China’s Transition to the Market: Status and Challenges

by

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China’s transition to the market has been astoundingly successful, the more so as its reforms, though far-reaching, are incomplete in many important dimensions. After a quarter century of dismantling its command economy to rely more on markets, China has vaulted into the front ranks of the world’s rapidly growing economies. Chinese nominal GDP reached one and a quarter trillion US dollars in 2002, and grew more than nine percent to $1.41 trillion in 2003, when per capita GDP for China’s 1.3 billion people exceeded US$1,000. It was only $206 in 1980. Concurrently, the share of GDP originating in primary industry has fallen from 30 percent in 1980 to 15 percent in 2002, with the shares originating in secondary and tertiary industry rising from 49 percent to 51 percent and from 21 percent to 34 percent, respectively (China Statistical Yearbook 2003).  

International trade has expanded even faster than the economy, with merchandise exports and imports together growing by 37 percent to reach $851 billion in 2003, following growth of almost 22 percent in 2002. China’s stellar trade performance impresses all the more given the comparatively slow growth in the major western economies in 2002-03. Measured by the share in GDP of total merchandise trade, integration with the international economy has progressed rapidly, from only 14 percent in 1980, to 32 percent in 1990 and 60 percent in 2003. At the same time, the composition of merchandise trade has shifted sharply from primary products towards manufactures, which were half of exports (two-thirds of imports) in 1980 but nine-tenths of exports (four-fifths of imports) in 2000. During the period, petroleum changed from a major earner of foreign exchange to a substantial net import.

China reported that foreign direct investment surpassed $50 billion in both 2002 and 2003, and foreign exchange reserves stood at $403 billion at end-December 2003, notwithstanding the transfer of $45 billion, via an intermediary company, to augment the capital of the Bank of China (BOC) and the China Construction Bank (CCB). The continuation of massive capital inflows and reserve accumulation throughout 2003 and into 2004 has begun to present the government with some challenges in its monetary and exchange rate management.

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1 Appendix 1 provides some indicators of Chinese economic performance mainly from official Chinese sources.
More than two-thirds of Chinese GDP now originates in the broadly defined private (non-state) sector, which predominates even more as a source of jobs. With agriculture diminishing in importance, most new jobs are in the service sector. Moreover, the progress since the mid-1990s in restructuring mainly small- and medium-sized state-owned enterprises (SOEs), and in many cases transferring their ownership to private firms, is remarkable (IFC 2003). By the end of 2001, “about 80 percent of SOEs had undergone some form of gaizhi …, and 70 percent of the gaizhi cases involved the transfer of ownership from the state to private owners.”2 After a slow beginning, the doctrine of “retaining the large and letting go the small” has gained momentum: the central government intends to maintain its ownership and control of a thousand or so of the largest SOEs, while allowing the others to pass to the control of lower-level governments or private interests.3

Undoubtedly, progress in gaizhi has been accelerated by the increasing official recognition given to the essential role of the private sector in sustaining China’s rapid growth, as exemplified in two speeches by former President and Party Secretary, Jiang Zemin: in the first speech he welcomed private entrepreneurs to party membership,4 and in the second he stressed the importance of the non-state sector in “promoting economic growth, creating jobs, and invigorating markets.”5 Although the transformation of the enterprise system is not free from problems, its speed underlines the truth that, in China, gradual doesn’t mean slow.

Many western observers insufficiently appreciate the sustained quality of Chinese economic management in the past decade, and the evidence of overheating early in 2004 seems sure to test it again. Since introducing measures to contain the inflationary cycle that peaked in 1992-93 (when growth reached 14.2 percent and 13.5 percent in consecutive years, with accompanying inflation exceeding 24 percent in 1994), the government has been able to maintain growth of 7-10 percent a year in 1996-2003 with low inflation (the consumer price index in 2003 was the same as in 1998), despite the severe regional disturbances associated with the East Asian currency and financial

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2 Gaizhi means literally “changing the system.”
3 About forty percent of China’s SOEs were privatized in 1996-2001 according to Yao and Song (2003).
4 Speech of Jiang Zemin, General Secretary of the Central Committee of the Communist Party of China (CPC), at the Meeting celebrating the Eightieth Anniversary of the Founding of the CPC, July 1, 2001.
problems in 1997-98, and the disruption caused by the SARS epidemic in the first half of 2003. Growth seems set to exceed eight percent once again in 2004; it was above nine percent in the first half, and the Government has taken steps to moderate investment expenditure.

China’s fine economic performance has been accomplished against a backdrop of continuing but still incomplete reform. Since the blueprint for a “socialist market economy” was announced in November 1993, considerable progress has been made on an ambitious agenda for economic reform, but much is left to do in improving the performance of state enterprises, and in reforming the financial system and the social safety net. Even where positive steps have been taken (restoring the health of the public finances, improving the framework for the conduct of monetary policy, freeing markets), further reforms are needed. Moreover, the adjustments necessitated by the commitments for accession to the World Trade Organization (WTO) emphasize that Chinese reform is very much an ongoing process.

The Objective of this Paper

In this paper we consider the extent to which China's markets now function effectively as China continues to reform its economy, and in particular implements the conditions for its entry into the WTO. We take a broad brush view of the evolution of markets, and investigate conditions in selected markets for goods, services, and factors of production. Our conclusions, presented in a highly aggregated way, concern themselves with broad classifications of goods, services and factors. More specifically, we consider developments in the markets for agricultural goods, industrial goods, retailing services, labor, credit, stocks, bonds, and land. We observe that China has benefited greatly from its experiments with markets and has largely succeeded in eliminating administered pricing. China relies on the forces of supply and demand to determine prices to varying degrees: predominantly in the goods markets, considerably in the markets for services, and partially in the markets for factors of production.

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Much remains to be done, however, to improve the efficiency of China’s markets. Some policies, laws, regulations and rules still need amendment and many of them need to be implemented more consistently, with less scope for regional discretion. Market-supporting institutions, especially the legal system, also need to perform much better. The continuing priorities for China’s governments are to eliminate barriers to the greater integration of the domestic markets, to encourage foreign participation in the Chinese economy and closer ties with global markets, to supply better information about economic conditions to all market participants, and to continue to experiment by introducing complementary markets and market supporting services.

I. Liberalizing Chinese Markets

The strategy of improving economic incentives by allowing prices to be determined in progressively freer markets has been at the heart of 25 years of Chinese reforms. During the period, China has made steady progress in freeing domestic markets, so that prices are now much more closely aligned with economic costs. Similar progress has been made in reducing the barriers to trade, so that Chinese domestic prices are increasingly better aligned with international prices. One result has been significant efficiency gains in China’s use of resources, thereby spurring growth. Of the former centrally planned economies, China can claim to have been among the most successful in transitioning from a centrally planned to a predominantly market economy. Although China retains the formal mechanisms of the central plan, the current (Tenth) Five-Year Plan (2001-2005) is only indicative, not mandatory. And, with some exceptions noted below, the rate of interest and the exchange rate are the only prices that are still administratively determined on the margin, though lending rates, in particular, now convey flexibility to banks within quite wide bands around the official rate. Significantly, what was in former times the State Planning Commission is, since March 2003, the State Development and Reform Commission.

