Chapter Eight

CHINA’S MACROECONOMY: EXPANDING DOMESTIC DEMAND AND INTERIM REFORMS

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INTRODUCTION

Currently, Chinese economic performance is characterized by the following trends: (1) the economic downslide has been checked somewhat as a result of governmental macroeconomic policies to expand domestic demand; (2) the strength of governmental fiscal and monetary policies is unprecedented, but the economy is not recovering as quickly as in the past, it is still adjusting with a weak upward tendency; (3) economic growth potential is enormous, but social investment and domestic consumption remain sluggish because of fairly strong structural restrictions. Chinese economic marketization has increased a lot during the more than 20-years of reform, and market mechanisms have increasingly been dominating economic performance, but the sticking point is that the government’s management style and macroeconomic policymaking emphasis have not eliminated traditional government dominance and allowed the transformation into market dominance. At present, Chinese economic development is at a crossroads, where its operating mechanism, growth style, development strategy, and existing structure all need changing and adjusting, and the lag of the economic structure is more and more remarkable. This chapter attempts to illustrate some macroeconomic policies to deal with the current problems and difficulties. It points out that the keys to breaking through the current difficulties and realizing sustainable, stable and sound development are to perfect, reform, and renovate current government policymak-
ing and management system selectively and gradually while continuing to implement short-term macro adjustment.

**Pushing Forward Reform of Market Access, Investment, and Financing Systems, and Creating a Favorable Environment for Social Investment Growth**

The centerpiece of investment and financing system reform is to restructure normal and canonical financing channels, lift some restrictions on market access of private enterprises, and create a favorable structural environment for improving social investment incentives. Quite a few specialists and scholars hold the opinion that structural barriers exist in almost any new economic growth. Outdated management styles, fairly strong administrative monopolies, excessive interference, and irrational fees can be found in infrastructure construction and management when cities are the centers of hi-tech industries, import and export agent business, and other basic and emerging service sectors such as education, medical care, public health, environmental protection, tourism, culture, publishing, network communications, community service, property management, and public transportation. Funds for social support are in short supply. The enormous potential demands in this area can bring about new economic growth. However, the precondition for fulfilling these needs is the government’s determination to push forward financing system reform, break administrative monopolies on market access, improve protection of intellectual property, create an environment favorable to social investment, and shape a policy environment favorable to middle- and small-sized enterprises, social employment, enterprise management innovation, and strategic restructuring.

The first step in such a direction, would be government encouragement to open up pilot credit institutions mainly serving middle- and small-sized enterprises. While strengthening financial supervision and building necessary financial insurance systems, the Chinese government should allow and encourage a proportion of rural foundations, credit cooperatives, and branches of state banks and urban cooperative banks below the county level to be transformed into independent small commercial banks or small trust companies, which can take the form of shareholding systems, shareholding cooperative systems, partnerships or joint ventures, and which could adopt rela-
tively flexible floating interest rates and take business risks independently.

Second, the Chinese government should expand exploration of and experiment with effective financing channels in capital market access for private enterprises. It should also push forward actively and cautiously with equity restructuring of listed companies, lifting some restrictions on acquisition of listed companies, encouraging capable private enterprises or naturalized citizens to make legal acquisitions in capital markets. Further, the government should carry out a complete summary of historical experiences and lessons in local property rights markets, while strengthening supervision and risk control, setting up local pilot capital markets in areas with developed economies and good market conditions, creating necessary conditions for middle- and small-sized enterprises to secure financing in capital markets.

Third, the Chinese government should relax market access restrictions on private enterprises, trying to reduce discrimination and improper interference in establishing, registration, and operation of private enterprises, prohibiting random fees. It should also speed up assigning and expanding private enterprises’ import and export rights and proxy rights, properly reducing assigning qualification standards, and allowing these enterprises to enjoy the same rebate treatment and convenience as state-owned foreign trade companies. While perfecting governmental and social supervision, to break up monopolies, the government should introduce competition, lower costs and improve quality of services, encouraging private enterprises to enter traditional public services, such as real estate management, environment protection, garbage disposal, intermediary financial services, professional training and education, and small town construction.

