

The Direction of China's Economic Reform

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Ladies and Gentlemen,

It is a great pleasure to be here, in the beautiful city of Melbourne, to exchange views and research findings on the world economy and financial issues with experts, scholars and friends of all fields present at this conference. I would like to take this opportunity to thank La Trobe University, the organizer of the 14th Global Finance Conference, and especially Professor Gordon R Walker, for inviting me to deliver this keynote address on economic reform in China.

I. Why does China's economic reform attract such worldwide attention?

A quarter of a century has passed since China's reform started. Reform and opening up as well as economic restructuring have brought about some major changes in China's politics, society and culture - not only people's mentality and mode of conduct have changed, but also their outlook of the

world and the way they interact with the outside world. With rapid economic development, China takes on a new look and Chinese people are more optimistic and confident than ever before. With its entry into the WTO, China has been an inseparable part of the world economy, abiding by international law and code of conduct, becoming a responsible member in the international community.

Unprecedented is this huge and deep reform, which not only brings Chinese people a wealthier life and more freedom, but also facilitates the world economy. Many countries, especially China's neighbors like Australia, have all benefited from China's economic take-off.

Let me first provide you some figures to illustrate the changes in China.

From 1978 to 2006, China's GDP rose from ¥362.4 billion to ¥20 trillion, an annual growth of over 9.4%; total foreign trade volume increased from US \$ 20.6 billion to US \$ 1.7607 trillion; and foreign exchange reserve grew from US\$167 million to US\$1.0663 trillion. Infrastructure, such as railway, transportation and power has been greatly improved. Currently, China's GDP ranks the 5th in the world, total trade volume the 3rd, FDI the 2nd, and foreign exchange reserve the largest in the

world.

Statistics from the World Bank indicate that from 1978 to 2003, China's poverty-stricken population decreased from 640 million to 220 million, and the poverty rate from 64% to 16%. According to statistics from the Chinese government, 250 million Chinese were living below the poverty line in 1978, and that figure dropped to 30 million in 2003. China's private savings amounted to ¥16 trillion (or approximately US \$ 2 trillion), with per capita savings over ¥10,000.

Not long ago, the U.S. Treasury Secretary, Mr. Henry Paulson pointed out that "China has become the leader in the world economy taking into account its economic size and its status in the world market. This leading position brings about responsibilities, since China's economic decisions and policies on energy and environment will all impact upon the world."

Thus, changes in China including its future reform direction have received worldwide attention.

II. External and internal factors for China to push forward economic reforms

We have noticed that, accompanying China's rapid economic growth and increasing wealth is the ever more serious

imbalance in development. The old model of economic development, which is based on heavy consumption, low efficiency and export-and-processing-driven economic development, has been increasingly questioned by the public.

There are some rather serious problems.

First, there is a widening gap on economic development and living standard among different regions, especially between coastal areas and western regions. The gap is also widening in the development of different sectors, and so is the income gap even in the same region.

Secondly, the living standard of the Chinese farmers, though accounting for 70% of the total population, improves slowly and the wealth gap between them and the urban population is still widening. The traditional mode of agricultural production cannot address the fundamental causes and thus has failed to increase farmers' income. In most places of China, farmers' medical and pension insurance are still individuals' or their families' responsibility, and inequality to receive primary and higher education still exists. Therefore, Farmers and low-income classes have received only limited benefits from the reform.

Thirdly, the extensive mode of economic development,

which is based on heavy energy consumption and severe pollution, not only damages the environment in some regions, worsening the shortage of energy and resources, but also indirectly pushes up global prices of raw materials and energy, intensifying the competition among major economies of the world for energy and raw materials.

Fourthly, China's export- and processing-oriented mode of economic development has mitigated the pressure on domestic employment to some extent, and has benefited consumers in the world. However, it has also led to trade disputes and made China the target of criticism. China's increasing trade surplus has become a prominent issue that need to be addressed urgently.

In recent years, there have been heated debates in China's academic circles on the direction of our economic reform due to the widening gap among regions and increasing social inequality. For the same reason, people start to think whether the old mode of economic development can guarantee a sustainable development of our economy and society.

Our leaders have realized that institutional problems constraining a sound economic development have not been thoroughly resolved, and some even getting worse. The

inadequate reform and imperfect institutions have led to many problems in economic and social development. To solve these problems requires further reforms and institutional innovation. Going back to the old mode of planned economy is not an alternative, and it cannot win the support of the majority of the people, either. However, without addressing these problems, especially making efforts to address the imbalance in regional development as well as the widening gap between the rich and the poor, the social foundation for China's economic reform would be shaky. The intensified social tension will result in more difficulties in reform and thus a higher price to be paid.

To correct mistakes in development and for the sake of social justice and equity, the Chinese government, in recent years, has gradually worked out a direction for future reform and for promoting a new mode of economic and social development.

III. Objectives and tasks of China's economic reform

A considerable number of Chinese scholars believe that China is entering a critical era where rapid development and problems coexist in its economic and social development. To develop China's economy in a sound and stable manner, we

must deal with the following:

First, our focus should be gradually shifted from the pursuit of economic growth and pure development speed to quality economic growth and sustainable development.

Second, efforts should be made to strike a balance between economic growth and social development, to establish a society centered on people's well-being with commitment to social equality and a harmonious social development.

Third, we shall build a resource-saving society, strive for a balance between the nature and human society, and realize an ecologically sustainable development.

Fourth, we shall focus on developing the services industry, expanding domestic demand and establishing a consumer society step by step.

Fifth, we shall deepen market-oriented economic reforms, shift the role of the government, reduce its direct intervention in the economy, strengthen the protection of private property and push forward the development of the non-public sector.