Pomfret (2002) provides an assessment of how countries making the transition from central planning have fared in their efforts to establish market economies.
**How did China make the Transition?**

Under central planning, enterprises and households are assigned rights to and obligations for fixed quantities of commodities at fixed prices. Rights and obligations are specific to individual enterprises and households, and there are governmental sanctions if they fail to fulfill their obligations. In converting its planned economy to a market economy, China faced two principal challenges: the replacement of (i) administrative allocation by market allocation, and (ii) administered prices by market prices. The ease with which those requirements can be stated contrasts starkly with the complexity of implementing them in a country as big as China.\(^8\)

The Chinese solution was the ingenious “dual-track” approach, under which two mechanisms were phased in to allocate each product. The “plan track”— the pre-existing central plan -- remained, and its rights and obligations continued to be enforced by the government. At the same time, a “market track” was introduced for output above the planned amounts. On the margin, all markets were immediately open, with prices determined by supply and demand. Under the dual-track system, producers were given autonomy and incentives to determine their production and participate in the market, provided their obligations under the plan were fulfilled. Consumers were completely free to determine their consumption and participate in the market, given allocated consumption goods and fulfillment of labor obligations.

Changes on the margin allowed incentives to respond to prices that align with economic costs, without excessive dislocation or damage to those unable to take advantage of the new arrangements. The profits and losses (and taxes and subsidies) of enterprises under the central plan remained the same before and after the initiation of the dual-track reform. Continued planned deliveries of consumer goods enabled authorities to maintain the pre-reform standard of living as a floor. At the same time, differences between plan and market prices made lump-sum transfers feasible, creating scope to compensate people disadvantaged by reforms. No one was worse off, producers and consumers enjoyed autonomy and incentive on the margin, beneficiaries of the process.

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\(^8\) For an accessible discussion of China’s planned economy, see Chapter 2 in Gregory C. Chow’s *China’s Economic Transformation*, 2002, Blackwell Publishers, Malden, Massachusetts.
supported further reform, and potential opponents were bought off, thus minimizing opposition.9

Tables 1-3 illustrate selectively the progress through 2001 of the dual-track approach. In the broadly defined markets for agricultural goods, industrial goods, and retail sales, the plan-track was phased out quickly. When reform began in 1978, the shares of output value sold at market prices rose from close to zero to 88 percent, 81 percent and 94 percent, respectively, by 1993. They continued to rise to 94 percent, 88 percent and 96 percent, respectively, by 2001. Taking a guarded view of developments, one can summarize the experience as one of rapid conversion to market pricing through 1993, with only slow progress (and even regress in the inflationary period 1993-95) thereafter. Although broad classes of markets are essentially free to set prices according to supply and demand, small but persistent elements of planned pricing continue in the new century.

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<thead>
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</tr>
</thead>
<tbody>
<tr>
<td>Plan price</td>
<td>94.4</td>
<td>37.0</td>
<td>24.0</td>
<td>22.2</td>
<td>10.4</td>
<td>17.0</td>
<td>9.1</td>
<td>6.7</td>
<td>2.7</td>
</tr>
<tr>
<td>Guide price</td>
<td>0.0</td>
<td>23.0</td>
<td>19.0</td>
<td>22.2</td>
<td>2.1</td>
<td>7.1</td>
<td>4.4</td>
<td>2.9</td>
<td>3.4</td>
</tr>
<tr>
<td>Market price</td>
<td>5.6</td>
<td>40.0</td>
<td>57.0</td>
<td>57.8</td>
<td>87.5</td>
<td>78.6</td>
<td>83.8</td>
<td>90.4</td>
<td>93.9</td>
</tr>
</tbody>
</table>

Source: *Price Yearbook of China (various years)*
Note: "Guide prices" are government-administered prices, but with reference to market supply and demand

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Table 2: Phasing Out the Dual-Track, Industrial Goods
(percent of output value, selected years)

<table>
<thead>
<tr>
<th></th>
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<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Plan price</td>
<td>100.0</td>
<td>64.0</td>
<td>44.6</td>
<td>13.8</td>
<td>15.6</td>
<td>9.6</td>
<td>9.6</td>
<td>9.5</td>
</tr>
<tr>
<td>Guide price</td>
<td>0.0</td>
<td>23.0</td>
<td>19.0</td>
<td>5.1</td>
<td>6.5</td>
<td>4.4</td>
<td>4.8</td>
<td>2.9</td>
</tr>
<tr>
<td>Market price</td>
<td>0.0</td>
<td>13.0</td>
<td>36.4</td>
<td>81.1</td>
<td>77.9</td>
<td>86.0</td>
<td>85.6</td>
<td>87.6</td>
</tr>
</tbody>
</table>

Source: *Price Yearbook of China (various years)*
Note: "Guide prices" are government-administered prices, but with reference to market supply and demand

Table 3: Phasing Out the Dual-Track, Total Retail Sales
(percent of output value, selected years)

<table>
<thead>
<tr>
<th></th>
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<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Plan price</td>
<td>97.0</td>
<td>47.0</td>
<td>28.9</td>
<td>30.0</td>
<td>4.8</td>
<td>8.8</td>
<td>4.1</td>
<td>3.7</td>
<td>2.7</td>
</tr>
<tr>
<td>Guide price</td>
<td>0.0</td>
<td>19.0</td>
<td>21.8</td>
<td>25.0</td>
<td>1.4</td>
<td>2.4</td>
<td>1.2</td>
<td>1.5</td>
<td>1.3</td>
</tr>
<tr>
<td>Market price</td>
<td>3.0</td>
<td>34.0</td>
<td>49.3</td>
<td>45.0</td>
<td>93.8</td>
<td>88.8</td>
<td>94.7</td>
<td>94.8</td>
<td>96.0</td>
</tr>
</tbody>
</table>

Source: *Price Yearbook of China (various years)*
Note: "Guide prices" are government-administered prices, but with reference to market supply and demand

The government also maintained its influence over the grain market during the reform period. In 1978, state procurement – all at plan-determined prices – accounted for 16 percent of a domestic grain production of 305 million tons. By 1987-88, total annual production had risen to about 400 million tons of which the state procured 24 percent, albeit with only 13 percent procured at plan-determined prices. By 1995, grain production increased to 470 million tons, of which state procurement accounted for 20 percent, evenly split between the quota (procured at approximately 60 percent of the free market price) and negotiated purchases (procured at approximately 90 percent of market price). Only 30 percent of total production was marketed outside the village of origin, meaning that government grain enterprises were procuring an astonishing 65 percent of grain output sold outside the village of its production (World Bank 1997). In 2002, grain production was 457 million tons,\(^\text{10}\) but Minister Ma Kai, of the State Development and

\(^{10}\) Zeng Peiyan, speech delivered to the NPC, March 6, 2003.
Reform Commission, announced a fall of 26.4 million metric tons in 2003.\textsuperscript{11} Together with the widening gulf between urban and rural incomes, food security concerns have prompted even greater attention to agricultural reforms as indicated by Premier Wen Jiabao (March 5, 2004, Report: pages 16-18).\textsuperscript{12} Although many of the initiatives he announced are welcome, in particular the increase in investment for agriculture, the enhancement of agricultural research and extension services, reform of agricultural taxes and charges, and direct income subsidies for poor farmers, the emphasis on putting more land into grain production is hard to reconcile both with the elimination of controls on grain purchases and markets and with China’s undertakings on agriculture for its accession to the WTO.