Fourth, the government should safeguard private enterprises’ legal interests. The new amendments to China’s Constitution and to The Law on Middle- and Small-Sized Enterprises recently in deliberation undoubtedly provide strong legal protection for private enterprises’ development. However, since Chinese private enterprises emerge from discrimination and repelling of traditional systems, the problem of undefined property rights as a result of the “Red-Cap” needs to be addressed. The Chinese government should accept en-
trepreneurs’ deserved interests, including property rights and intellectual property rights. Resolving “left-over historical problems” properly would be of great significance in protecting private enterprises’ incentives, promoting sustainable, stable development of private enterprises. The emphasis should be on trials and judgments in civil actions, justice and effectiveness of law enforcement activities.

And lastly, the government should encourage various industrial associations, research and consultation institutions, and intermediaries to provide comprehensive services to private enterprises, making them the link between government and private enterprises. Governmental support, service and supervision should also be carried out by these institutions. The government should improve its management style via various intermediary institutions and interest groups, weakening state-owned monopolies and introducing property social supervision and competition.

Promoting Stable Growth of Consumption Through Employment and Social Security, and Upgrading the Consumption Structure by Lowering Price Thresholds

Current sluggish consumption demand results from two factors. The first is that unstable revenue expectations deviate from expenditure expectations; the second is that price thresholds for upgrading consumer goods are excessively high (deep-rooted structural factors are behind these problems). Unstable revenue expectations result mostly from employment pressure and expected reform on social security, housing, and education. Affected groups are very extensive. Price thresholds are related to industrial monopoly and excessively high administrative charges. In contrast with market competition lowering prices, monopolistic product and service prices remain high, and groups with high social revenues are usually found in these industries. Thus, promoting stable growth and structural upgrading for consumption should begin with perfecting social security system, expanding employment, and reducing prices of monopolistic products and services. The government should take the following steps to effect such changes:

- Create jobs, providing good market access conditions for unemployed and laid-off workers. Currently in China, in the course of
economic development, rural redundant laborers and state-owned enterprises’ laid-off employees need to be gradually transferred and reemployed. The problem is a kind of reform cost, which is also related to social stability and improving social expectations. The important aspect of governmental employment reform should be placed on vigorously developing middle-and small-sized enterprises and on encouraging communities and individuals to establish small businesses. Meanwhile, the labor market should be developed and perfected, by setting up multilevel professional advisory agencies. Social security and social welfare programs should be separated based on professions and market competition employment systems oriented toward rural industrialization and urbanization. Nondiscriminative labor markets should come into being gradually.

- Accelerate the pace of perfecting social security system with elderly workers in state-owned sectors as the focus. It is an objective of market economies and an important component of system innovation during the course of transition to realize employment mechanisms and social security systems in which professions, social security, and welfare are separated. Recently, various welfare and security reform measures have been adopted because of revenue and employment instability, and the rising prices of medical care, education, and housing. People do not know how to calculate how much personal savings will satisfy a family’s basic needs. This is the major reason behind current residential consumption “deflation” and savings growth. With respect to stabilizing expectations, the emphasis should be on ensuring social security reform in which historical contributions of retirees and some older worker should be recognized and their deserved benefit should be ensured. Living expenses for laid-off workers should be given to them in a timely fashion. The fiscal authorities should provide a floor for social security payments, begin to levy social security taxes, expand social security coverage to all enterprises and institutions, provide stable and reliable funding sources for social security of citizens, and shape a multilevel social security system that includes insurance, relief and welfare benefits.

- Upgrade the consumption structure by promoting competition and reducing administrative fees. Chinese residential consump-
tion of basic durable consumer goods has reached a saturation point; thus the emphasis of expanding consumption should be on cultivating new product trends and upgrading the consumption structure. Current sluggish demand results from high price thresholds. The major reason behind high prices is industrial administrative monopolies and excessive administrative taxes and charges in prices on monopolistic products and services. Houses and cars are believed to be new consumption “hot points,” which can start overall consumption demand and consumption structure upgrading. However, as much as 30–70 percent of current commercial house prices is taxed by the government. The additional charges for a car purchased in China are as much as 25–40 percent of car prices (two times higher than that of a car of the same kind purchased elsewhere). Excessively high price thresholds have restrained purchasing and upgrading for many middle-income families, causing many consumers not to use credit for car and home purchases. In residential consumption hot points, some “structural deflation” of consumption may be unavoidable because of preparatory savings and accumulation by potential buyers. As a result, demand may fall into long-term sluggishness. To expand consumption, in addition to changing housing and consumer credit policies, administrative fees and taxes on housing, cars, and emerging hot points should be cut to lower price thresholds. Also, residential rents should be increased to a reasonable level. In the short run, the main purposes are to improve living conditions and reduce taxes. In the long run, a home investment market will eventually take shape.

