's reform process has been driven to a significant degree by its opening to the world economy. While it continues to face enormous domestic reform challenges, it is more open than other emerging markets by many measures. Its openness to trade as a share of GDP is remarkably high, at over 50%, and its tariff levels are now below 10%, in comparison to over 30% percent in India and Brazil. By some accounts, its progress in integrating internationally has been more rapid than its progress in integrating domestically, quite the opposite of the experience of many OECD countries.

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11 See Alwyn Young (2000), "The Razor's Edge: Distortions and Incremental Reform in China," *QJE* 115(4), for more details on the earlier period, and Xu and Voon (2003), "Regional Integration in China," *Economics Letters* 79.

China has also been the recipient of large amounts of foreign direct investment (FDI), attracted to the country's size, rapid growth, and relatively attractive regulatory environment. FDI has been associated with rapid growth of China's imports and exports, in part because much of this trade is intra-firm. These increasing trade linkages have led to substantial degrees of co-variation in key financial variables with its key trading partners, Japan and the U.S., meaning that these economies are increasingly interdependent.

China's Asian neighbours have also been affected substantially by its trade liberalisation. Intra-regional trade has advanced – especially in raw materials, but at the same time, factories and manufacturing has been increasingly shifted to China.[12] Consequently, bilateral trade surpluses between China and several OECD countries have grown.

2.3d Strengthening the environment for private enterprise development

As noted previously, the Chinese economy is increasingly being driven by the growth of the *private* sector, not just non-state firms. The private sector has become the largest source of job creation, despite numerous impediments to growth, especially at the local level. These impediments include difficulty in obtaining finance and insufficient access to appropriately qualified workers. Private firms remain small in scale: their average size was 24 in 2001, although they have grown rapidly since 1996 when they averaged only 6 employees in size.

2.3e Dealing with the financial market – SOE handicap nexus

Financial market development has lagged reforms of the rest of the economy during the reform period. Despite a close correlation between growth and financial market development in most economies, much of China's growth – especially in the non-state sector and fastest-growing provinces – did not rely heavily on the state banking system. The state banking system primarily serves to fund state-owned enterprises, and has contributed to a build-up of non-performing loans (NPLs) to very high levels especially if contingent liabilities are included.[13]

Recapitalisations and major reform of banks and their state-owned enterprise clients will be necessary before the NPL problem can be contained. Some complementary developments appear to be happening on the capital markets, as some state-controlled listed firms are allowing themselves to be taken over by non-state shareholders, and an M&A market may be emerging.

The OECD has been involved in these developments by providing policy recommendations in several areas. These include improving corporate governance of state-owned enterprises and developing sectors needed for effective financial markets, including financial intermediaries and insurance. The first OECD-China policy dialogue on corporate governance was held in early 2004 to discuss the ownership structure and management of state-owned enterprises, board-related issues and enforcement. Ongoing dialogue is focused on the corporate governance of state-owned assets.

2.3f Governmental reform challenges and the rule of law

The OECD study China in the World Economy (2002) identified the insufficient capacity of China's central and regional governments to carry out policy as a key weakness in its reform. In particular, the

[12] A study commissioned by the OECD examined the impact of China's trade liberalisation on its Asian neighbours, and found that the effects on most of its neighbours will be positive, but the Philippines, Malaysia, Thailand and Indonesia will be hurt if they do not improve their regulatory environment.

[13] An OECD study underway on China's expenditure policies has found that substantial contingent liabilities from the financial sector pose a substantial risk to the Chinese economy.

decentralised nature of the fiscal system – that had been credited in the early reform period for motivating reforms in agriculture and within industrial enterprises – had come under increasing strain by the mid-1990s. Local governments increasingly were forced to supplement their budgets with distortionary fees and to reduce public good provision. Adjustments to governance and fiscal/tax systems to deal with some of these problems led to strengthening of central government control at the same time as the overall scale of government was reduced. A closely related systemic challenge has been to strengthen rule of law and enforcement. WTO accession has had a major role in increasing transparency of legal codes, but enforcement of regulations in some areas has lagged, such as with intellectual property rights protection. There is also indication that the Chinese government realises that deficiencies exist in many areas of public governance.