The grain market continues to be influenced by the effective monopsony power of state interests, despite vigorous competition between government enterprises and private retailers who purchase their stocks mainly from state-owned enterprises. In the interests of “price stabilization” provinces have stored vast quantities of grain, an increasingly (and massively) inefficient way of ensuring that local officials can cope with localized harvest failures and other events that might threaten continuity of food supply. Those objectives could be achieved with much lower stocks, which could be maintained more efficiently by private traders under more competitive market conditions. The announced reforms in 2004 might be endeavoring to accomplish precisely those objectives.

\textit{Diversifying Ownership}

The move to market pricing has been fostered by the rapid diversification of ownership. In 1979 total retail sales were dominated by state-owned (54 percent) and collectively-owned (43 percent) enterprises, but their combined share had fallen to only 37 percent in 1998, when individually owned ventures also accounted for 37 percent of total sales and other ownership forms for the remaining quarter. Changes in reporting


\textsuperscript{12} Premier Wen Jiabao, in his Report to the Second Session of the Tenth National People’s Congress on March 5, 2004, foreshadowed sweeping reform of the grain distribution system and state-owned grain enterprises, including: “All controls over grain purchase and sales markets will be lifted.” (See page 17, English translation.)
make more recent information incompatible with earlier data, though the weight of wholly and partially state-owned firms in 2002 seems larger when smaller retailers are excluded (Table 4).

<table>
<thead>
<tr>
<th>Ownership Type</th>
<th>1979</th>
<th>1998</th>
<th>2002*</th>
</tr>
</thead>
<tbody>
<tr>
<td>Collective</td>
<td>43.1</td>
<td>16.6</td>
<td>8.0 a/</td>
</tr>
<tr>
<td>State</td>
<td>54.0</td>
<td>20.7</td>
<td>18.4</td>
</tr>
<tr>
<td>Individual</td>
<td>0.2</td>
<td>37.1</td>
<td>na*</td>
</tr>
<tr>
<td>Joint</td>
<td>0.0</td>
<td>0.6</td>
<td>2.6</td>
</tr>
<tr>
<td>Other</td>
<td>2.6</td>
<td>25.2</td>
<td>71.0 b/</td>
</tr>
</tbody>
</table>

*The National Bureau of Statistics no longer reports information on individual businesses; data reported are for firms that employ 20 or more people and have annual sales volume exceeding 20 million yuan

a/ Includes cooperatives

b/ Includes state (0.9%) and collective (0.3%) joint ownership enterprise and state sole funded limited liability corporations (0.9%). Foreign invested enterprises account for 9.7% and domestic private enterprises (siying qiye) for 13.2% of total sales.

Source: *China Statistical Yearbook* (various issues)

Similar changes have occurred in the shares of total gross industrial output (GIO) accounted for by the state sector. Between 1985 and 1999, the share of state-owned enterprises in GIO fell from two-thirds to less than a third, and the ADB (2003) observes: “…. the other striking feature is the extraordinary growth in the activity of private firms of all types --- from next to nothing in 1985, their share in total (GIO) was rapidly approaching half in 1999.” By 2002, value added in China’s manufacturing industry was Rmb 4.6 trillion yuan (45 percent of GDP), of which only Rmb 1.2 trillion yuan (about one quarter) was produced by SOEs and state-controlled holdings.13

To a large extent, our judgment is that progress in freeing domestic markets for other services is quite impressive too, though there are occupations where -- as in wholesale and retail distribution -- competition has been limited until very recently.

13 *China Statistical Yearbook 2003*
Public utilities, financial services, and such professional services as accounting and audit, marketing, legal, and management consulting are areas where entry barriers have impeded competition, especially from abroad. The negotiations for WTO accession targeted service markets to a marked degree, and heightened competition in the markets for services, especially financial services, will be one desirable outcome of China’s WTO accession. At the same time, accommodating foreign competitors in areas where domestic suppliers of services have been notably inefficient will require sustained efforts to improve local firms’ performance, if their inability to compete is not to lead to pressures to re-impose protections.

II. How Complete is Market Reform?

The general current perception is that China’s markets for final goods are largely free, despite a sense that pervasive protectionism lingers at the local level. The dual-track system of prices introduced in the mid-1980s to facilitate China’s transition from a centrally planned to a socialist market economy has essentially been phased out. For almost all goods sold in Chinese markets, the forces of demand and supply have been the primary determinants of market prices for a decade or more. What remains is a single-track, market-based system, with some important exceptions: the prices of natural gas, petroleum, edible oils, grains, tobacco, water, salt, and products related to national security are still administered to a greater or lesser extent.

Although markets now determine the prices of virtually all goods in China, that does not mean that all markets are competitive nor that all prices are determined by marginal costs. Moreover, there are questions about the extent to which China comprises a single market. In part, those questions reflect an explicit policy from the early Communist years of establishing self-contained regions within China to ensure the

14 Mattoo (2004) summarizes China’s commitments to open its markets for services as a condition to accede to the WTO. The web page of the US Trade Representatives Office provides information about China’s generally good progress through December 2003 in implementing its WTO commitments on services (http://www.ustr.gov). Also see footnote 16.

15 Arrangements for trade in services are complex. See, for example, CEPA: Gateway for China-Hong Kong Integration, Deutsche Bank Asia (available at http://ap.research.db.com/) for an analysis of the provisions of the closer economic partnership agreement signed at the end of June 2003 by Hong Kong SAR and China, in particular the liberalization of market access to apply to 17 categories of services.
continuing supply of essential commodities in the event of an invasion or foreign occupation of part of the country. Subsequently, a rudimentary distribution system and poor internal communications contributed to the isolation of markets. Even now, transport and other distribution costs are a significant barrier to the development of an integrated national market. Opinion differs about the extent to which the domestic market is now integrated; even if it is mainly integrated for final goods, factor markets are still fragmented to a marked extent.

There is a body of anecdotal and other evidence that points to widespread protection of local markets, even as similar evidence points to the increasing availability of goods produced throughout China in most local markets. Local officials can and do create barriers to firms from elsewhere in China that constrain access to local markets. A range of instruments is used: licenses that can be withheld arbitrarily; technical, health or other standards; levies imposed on goods as they transit provincial boundaries; or explicit subsidies (or tax concessions) to firms that ‘buy local.’ Central authorities have consistently opposed local protectionist forces, with recent additional emphasis occasioned by the provisions for unrestricted market access under the accession agreement for the WTO, but the fight to integrate the market continues.

Some analysts conclude, nevertheless: “Such comparative data as are available should convince us that China has the basic characteristics of a single country, rather than an international trading union.” Using data from 1987 and 1992, Naughton (2003) further finds that there are only “two provinces for which foreign trade is more important than domestic interprovincial trade…Guangdong and Fujian.” Given that both are coastal provinces that played leading roles in opening China to the World, that result is not too surprising.

Others have reached opposing conclusions based on trade across provincial borders, as well as on the comparison of price data within and between provinces, with particular emphasis on “spatial discontinuities implied by provincial borders” (Poncet 2003a). Some researchers conclude that not only has the general lack of integration of regional markets that the World Bank noted in its study in 1994 been sustained, but also the forces impeding internal trade flows might have intensified in the 1990s (Young 2000, Poncet 2003b). None of these studies seems sufficiently authoritative to admit firm
conclusions and more research is needed to establish the extent to which the domestic goods markets are now integrated.

Chinese tariffs are low by the standards of many developing countries and will be even lower after the further reductions agreed under the WTO protocols are implemented. Table 5 gives examples at the SITC two-digit level of what China’s undertakings will mean for tariff reductions, and Table 6 summarizes the main limitations on entry into the provision of important classes of services. If China’s commitments are implemented faithfully, within about three years tariffs for many classes of goods will be bound in ranges that continue the process of tariff reduction characteristic of China’s commercial policy during the past decade.