- Develop new urban growth. The dual structure dividing the Chinese city and countryside is the basic contradiction impeding economic development. It is impossible to improve agricultural efficiency and realize agricultural industrialization and marketization if the majority of the rural population remains unchanged. Experience has shown that the rapid transformation of middle- and small-sized towns into developed areas is a vigorous new economic growth point. To gain the full benefit from middle- and small-sized towns, guidelines for urbanization should be made clear: emphasis should be placed on construction in middle- and small-sized towns near big and mid-sized cities and near developed regions. Such an effort requires not only coordination among fiscal, financial, household registry, and land
management systems and infrastructure construction, but also examination of specific local conditions.

**Speeding up the Shift of Governmental Functions, and Perfecting Macro Policymaking and a Macro Control System**

The remarkable structural contradiction in current Chinese economic performance is the following: provincial and ministerial segmentation administrative management is in conflict with the operating mechanism of economic marketization. The interweaving of power and markets destroys market order and constricts market vigor; efforts at macro control are still limited to administrative measures only oriented toward the state-owned economy itself, not the society as a whole. Thus, acceleration of governmental administrative reform is not only the key to sustainable, stable, and healthy economic development, but also the central link of economic system’s transition to a market economy.

To begin, the government should reaffirm the principles of “government controlling markets and markets guiding enterprises” put forward in the 13th Party Congress. The division between government and markets should be clearly defined. The shift of government functions should be speeded up. Based on the actual progress of economic marketization, the government should retreat from areas in which governmental interference is improper, and increase its presence where market power does not function well. The main purposes of governmental function shifting is to promote and perfect market mechanisms, reduce the government’s direct administrative interference in the microeconomy, and to transfer some government functions to enterprises, and market and social intermediaries. Regarding the establishment and perfecting of market rules, while attaching importance to supervision of market players’ behavior, more emphasis should be put on maintaining equal rights among market players, strengthening contractual relationships, and promoting market competition. Regarding the perfection of a macro control system, control capability should be strengthened, adequate and reliable public goods should be provided, and a favorable environment for economic development should be created. For example, the Shenzhen Municipal government on its own initiative discontinued many of its outdated examination and approval rights
processes, and in doing so provided a good example for the whole country.

In addition, it is necessary to plot out the rational duties for each level of government, forming a highly efficient administrative management system with balanced obligations and rights. Government functions and budgetary expenditures at every level under market economy terms need to be defined. Overlapping of duties among government levels should be eliminated. On this basis, taxes, fees, and expenditures of every level of government should be standardized into a regular transfer payment system to offset necessary local expenditure shortfalls and to ease imbalances among various localities. The law and legal procedures should be defined clearly so that governmental decisionmaking can be more democratic and scientific, and legal, media and social oversight of government should be strengthened. A government responsibility system consistent with government functions should be established and perfected to coordinate government obligations, rights, interests, and available resources. Regular systems should be developed for examinations of and recruitment for civil servants, with hiring, firing, review, and promotion procedures. Civil servants’ salary levels should be increased to optimize stimulation of government work and improve governmental efficiency. Overall, government should be streamlined, cutting out redundant positions and generally building an honest and clean system of government.

Furthermore, fiscal reforms should be deepened. Taxes and fees should be adjusted. Specifically, production VAT (value-added tax) should be changed into consumption VAT as quickly as possible. Tax policies should be adjusted. In particular, the restrictive taxes and charges in response to an “overheated” economy should be removed—such as the adjustment tax on fixed asset investment and the high level of “three-inspection” charges that are unfavorable to exports. Without increasing the overall social tax burden, the government should define a fiscal revenue level consistent with governmental functions by reducing large-scale charges outside of the budget and clearing up auxiliary banking activities of provincial governments. All these measures will result in greater transparency of fiscal expenditures and higher control capabilities of fiscal policies of the central government. Financial system reform should be pushed forward in a stable way, and the role and function of the central bank
should be strengthened. While the central bank is relatively independent in making and implementing monetary policies, a supervision mechanism by which the People’s Congress and its standing committee supervises the central bank should be established. Meanwhile, a financial market system should be completed, including marketization of state-owned commercial banks and interest rates that conform with the market. Monetary and capital markets should be developed and perfected. Monetary policy means and policy instruments should be diversified, shaping a pattern so that the central bank employs a cash reserve ratio, rediscount rate, and open market business to control economic performance effectively.