The year 2006 witnessed a 10.7% GDP growth rate in China, as well an increase of 27.2% in its foreign trade. Some scholars from abroad have estimated that China's GDP will keep on growing by 9.7% or 10% in the year 2007 as well. For China,

it is necessary to maintain a reasonable high economic growth when facing with great pressures from a large population and job market. But behind the long-term high-speed growth, some long-standing structural problems are looming:

First, China's high economic growth, to some extent, is the result of huge government investment. Many local officials and leaders often "create" high GDP growth by making enormous amount of investment, only for their personal pursuit of immediate administrative performance. This can also explain why the Central Government's efforts to bring the over-heated local investment under control have ended up in failures.

Second, overinvestment has caused duplication and repetition and massive waste of resources, and high input with low yield as well as massive damage to the environment. China's limited resources and energy supply cannot sustain that mode of growth for long.

Third, slow improvement of economic quality, dominant low-end product structure and small percentage of high-value added products; the overall technological level is low and companies lack innovative capability; Chinese companies, generally speaking, are small-scaled and scattered widely with weak competitiveness.

Fourth, while China's manufacturing and processing industries are developing rapidly, its service industries, in particular such high value-added industries as finance, insurance, logistics and hi-tech industries like software design, are growing sluggishly and remain less open to the international community. Perhaps China could not avoid becoming the World Factory and processing factory from the perspective of world economic development and the law of international labor division, but this choice has imposed a heavy burden on China's environment, consuming enormous amount of resources on the one hand and on the other hand, it will probably delay China's industrial upgrading and technological innovation.

Considering that China is a country with severe shortage of arable land, fresh water, energy and critical minerals, this mode of economic growth can not sustain in the long run. Against this background, Chinese leaders have adopted a "new approach to development" and advocated a sustainable economic growth, demonstrating their reflection and correction on the existing mode of economic development.

Part of the new mode of economic growth is the adjustment of social relationships. The imbalance in social development, the widening gap between the rich and the poor, as well as the

increasing marginalization of the vulnerable groups have become prominent in China, drawing great attention from the society. In fact, as China's overall economic strength is growing, the Chinese government and Chinese society as a whole have more resources and tools to adjust social relationships. As an objective of the administrative reform, governments at all levels will turn to social management and provide public services. By reforming tax and income distribution systems, we will be adjusting the income distribution and realizing the "redistribution" so as to moderate and even narrow the rich-poor divide. To let the majority share the fruits of the reform and establish a society where people are the priority and the social relationships are harmonious, the Chinese government should create conditions to expand the social security system, which includes the old-age insurance, the healthcare system and the unemployment insurance, from urban areas to rural areas. Statistics show that only 1/10 or 1/5 of the Chinese population have been covered by the three insurance systems. Considering that eight hundred million Chinese people are living in the rural areas, the biggest problem, also the one most difficult to deal with, is how to raise farmers' living standard and guarantee their basic rights.

The Chinese government will, in terms of institutions and mechanisms, clear the obstacles curbing the increase of farmers' income, the development of agriculture and the progresses in the rural areas. The dual economic structure should be broken down by allocating labor resources, land resources, capital resources and other resources in a more extensive manner, and by facilitating the development of small and medium business and the non-public sectors. Through legislation and other means, our government has also strengthened the protection for disadvantaged groups, especially farmers and migrant workers.

It will be an important task for China's future economic reform to strike a balance between economic development and social development

The key to China's economic reform is to let the market play a fundamental role in resource allocation. That is to say, we need to further market-oriented reform, on which we have already made some progresses. However, there is a serious problem of monopoly and lack of competition in many important sectors, especially in large-scaled SOEs. Indeed, China encourages the development of private sectors and diverse forms of ownership. For instance, the recently-adopted *Law on Rights in rem* by the National People's Congress has

enhanced the protection for private property. However, in reality, many non-SOEs still cannot enjoy the same treatment as that of the SOEs. For example, it is very difficult for many private businesses to get loans from the state-owned commercial banks.

In 2006, China's SOEs made a profit of ¥700-800 billion. It is said that half of the profits is from monopolized industries such as petroleum and petro-chemical industry. But many SOEs, though not efficient, vigorous or competitive in the market, possess lots of public resources. Things have become better after China's entry into the WTO, especially in those sectors which have been opened to foreign capital. China's SOEs have enhanced their market competitiveness through restructuring. Nevertheless, generally speaking, China's SOEs still have a long way to go in reform and restructuring.

As I mentioned, China's export-oriented economy is facing a bottleneck to develop. China's export dependency has increased from 23% 10 years ago to 43%, even higher than the 35% of Japan. To achieve a sustainable and stable growth in China's economy and to reduce trade dispute with foreign countries, we must expand our domestic demand, open up the potential domestic market, fully develop the modern services industries, and gradually set up a consumption-driven society.

According to some foreign scholars, private consumption in China only accounts for 35% of the total GDP, half of that in the U.S., and is the lowest on the list of major economies. By contrast, China's saving rate scores 47%, the highest among major economies. This can be explained by many factors. On the one hand, due to our history and tradition, Chinese people like to save for unexpected events. On the other hand, people restrain their consumption because of the absence of a sound social insurance system such as pension and medicare, and parents need to invest a lot of money in their children's education.

Furthermore, there is a huge wealth gap in China. The consumption demand of the haves and the wealthy white-collar class has been answered, while the vast majority of farmers and the low-income urban citizens have rather limited purchasing power. To solve this problem, we need to, first of all, address people's concern by increasing the income of the poverty-stricken population and set up a sound social security system. This is, however, a tough job for any government.

To sum up, it should be an important target of the Chinese government to regain economic balance by stimulating the domestic demand through consumption when making its

economic policy.

Thank you for your attention!