At a more aggregated level, the US Trade Representative’s office estimates for US exports that five years after China’s accession to the WTO (essentially meaning in 2007), tariffs on major industrial goods will fall to seven percent compared with 25 percent in 1997, and to 14 percent from 31 percent for agricultural goods. Moreover, most non-tariff measures, notably including licenses, quotas, and tendering arrangements, were eliminated at accession. China negotiated some exceptions, with quotas remaining on processed petroleum (until 2004), rubber products (2004), and automobiles and automotive parts, for which quotas will be progressively liberalized and eliminated in 2005.

But tariffs, quotas and other impediments to international trade are often augmented by additional policies that have the effect of protecting the domestic market. Huang, Rozelle and Chang (2003, pages 6-7) show that domestic taxation policy serves to protect domestic agriculture. They cite national regulations requiring imported goods (not for immediate re-export) typically to be subject to value-added tax (VAT) in the range 13-17 percent. Traders who procure agricultural commodities directly from farmers are exempted from the tax. When applied to soybeans, Huang et. al. conclude that domestic producers receive price protection in the domestic market of about 10 percent. A noteworthy conclusion of the same paper is that most of China’s agricultural markets appear to be “well-integrated into the economy” in the sense that, despite remote

locations and the high costs of reaching distant markets, movements in border prices for
undifferentiated agricultural commodities (such as soybeans and maize) correlate with
price movements in local markets.

Table 5: Examples of China’s WTO Commitments on Tariffs, Goods

<table>
<thead>
<tr>
<th>Harmonized Schedule Chapter</th>
<th>Accession Bound Rate Range</th>
<th>Final Bound Rate Range</th>
<th>Date of Final Liberalization</th>
</tr>
</thead>
<tbody>
<tr>
<td>03: Fish</td>
<td>34.7 – 0.0</td>
<td>16.0 – 0.0</td>
<td>2003 - 2005</td>
</tr>
<tr>
<td>16: Prepared fish</td>
<td>25.0 – 11.7</td>
<td>23.0 – 5.0</td>
<td>2002 - 2006</td>
</tr>
<tr>
<td>29: Organic chemicals</td>
<td>20.0 – 3.5</td>
<td>10.0 – 2.0</td>
<td>2002 - 2005</td>
</tr>
<tr>
<td>31: Fertilizers</td>
<td>50.0 – 3.0</td>
<td>NA</td>
<td>Accession</td>
</tr>
<tr>
<td>48: Paperboard</td>
<td>19.2 – 7.5</td>
<td>7.5 – 2</td>
<td>2003 - 2005</td>
</tr>
<tr>
<td>52: Cotton yarn &amp; fabric</td>
<td>19.4 – 6.7</td>
<td>14.0 – 5.0</td>
<td>2002 - 2004</td>
</tr>
<tr>
<td>60: Knitted fabrics</td>
<td>25.0 – 17.5</td>
<td>12.0 – 10.0</td>
<td>2004 - 2005</td>
</tr>
<tr>
<td>73: Iron and steel</td>
<td>26.7 – 4.7</td>
<td>25.0 – 4.0</td>
<td>2002 - 2005</td>
</tr>
<tr>
<td>87: Vehicles and parts</td>
<td>61.7 – 5.0</td>
<td>45.0 – 4.0</td>
<td>2002 - 2006</td>
</tr>
<tr>
<td>94: Furniture</td>
<td>21.0 – 6.0</td>
<td>21.0 – 0.0</td>
<td>2002 - 2005</td>
</tr>
</tbody>
</table>


In several service sectors, as Table 6 illustrates, China has chosen to liberalize over time. Wholesale and retail trade services are limited at first to joint ventures, with the latter also subject to geographic limitations. Foreign-owned insurers are limited as to what kinds of insurance they may provide: for example, reinsurance and certain forms of transportation insurance are forbidden. Initially, they are allowed to operate only in certain large cities, such as Shanghai and Dalian, but these restrictions will lapse after three years. Foreign-owned banks are circumscribed in their ability to offer domestic
currency services, but the scope of services and geographic regions in which they are allowed to operate will be greatly extended over five years. Transportation is less subject to gradual liberalization, as restrictions are mostly lifted at the time of accession, but the maritime and aviation sectors are open only to new entrants with minority foreign ownership. Rail and road transport are scheduled for complete liberalization within six and three years, respectively.

Table 6: Examples of China’s Limitations on Access to Service Markets

<table>
<thead>
<tr>
<th>Sector</th>
<th>Cross-Border Supply</th>
<th>Consumption Abroad</th>
<th>Commercial Presence</th>
<th>Presence of Natural Persons</th>
</tr>
</thead>
<tbody>
<tr>
<td>Insurance</td>
<td>Unbound, with exceptions</td>
<td>None</td>
<td>Subject to 3-year geographic and scope liberalization, 5-year capital liberalization</td>
<td>Unbound</td>
</tr>
<tr>
<td>Banking</td>
<td>Unbound, with exceptions</td>
<td>None</td>
<td>Subject to 5-year liberalization</td>
<td>Unbound</td>
</tr>
<tr>
<td>Retail Services</td>
<td>Unbound except for mail order</td>
<td>None</td>
<td>Subject to 5-year liberalization</td>
<td>Unbound</td>
</tr>
<tr>
<td>Wholesale Distribution</td>
<td>Unbound</td>
<td>None</td>
<td>Subject to 3-year liberalization</td>
<td>Unbound</td>
</tr>
<tr>
<td>Transport</td>
<td>Unbound</td>
<td>None</td>
<td>Subject to limitations on foreign ownership</td>
<td>Unbound</td>
</tr>
<tr>
<td>Telecommunications</td>
<td>Subject to regulations</td>
<td>None</td>
<td>Subject to 3-year geographic and ownership limitations</td>
<td>Unbound</td>
</tr>
</tbody>
</table>


Note: Natural persons, as defined by the WTO, are citizens or permanent residents of a member country. Column heading refer to the four “modes” of trade in services.

There are important provisions as well to introduce freer markets and greater competition for state trading companies, which must become more independent and make price decisions on a commercial basis. Competition in international trade will intensify in four stages. At accession, all Chinese enterprises were allowed to trade subject to capital
requirements that will be lowered over time. In 2003, joint ventures with minority foreign ownership were able to trade. Beginning in 2004, joint ventures with majority foreign ownership will acquire trading rights. And in 2005, all Chinese and foreign companies, as well as many individuals, may engage in international trade.

The closer economic partnership agreement (CEPA) with Hong Kong (see footnote 12) extends the provisions of the WTO accession preferentially to Hong Kong, with most taking effect from the beginning of 2004. Deutsche Bank analyst Jun Ma lists the many examples of products of Hong Kong origin that will be tariff-exempt from January 2004. He characterizes China’s offer of tariff liberalization measures as “more generous than…expected.” But he views the concessions made on access to China’s service sectors as having greater long-term impact for the Hong Kong economy. Using fairly restrictive criteria to define a venture as having its origin in Hong Kong, those ventures that qualify will receive preferential treatment compared to other nationals’ firms, and will be allowed to enter Chinese service sectors selectively either earlier than provided for in the WTO accession protocols or with less stringent requirements for entry, or both.