**Unswerving Continuation of Expanding the Effort to Open Trade**

The opening-up effort must be continued unswervingly while implementing a macro policy for expanding domestic demand. Practice has shown that the open trade policy brings capital, technology and new consumption perceptions to China, promoting Chinese economic integration with the world economy, which is of great importance in promoting marketization of the Chinese economy and in improving economic performance.

The role of international capital and technology in renovating traditional industries is a key to opening trade. Since reform and the open trade policy was adopted, China’s light manufacturing industry, which makes, for example, household electrical appliances, and the telecommunications industry have developed rapidly in recent years. The international competitive power of these industries has risen, showing a broad prospect for renovating domestic industries with international capital and technology. China should grab the favorable opportunity available now that the world economy is facing major restructuring. It should create conditions to attract foreign capital for domestic traditional industrial renovations. With the
gradual surfacing of policy effects of expanding domestic demand, a relatively high economic growth rate will provide strong appeal for foreign capital's entry into China. Progress in this respect rests not only on such elements as good infrastructure but also on the legal system, market access, and fair competition.

Domestic enterprises should be encouraged to participate in international competition. Participating in international competition is an important way for domestic enterprises to gain technological innovations. At present, the emphasis should be on providing necessary policy environment and simple and high-quality services to domestic private enterprises. Meanwhile, the mutual open trade between Guandong province and Hongkong, and between Fujian province and Taiwan, is bringing about faster circulation of personnel, capital, technology and products, pushing mutual complementary relations between these regional economies to a new level.

Greater efforts should be made to enter the WTO. Although the current domestic and international situation leaves prospects for China’s entry into WTO uncertain, the resolution to enter the WTO should not be shaken. Economic globalization is the major tendency of world economy. China will only lag far behind developed countries if isolated. Entry into the WTO is favorable not only to bettering China’s foreign trade environment, but also for China’s gaining insights about its shortcomings and the common rules of international trade, in addition to avoiding risks in international economic activities. The short-term shock to some domestic industries is not always negative. In fact, it is because of long-time protection that some industries continue to need protection. The automobile industry is a case in point. However, preparatory countermeasures are necessary in every sector.

**Improving the Legal Basis of the Market Economy While Perfecting the Socialist Property and Credit Systems**

The basis of a successful market economy system lies in an equal rights contractual relationship among market players safeguarded by complete legal and strict law enforcement systems. Legal systems should fit the basic framework of a market economy system and should be a driving force behind overall systematic innovation.
Efforts should be directed toward obvious problems in reform practices and current economic relations, formulating and perfecting relevant laws selectively and gradually. The principles behind legislation should aim to safeguard equal and legitimate rights of market players and to maintain a good market order as follows:

- While abiding by China’s Constitution’s stipulations for all kinds of ownership, China should effectively protect citizen’s legal property, ensuring that all kinds of property rights are enjoyed equally in market transactions. Clauses in laws and regulations that go against basic principles of the constitution should be deleted; discrimination and violation of rights in law enforcement should be banned.

- The general rules of the civil code should be revised to protect potential litigant’s legal rights and interests, to respect wills and similar codicils, and to provide a legal basis and rules for administrative policymaking and management. The civil code should also prevent too much administrative interference into the normal lives of ordinary citizens.

- Laws and regulations unsuitable for realistic economic relations should be revising and/or repealed. “Ministerial legislation” should be restricted, and contractual, credit, and property relationships in market economy conditions should be standardized. The judicial system should be reformed be removing local protectionism in jurisdiction and enforcement.

- Judicial supervision should be strengthened. Respecting legislative contradictions and problems in judicial practices, the following measures should be taken: revising and perfecting relevant laws according to legal procedure, perfecting open trial system; punishing those who bend the law to help their friends or relatives; and improving quality of law enforcement and officers.