In order to deal with this challenge, the OECD's Governance Project involves most OECD directorates working on China to identify problems and policy options to improve governance on an economy-wide and a sector-specific basis. This work is addressing broad issues like anti-corruption as well as the reform of specific public services and government agencies themselves. This work also addresses governance challenges in essential parts of the economy such as banking regulation and economic statistics.

3 China's economic development strategy

China and OECD member countries have broad agreement on the goal of further integrating China into the world economy by supporting its transition to a market-based economy. Specific priorities differ in some respects.

The current Chinese government development strategy, following the broad outline of the 10th five-year plan, was described in communiqués from the 16th Party Congress in November 2002 and the 10th National People's Congress in March 2003. China's long-term development objective is to build a well-off society in an all-round way (*jiankang xiaokang shehui*). The main implication of this idea is that the focus of policymaking is designed to focus on improving per capita incomes with attention to their distribution and the sustainability of growth.

Current priorities were set out in the Third Plenum Meeting of the Central Committee in November 2003. The major emphasis of future policy is now on "balanced" economic development, between rural and urban areas, across regions (domestically and internationally), and in the social and environmental spheres. A second major theme is to accelerate reform of the financial/banking sector and at the same time strengthen the performance of the state-owned enterprise sector. The third major area is to strengthen the rule of law, most visibly by strengthening private property rights through a constitutional amendment in 2004 (Wen Jiabao, 2003.11.24).

Main issues included in the Third Plenum "decision" are listed below (CCPCC, 2003):

- Accelerate market economic system reforms
- Further restructure state-owned enterprises
- Support the development of the private sector
- Strengthen property rights and facilitate urbanisation
- Deepen financial system management reforms
- Accelerate changes government's role in macroeconomic policy
- Increase trade integration and investment openness
- Create jobs and improve the social welfare system

- Further science and technology, education and health reforms
- Strengthen government administrative reform and strengthen the rule of law
- Modernise party ideology and address corruption

It is to be noted that, for the first time China issued a China-E.U. Policy Paper (mid-2003) which emphasises deepening economic cooperation and trade on a multilateral basis and working together on sustainable development issues to alleviate poverty and protect the environment.

Table 6. GDP growth decomposition

Source	Period	Labour	Capital	Total factor productivity	*Structural reform TFP**
Chow and Li (2002)					
	1978-1998	10%	62%	28%	
IMF (2003)					
	1990-1994	*8%*	*62%*	*26%*	*5%*
	1995-1998	*6%*	*66%*	*20%*	*8%*
Fan et al. (2003)					
	1978-1995	15%	26%	42%	*17%*
Wu and Xu (2002)					
	1979-1997	6%	68%	26%	
	1979-1991	16%	80%	4%	
	1992-1997	0%	62%	38%	
Wu (2003)					
	1982-1997	12%	44%	19%	
	1982-1984	15%	64%	5%	
	1986-1991	6%	62%	15%	
	1992-1997	10%	58%	14%	
Ho and Jorgenson (2002)					
	1981-1995	19%	69%	12%	
	1981-1989	19%	73%	8%	
	1989-1995	19%	64%	18%	
Maddison (1998)					
	1978-1995	70%		*30%*	

Note: TFP - total factor productivity, (*) attributable spec. to structural reallocation

4 Accurately measuring China's economy

A number of observers have questioned the accuracy of China's extraordinary economic growth rates. Just as China's economic system has gone through a dramatic transition from plan to market, China's economic statistics have also gone through a several phases of transition toward international practice. Remaining differences with standard practice have led some observers to discount economic growth figures by as much as 2-3%. Two problems are usually identified. The first is related to price measurement, where output is not appropriately adjusted for inflation. The second is related to inadequate coverage of the service sector. For much of the reform period, the size of the service sector was thought to be underestimated, but to be relatively small and growing slower than the rest of the economy. However, in the past couple of years, there have been increasing suggestions that the situation has reversed and that the service sector is larger than earlier believed and growing faster than the rest of the economy. In fact, a few observers now believe that GDP growth may now be *underestimated* by as much as 2-3%, based on the growth of physical output indicators, implying over 11% growth in 2003!

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