For example, Hong Kong banks with minimum assets of US$6 billion will be eligible to open branches in China, compared with a minimum asset requirement of US$20 billion for other foreign banks. Hong Kong representatives in Chinese representative offices of Hong Kong law firms will have to reside in China for only two months a year compared with six months for similar representatives of other nationalities. Hong Kong should benefit significantly from the advantage of an early start, and China might benefit as well from yet another dose of “gradualism,” this time as it applies to adjustment to the additional competition from foreign firms that will result from membership in the WTO.

Finally, China still restricts rights to land ownership, and the documents for its accession to the WTO make clear that all land is owned by the State. Individuals and businesses can lease land, but the leases are subject to term limitations. For residential purposes, the limit is 70 years. For commercial, tourist, and recreational purposes, the
The Overall Impact of the WTO

China’s accession to the World Trade Organization (WTO) raises its own questions about how well the markets for goods and services work, and how they will handle the heightened competitive pressures engendered by both the entry of foreign enterprise into activities previously denied to them, and the further reduction of trade protection. Ianchovichina and Martin (2004) estimate that China’s weighted average tariff will fall from 13.3 percent in 2001 to 6.8 percent by the end of the implementation period. They regard this as a significant reduction in protection, but one that is minor compared with the decline in tariff levels achieved over the decade preceding WTO accession. By implication, the adjustment to the post-WTO regime should be routine, given what has taken place before.

On the other hand, the commitments made to open trade in services are more dramatic and therefore are likely to have a more disruptive impact on domestic suppliers of those services (Bhattasali, Shantong, and Martin 2004). Table 6 indicates that financial services, wholesale and retail distribution, and communications will be among the most affected areas, but the impact will be felt strongly across the whole range of services: from construction to education to the professions. Mattoo (2004, page 117) concludes that “Over the space of some six years, one of the most closed services markets has promised to become one of the most open.” As well, he notes the potential for sequenced liberalizations, which sustain geographical and ownership restrictions, to delay the benefits from foreign investment and heighten regional inequalities.

Within China, local officials have been particularly concerned about the effects of reform on agricultural output and the implications for employment and incomes in rural areas. The work of Huang, Rozelle and Chang (2003) suggests that undifferentiated agricultural commodities are likely to be the hardest hit by foreign competition, particularly products that have been favored with protection from policies not principally

17 Land markets are described in more detail later in the paper.
directed at international trade, but inadmissible under the rules of the WTO. Ianchovichina and Martin project that beverages and tobacco will be among the sectors that face considerable pressure to adjust. Most analysts agree that the automotive sector will go through a major realignment, mainly because of policies that have fostered a proliferation of uneconomically sized automotive assemblers throughout China, a result of the flawed notion that China needed to promote “pillar industries.” The automotive sector enjoys booming demand, but domestic producers will face intense pressure from imports as protective barriers are rolled back, which will contribute to incentives to rationalize the domestic assembly of cars.

The work of Martin and others demonstrates that China’s compensation for the inevitable adjustment costs of WTO entry will lie in the gains from further specialization according to comparative advantage. The benefits to China from further opening will be considerable, substantially higher, as one should expect from what is essentially a unilateral action on China’s part, than those accruing to other countries from Chinese accession. Other analysts point to the impetus that China’s accession to the WTO gives to globalization generally, and to the mechanisms for further liberalization of global trading arrangements.

David Roland-Holst, for example, uses a dynamic general equilibrium model to evaluate global versus selected regional trade liberalization options for East Asia through 2020. He finds that “global trade liberalization would increase overall trade more than three times as much as any arrangement confined to East Asia.” He finds also that the more comprehensive the regional agreement the greater the gains accruing to its members. A more surprising finding, however, is that a regional trade-liberalizing initiative comprising the members of the ASEAN Free Trade Area plus China, Japan and Korea would return to the participants most of the benefits from a global agreement under the WTO. If the Doha round continues to experience difficulties, this analysis suggests that East Asia could do worse than deciding to “go it alone.”

The potential efficiency gains to China from greater competition in the provision of traded goods and services clearly are considerable. But many domestic suppliers of

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such sensitive services as banking, insurance, telecommunications, retailing and logistics are likely to fare poorly, at least initially, in direct competition with foreign suppliers. One can anticipate therefore that Chinese officials will seek all recourse offered to them under the WTO to continue to shield domestic suppliers from the full force of competition. To an extent, this has already been done in the provision for graduated elimination of ownership and geographical restrictions on the activities of foreign service-providers. Even so, one suspects that Chinese banks, for example, will be unable to work off the legacy of non-performing loans to SOEs with which they are burdened during the transition period. Come 2007, we consider that Chinese officials probably will be seeking compromises in several areas to slow the entry of foreign competitors, effectively trading off the early realization of substantial efficiency gains against the perceived subsequent benefit of maintaining competitive domestic suppliers of important classes of services.

III. Issues in China’s Factor Markets

Most observers still consider that China’s factor markets function much less freely than markets for goods and services, even allowing for recent measures that have enhanced factor mobility. The prices of labor, capital and land all remain subject to distortions caused by restrictions on mobility, ill-defined property rights, administered allocation and pricing, and other interventions designed to affect “market” outcomes.

The Labor Market

The development of labor markets has been impeded by direct (administrative) restraints on the ability of workers to relocate within China, as well as indirect ones mainly related to the lack of portability of benefits. The most noteworthy among these are health benefits, housing and pensions. Xin Meng (2000) summarizes the non-existence of a functioning labor market before reforms began in 1978 as follows: “The main characteristics of (China’s) labor arrangements before (1978) were the segregation of the
rural and urban economies, the extreme immobility of labor and the disincentives implanted in the income distribution system.”

More recently, Fleisher and Yang (2004) point to the extreme divergence of urban and rural incomes, which places China among those countries where the ratio of urban to rural income is greatest (approximately 3), as *prima facie* evidence of the barriers that still impede labor mobility. 20 They cite similarly wide divergences in the productivity of labor in agricultural compared with non-agricultural occupations, true of both urban and rural areas. But, notwithstanding the market impediments that remain, they also point to important successes in labor market reform. Chief among those successes are the decline of the planning framework for enterprise employment, the diminishing importance of the state sector and collectives as suppliers of jobs and output, the profound changes in work incentives for both rural and urban employees and their managers, and growing integration of product and labor markets nationwide. 21 They cite estimates that attribute from a sixth to a fifth of China’s annual growth in the reform era to the movement of labor from lower to higher productivity occupations. 22

Differences in productivity of urban and rural workers are not the only indicator of a major source of inefficiency in allocating labor. Within rural areas, large productivity differentials persist between agricultural and non-agricultural activities. Fleisher and Yang identify three factors that comprise persistent impediments to the mobility of rural labor. First, they note, farm families enjoy land-use rights “but not rights of alienation.” Families leaving the land forego future earnings from their land holdings, meaning that wages in new employment must compensate for their loss; they would accept lower wages if they could sell their land-use rights. Labor mobility is impeded further by the requirement that households sell part of their grain output in quantities and at prices determined by the government, which limits their ability to reallocate family

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labor to other jobs. The rural reform program foreshadowed in Premier Wen Jiabao’s speech on March 5, 2004 (see footnote 10) might have greater mobility of rural labor as one of its principal objectives.