CONCLUSIONS

The major problem in current economic performance is the structural contradiction that needs to be resolved by the Chinese government through conforming to reality and the requirements of economic marketization. Such conforming requires not only middle-
and long-term strategic planning, but also searching for transitional points. Presently, the transitional plan is to adjust corresponding policies and push forward relevant reforms with expansion of domestic demand and new economic growth at the center. These policies and reform measures must be effective in the short run, rational in the middle run, and favorable in the long run. At first, the major effort should be to avoid chaotic policy objectives that might cause serious contradictions for middle- and long-term development because of shortsighted policies.
COMMENTS ON XIAOMIN SHI’S CHAPTER

Alice Young

Xiaomin Shi’s chapter conveys both the progress China has made over the past 20 years and the problems China faces in transitioning from a state economy to more of a market economy. He has made a number of excellent suggestions to reform government policy “selectively and gradually,” such as stimulation of mid-sized and small enterprises through new credit and the capital markets, regional decentralization and encouragement of pilot projects, market access, and privatization of services. These are all important steps that should be taken, but I have several concerns.

First of all, it was difficult to ascertain how his “selected” suggestions differ in any major respect from the espoused Deng Xiaoping/Zhu Rongji policies of the Chinese government. The stimulation of mid-sized enterprises, regional decentralization, and the encouragement of experimental pilot projects have all already been described in various Chinese government directives.

Second, all of his suggestions first require the strengthening of financial oversight, risk management expertise, and judicial enforcement, none of which are readily available in China at the present time. The shift contemplated by the author is not only government to market control, but central to provincial control. Beijing is far away, as the famous Chinese proverb says, and although decentralization can better promote local economic growth, local institutions are inexperienced in risk management and capital markets, which are necessary ingredients for successful financial supervision and privatization. Although decentralization provides greater local flexibility, it can also result in local protectionism and restraints on capital flow movement from province to province. It was primarily through central government control that investment incentives could be shifted from the coastal economic trade zones to the interior zones to stimulate economic development in those less prosperous areas. Moreover, getting rid of the local protectionism that usually accompanies decentralization, and strengthening judicial supervision to ensure fairness, is viable if and only if the quality of law enforcers improves. It should be noted that 66 percent of the judges in China
have no legal background whatsoever and are in fact mostly former
Peoples’ Liberation Army cadres.

Third, his recommendations do not appear to address Nicholas
Lardy’s concerns stated in his report to the Aspen Institute
Congressional Forum in 1999, namely:

- the state-owned enterprises’ (SOEs) oversupply of unsaleable
  products
- the overexposure of the government-owned banks to SOE debt
- the inadequacy of tax revenues to finance government expendi-
  tures for these reforms

For example, the author emphasizes creating employment opportu-
unities for mid-sized, small private enterprises as a means of stimulat-
ing the economy, but he fails even to mention the elephant in the
room—interim reform must also deal with the SOEs and the insol-
vent banking industry. Mid-sized and small private enterprises can-
not begin to replace the previous government-subsidized SOE social
insurance safety net, which provided medical and pension benefits
to most of the working population. Moreover, the problems of the
SOEs are exacerbated by the rapidly aging population, the one-child
policy, increased longevity, lack of funded social insurance plans,
and finally poor returns because of government restrictions and lack
of asset management and risk management skills.

It should be noted that the author’s proposal to reduce discrimina-
tion against private enterprises means not only the discrimination
between SOEs and private enterprises, but also between foreign and
domestic businesses, which China’s entry to the WTO will in any case
force it to address. Safeguarding private enterprises’ legal interests is
vitally important, but the key to a market economy in my mind is
consistency, transparency, fairness, and evenhanded enforcement,
whether it be private enterprises, SOEs or foreign enterprises.

Finally, in the interim period, must all measures by necessity be ad
hoc? As a pragmatic lawyer rather than an economist, I would have
preferred that Xiaomin Shi’s chapter propose guidelines that attempt
to create a balance between government control and market domi-
nance, central control and localization, private enterprise stimula-
tion and SOE reform, and to address unemployment and the bad
debt of the banks.

Having said that, from my 20 years of transactional work in China,
and if we take the long-term view of 5,000 years of Chinese history,
the author’s modest interim reform approach may have ample time
to be further refined and implemented.