The other two factors discussed by Fleisher and Yang are local protection and the hukou system. They cite a survey reported by the Development Research Center of the State Council in 2003 that identified “intervening in the labor market” as the form of protection most commonly used by officials to benefit local enterprises. Moreover, long-time residents are favored in both pay and benefits relative to those who come from elsewhere seeking employment. The hukou system is less constraining than in the past, with residency typically being granted in smaller cities and towns to those who “have a permanent source of living and housing in the locality.” But migration to the larger cities is still severely restricted, and people who move there seeking jobs are unable to secure all of the benefits for their families that registered residents enjoy.

In recent years, labor scarcity in rapidly growing cities in eastern provinces has been a spur to reform. In particular, shortages of senior managerial and technical skills seem to be contributing to the emergence of greater mobility and more extensive recruitment of those skills nationwide and even internationally (ADB 2003). Senior officials of less developed provinces have begun to express unease about the “brain drain” of their graduates to employment with enterprises, including foreign-invested ones, located in the coastal region. More generally, Table 7 illustrates how the onset of reforms involved significant restructuring of the broad labor market, parallel to the dual-track reforms in the markets for goods and services. In 1978, three-fifths of the non-farm workforce was employed in the state sector, and all state workers were guaranteed permanent employment. By 1997, the share of permanent state employees in the non-farm workforce had fallen below one in six, reflecting the dramatic increase in total employment of the non-state sector (from 40 to 70 percent) as well as the increasing use of contract employees by the state. In 1997, more than half of state employees were contract workers.

23 Op. cit. page 17. It also restricts their choice amongst crops, though plenty of anecdotal evidence suggests that entrepreneurial farmers grow what suits them best and purchase grain in the market to meet their compulsory sales to the state.  
24 Brooks (2004, page 57) describes progress in reforming the hukou system and the barriers that remain.  
25 Fleisher and Young (2004, page 17)
Table 7: The Dual-Track in Non-Farm Employment, State and Non-State Sectors

(­million employees)

<table>
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<td>State</td>
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<td></td>
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<tr>
<td>Permanent</td>
<td>74.5</td>
<td>87.7</td>
<td>99.8</td>
<td>103.5</td>
<td>109.2</td>
<td>109.6</td>
<td>107.7</td>
<td>78.8</td>
<td>74.1</td>
<td>69.2</td>
</tr>
<tr>
<td>Contract</td>
<td>0.0</td>
<td>0.6</td>
<td>10.1</td>
<td>13.7</td>
<td>24.0</td>
<td>42.8</td>
<td>54.2</td>
<td>na</td>
<td>na</td>
<td>na</td>
</tr>
<tr>
<td>Non-State</td>
<td>48.9</td>
<td>62.1</td>
<td>138.3</td>
<td>152.5</td>
<td>195.9</td>
<td>224.7</td>
<td>238.3</td>
<td>237.8</td>
<td>240.4</td>
<td>251.4</td>
</tr>
<tr>
<td>Urban</td>
<td>20.6</td>
<td>29.8</td>
<td>42.8</td>
<td>43.8</td>
<td>50.5</td>
<td>60.9</td>
<td>66.6</td>
<td>68.9</td>
<td>71.4</td>
<td>79.3</td>
</tr>
<tr>
<td>Rural</td>
<td>28.3</td>
<td>32.3</td>
<td>95.5</td>
<td>108.7</td>
<td>145.4</td>
<td>163.9</td>
<td>171.7</td>
<td>168.9</td>
<td>169.0</td>
<td>171.7</td>
</tr>
<tr>
<td>State Permanent/Total</td>
<td>0.60</td>
<td>0.58</td>
<td>0.38</td>
<td>0.35</td>
<td>0.28</td>
<td>0.20</td>
<td>0.16</td>
<td>na</td>
<td>na</td>
<td>na</td>
</tr>
</tbody>
</table>

Source: *China Statistical Yearbook (various years)* and author’s estimates.
Note: From 1998 the *China Statistical Yearbook* no longer publishes the number of contract staff and workers in state-owned economic units.

The State Statistical Bureau ceased reporting the breakdown between contract and non-contract employees in state employment in 1998, presumably because the distinction vanished with the civil service reform in that year. This reform essentially made all state employees contract employees, and sharply reduced their number. By 2000, there were 107 million employees of urban enterprises with labor contracts and the number of contract employees of rural collective enterprises reached 23 million. This compares with total employment in 2000 of 721 million. By 2002, total employment reached 737 million, with 248 million employed in urban areas.\(^{26}\)

Lay-offs in the state sector caused a contraction of almost 30 million workers in the non-farm state workforce by 2000, when the share of non-state workers rose to 76 percent, and more than nine million additional state sector jobs had been lost by 2002, when the corresponding share of non-state workers reached 78 percent. These numbers probably exaggerate the true flexibility of the labor markets, as governments at all levels continue to monitor closely the firing practices of enterprises, and intervene when employees threaten to become restive.

\(^{26}\) *China Statistical Yearbook 2003.*
Nevertheless, there has been considerable recent progress in developing the (urban) labor market, with pilot efforts to standardize and modernize employment practices in 100 cities nationwide. Municipal employment analysis of supply and demand conditions are reported in 62 of the cities, and 64 of them offer real-time information networks. Services offered under the pilot include assistance in locating jobs, occupational training, employment counseling, and social security benefits, including pensions, basic health care, unemployment insurance (all compulsory), disability insurance and maternity benefits. Coverage under all five programs costs employers around 30 percent of a worker’s wage, with the worker’s contribution somewhat over a third of the payment made by the enterprise or work unit. Essentially, China is transitioning in the customary gradual way from a system of guaranteed employment with little choice of employer, into one that offers considerable choice between employment opportunities but at the cost of security of long-term employment.

**Credit Markets**

China’s debt markets comprise predominantly bank loans and bonds; the former is about six times as large as the latter, with bonds dominated by issues of the Central Government. Despite recent experiments in liberalizing lending rates for bank loans, including provision in 2004 for banks to adjust lending rates up to 70 percent above the mandated rate,\(^{27}\) and even greater freedom to set rates for particular borrowers in particular cities, lending and deposit rates are still largely administered. As well, yields on bonds are remarkably similar no matter what their maturity. Both in access to bank credits and in issuance of bonds, borrowers other than the Government and state-owned enterprises are severely disadvantaged. One has to conclude, therefore, that the debt markets have far to go before they conform to the ideal of competitive markets.

Despite the four large state-owned commercial banks (SCBs) being no longer formally servants of the credit plan, they still allocate the bulk of their lending to state-

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\(^{27}\) Rural credit cooperatives can charge up to twice the benchmark rate; the minimum lending rate that can be charged by all classes of lenders is 90 percent of the benchmark.
owned enterprises (SOEs). Many SOEs are loss-making, and use bank credit to meet current obligations to their workers and pensioners with scant concern for repayment. Despite their indifferent performance, the SCBs continue to dominate the domestic credit market. They accounted for more than 60 percent of domestic banking assets in 2001, when three of them – the Industrial and Commercial Bank of China (ICBC), the Bank of China (BOC), and the China Construction Bank (CCB), in that order – were among the 50 largest global banks, and all four (the other being the Agricultural Bank of China (ABC)) were in the top ten banks in Asia by asset size (Solvet 2002). They continue to account for 60 percent of banking assets at the end of 2003. Along with the state policy banks (since 1994) and the four asset management companies (AMCs -- set up in 1999 to deal with some of the bad loans on the books of the four SCBs and one of the policy banks, the China Development Bank -- CDB), the SCBs comprise overwhelmingly the core of the Chinese banking system, notwithstanding the recent emergence of many smaller banks and increasing activity from foreign banking interests.

The SCBs were, and remain, hamstrung by the legacy of the plan, with non-performing loans (NPLs) variously estimated in 2002 to comprise a quarter to a half of their portfolios, with the official figure generally at the bottom of the range. At the end of 2003, the People’s Bank of China (PBC) reports NPLs at Rmb 1.9 trillion, or a fifth of outstanding loans of the SCBs. Solvet (2002, page 41) puts the figure at about a third of outstanding loans, and assumes a recovery rate of about 20 percent (consistent with the experience of the AMCs) to calculate projected system-wide losses of about 30 percent of GDP in 2001. Solvet is one of several analysts who have concluded that the big four banks are unlikely to be able to restore themselves to profitability and financial health simply by growing their way out of their problems. Essentially, the SCBs are insolvent. Despite this, they are highly liquid, as befits an economy where the ratio of money plus quasi-money (M2) to GDP reached 190 percent at the end of 2003.

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28 Solvet provides an excellent, if self-indulgent, summary of the status of banking in China.
29 The policy banks (in order of asset size) are the China (State) Development Bank, the Agricultural Development Bank of China and the (much smaller) Export Import Bank of China, which together have total assets less than ABC, the smallest of the SCBs. The asset management companies (AMCs) and their partner banks are: Cinda – CCB and CDB, Great Wall – ABC, Huarong – ICBC, and Orient – BOC.
30 The World Bank, Goldman Sachs, Hong Kong, and Nicholas Lardy (2003) have all argued that under reasonable assumptions the SCBs will be unable to reconstitute their capital from their future earnings.
The People’s Bank of China (PBC) has set targets of 15 percent for NPLs in total loans of each of the four large SCBs by the end of 2005. The official aggregate ratio for the SCBs’ NPLs was 30 percent at the end of 2001, about 26 percent in 2002, and 20 percent by the end of 2003. Setting aside concerns about the accuracy of the official figures as some observers put the ratio of NPLs far higher, one might question whether banks are going about reducing their NPLs in the right way. Credit expansion in 2002-03 has picked up strongly, and much of the improvement in the banks’ portfolio performance might be attributed to the youth of their portfolios rather than improvements in their lending practices. Many analysts, including in particular the authors of this paper, would argue the need to ensure that banks are free to make decisions based solely on commercial considerations, before a massive, once-for-all capital injection is provided to write off unrecoverable loans and establish a satisfactory capital base for the SCBs.

Even if freed from the obligation to prop up shaky SOEs, there is every reason to question the ability of the management of the four SCBs to reduce loan losses to acceptable levels immediately. In that regard, while one might accept that the SCBs are too big to fail, one might also ask whether they are too big to reform. More radical solutions might be needed to improve the performance of the SCBs and permit them to compete on an equal footing with foreign banks by the second half of this decade. There seems much to recommend in experiments to break up one or more of the SCBs and to seek strategic foreign partners who could inject new capital along with management and financial expertise to establish sound practices in the residual banks.

Even if this advice is good, the Government seems bent on a different path judging from its announcement, early in January, 2004, that it was injecting US$45 billion from the PBC’s international exchange reserves as new capital to the BOC and CCB, with half of the funds going to each. A company, Central Huijin Investment Ltd., was established to hold the equity in the two banks as its only asset, and its board comprises officials from the PBC, State Administration of Foreign Exchange and the

31 China’s loan classification system was amended from a four to a five category system in 2001. Under the former system, the NPL ratio would have been lower, and even under the new system the official figure might be substantially lower than 20 percent depending on how the BOC and CCB use their injections of new capital. See discussion on page 25. Steven Barnett in Chapter VII of Prasad (2004) reports the NPL ratios for BOC, CCB, and ICBC as 16 percent, nine percent and 21 percent, respectively at the end of 2003. The ratio for ABC is unavailable but known to be much higher. He also notes the “substantial amount of special mention loans” that threaten also to become nonperforming (See Box 7.1, page 48).
Ministry of Finance. The new company effectively becomes the largest shareholder in the two banks; possibly, it is a precursor of a financial version of the State-owned Asset Supervision and Administration Commission (SASAC), which was established to perform the State’s ownership functions for the Central Government’s SOEs.

The funds injection will improve their balance sheets and possibly help in propelling the BOC and the CCB into successful early initial public share issues (IPOs). In turn, that would further augment those banks’ capital at comparatively low cost to the Government, depending on the policies that would be adopted towards the rights of the minority shareholders. Many governance issues remain to be resolved, and the degree of management autonomy that will be extended to the BOC and CCB remains uncertain. What is clear, however, is that the weakness of their portfolios severely erodes the SCBs’ capacity to compete with better-capitalized banks, and probably presages reluctance by the Government soon to allow market forces freely to determine the allocation of credit. In particular, as foreign banks compete for a greater share of the Chinese market, controls on deposit rates are unlikely to be eased.

Lending to private enterprises continues to be a relatively minor activity of the SCBs, partly because of their weak portfolios, and partly because they still have insufficient flexibility to set interest rates at levels that would make such lending profitable when adjusted for transaction costs, monitoring costs, and risk. Despite concerns about the effects of rising borrowing costs on the financial health of the SOEs, an early market-enhancing reform that would help the banking system would be to give the banks even more discretion to determine lending rates. But the SCBs increasingly do lend for consumer purchases that have an “investment character.” Consumer lending, which was virtually zero in 1997, has grown explosively subsequently, comprising more than eight percent of financial institutions’ portfolios by the middle of 2003. Housing finance accounts for three quarters of the lending, with the remaining quarter divided between automobile loans and all others. The rapid growth of consumer lending has helped reduce the share of non-performing loans in SCBs’ portfolios, but the

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development is too recent to judge the longer-term effects on loan performance and portfolio quality.

**Securities Markets**

The securities and other asset markets have developed quickly but with a heavy bias towards securities issued by the Central Government, its specialized financial agencies, and listed SOEs. Securities are listed on either or both of two main boards in Shanghai and Shenzhen. Foreigners participated by purchasing “B-shares,” with “A-shares” reserved for Chinese nationals. This segmentation of the market persisted until recently.

In November 2002, the China Securities and Regulatory Commission (CSRC) promulgated the “Provisional Measures on Administration of Domestic Securities’ Investments of Qualified Foreign Institutional Investors (QFII),” which allows qualified foreign fund management institutions, insurance companies, securities companies and other asset management institutions to invest in Chinese securities markets. The QFII will be able to purchase A-shares, treasury instruments, bonds and other financial instruments as approved by the CSRC, up to an investment quota granted/approved by the State Administration of Foreign Exchange. Applicants for QFII status must satisfy the CSRC’s requirements on asset size, financial and credit standing, and other factors. By August 2003, seven foreign companies – Citigroup Global Markets, Deutsche Bank, Goldman Sachs, HSBC, Morgan Stanley and Co. International, Nomura Securities, and UBS – had received CSRC approval to invest in China’s securities markets.

China’s extraordinary foreign reserve holdings almost surely have influenced this decision, along with a desire to introduce greater liquidity and fund management expertise into China’s capital markets. In 2004, the heavy volume of capital inflow has discouraged further substantial investment approvals; nevertheless, by mid-year eight additional QFIIs had been approved albeit with quotas set at, or just above, the $50 million minimum. The new investors are: Credit Swiss First Boston (Hong Kong), Daiwa Securities SMBC, Hang Seng Bank Ltd., ING Bank N.V., JPMorgan Chase Bank, Merrill
Lynch International Inc., Nikko Asset Management Co. Ltd., and Standard Chartered of Hong Kong.\textsuperscript{33}

The stock market listings are dominated by SOEs, and those markets are unlikely sources of capital for the vast majority of Chinese private ventures in the near term. No more than about 20 privately held firms have been allowed to list, though early in 2004 more than 200 listed firms are regarded as private because of subsequent sales of Government held shares. An issue is the extent to which these firms now function as if they are privately owned; in particular, are the firms’ managers free to make their own hiring and firing, and investment decisions free of official interventions. For over 1300 listed firms, the overwhelming objective seems to have been to attract new funds, an entirely rational response to market prices that seem absurdly high in relation to the financial fundamentals of most listed enterprises. Listed SOEs in particular seem disinterested in using the discipline of the market to improve their governance, financial transparency and efficiency.

Despite evident problems, especially the comprehensiveness and reliability of the financial information available for listed firms, the Chinese stock markets comprise the third biggest market in Asia (after Japan and Hong Kong), with a daily market turnover in 2003 of about US$1.6 billion equivalent. (Average daily turnover in 2003 was barely half of the level in 2000.) The market capitalization is approximately equivalent to US$ 500 billion,\textsuperscript{34} but two-thirds of the stock is in state-owned, non-tradable (or non-circulating) institutional shares.\textsuperscript{35}

Notwithstanding the glaring deficiencies of the markets, the CSRC impresses as a competent and responsible agency that has introduced a succession of beneficial measures and liberalizations. The second half of 1999 saw the introduction of indexed funds in China and permission for SOEs to trade stocks. Plans to sell some of the

\textsuperscript{33} Of a total approved quota of close to $1.9 billion, UBS has the largest quota: $600 million.
\textsuperscript{34} At the end of 2002, 1224 enterprises were listed on the Shanghai and Shenzhen exchanges. By end-2003, 1287 firms were listed; and another 59 firms were listed in the first half of 2004. Market capitalization reached its recent peak at around $610 billion equivalent at the end of the first quarter of 2004, and was approximately $490 billion at the end of June 2004, of which only about 31 percent comprised tradable securities. (See People’s Bank of China, 2003)
\textsuperscript{35} The Wall Street Journal reported on August 26, 2003 that of the totality of 1259 companies listed on the Shanghai and Shenzhen exchanges, with shares that could be bought by public investors accounting for 32 percent of the market valuation of $502 billion, only 175 had a market capitalization exceeding $200 million, while 112 companies were in danger of being de-listed for poor earnings performance.
Government’s share-holdings in listed companies to help fund pension obligations had to be shelved, however, in October 2001 when the prospect of such selling led to disorderly markets and consequent investor unrest. The segmentation of the markets into A- and B-shares, with the former held by domestic residents and the latter by foreign investors, began to be phased out in February 2001, when domestic citizens with foreign exchange holdings were allowed to purchase B-shares. The Government intends to unify the main boards of the Shanghai and Shenzhen exchanges in Shanghai, when a new, second board for non-state-owned enterprises will be established in Shenzhen. The new board will have less stringent requirements for annual profits and capitalization of listed firms, essentially becoming a Chinese version of the American Stock Exchange. And the listing process for the main boards has begun to be more neutral regarding ownership, though the CSRC remains very cautious in approving listings of private firms.

That notwithstanding, private firms and others under non-state ownership are likely to feature more prominently in newly listed companies. But the process, like so many reforms in China, is also likely to be gradual. China’s regulators require a lengthy process before stocks can be listed, including a training program for officers of the listing companies on the responsibilities of senior executives of publicly traded companies. The program is a commendable requirement, and can run for as long as a year. The gradual nature of the process leaves the question of how to channel more risk capital to private ventures unanswered. One might conjecture that there is a bigger role for venture capital, and that smaller, regional stock markets can emerge (as already seems to be happening informally) in a manner that helps smaller firms find reliable investment partners.

Until very recently, for almost all enterprises and sub-national governments there was no bond market to speak of. That has begun to change for selected SOEs, 19 of which issued around US$ 590 million (equivalent) in corporate bonds in 2000, increasing to $4.3 billion in new issues in 2002 (Bottelier 2004). Since the central bank law (in 1995) prohibited the funding of governments through credit creation, the Central Government has been issuing more bonds, in particular to finance infrastructure

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36 He notes, however, that the volume of corporate bonds issued in 2002 was only about half as great as in 1992, when local government issues mainly to finance locally owned SOEs “was part of the widespread financial irregularities that contributed to overinvestment and high inflation.” After 1996, equity issues became a much larger share of capital market financing than bond issues, partly because (and unlike many other countries’ markets) the exceptionally high price-earnings ratios made equity cheaper than debt.
expenditures in poor western provinces. The policy banks and the AMCs also have issued bonds to fund their activities. Many bond issues are non-tradable placements, usually with banks, and there is no active secondary market for many other securities that have been placed at administered interest rates rather than publicly issued. Bottelier (2004) notes, however, that the absence of secondary market activity in corporate bonds can be attributed to their scarcity: holders of bonds see them as too valuable to trade. The potential market demand for corporate bonds can be inferred from the fact that household savings deposits with the SCBs are more than 300 times the volume of listed tradable corporate bonds.

Government bond issues, including bonds to recapitalize the banks and to finance the policy banks and the AMCs, have increased rapidly since the East-Asian currency crisis. They are the principal factor in the rise of China’s total government indebtedness, to more than a third of GDP in 2003. Of this amount, external debt accounted for four percent of GDP, and domestic debt for 30 percent. China is one of the most creditworthy developing nations, with its limited international bond issues typically being significantly oversubscribed at spreads that are low by international standards for developing countries. The huge inflows of direct investment into China, combined with current account surpluses and China’s high domestic savings, have meant that China has had little need to access the international bond market. Recent issues serve mainly to maintain a minimal market presence and establish reference rates for Chinese borrowings, and possibly to roll over some maturing bonds.

The budget deficit for 2003 was estimated at 320 billion renminbi (Rmb) yuan, or approximately three percent of GDP. To finance its deficit and retire maturing debt, the Ministry of Finance issued bonds worth about Rmb 628 billion yuan in 2003. That contributed to a build up in Government bonds outstanding to more than Rmb 2 trillion yuan in 2003, with in excess of a further trillion yuan in bonds of the policy banks, predominantly CDB (Bottelier 2004). Those bonds contributed to more than 30 issues that are listed and traded on the Chinese stock exchanges, although most bond trading is through the inter-bank market. The annual turnover on the stock exchanges, approximately US$100 billion (equivalent), is only an eighth of the volume of the trades between the banks. In addition, the PBC increased its outstanding sterilization bills to
more than Rmb 500 billion yuan by the end of 2003, with most of the expansion caused by the demands of monetary management in the last three quarters of the year.

This adds up to increasingly active primary and (potentially) secondary markets for debt of the Central Government and its specialized financial agencies, including the PBC, supported by more than 40 primary dealers and a handful of credit rating agencies. Bottelier contends, however, that the “legal and regulatory framework for government debt issues and secondary market trading is very limited.” He asserts that the efficiency of the market could be greatly enhanced by reducing fragmentation of regulatory oversight,\(^{37}\) of government instruments (there are three kinds of government bonds), and of markets (since February 2002, there are four separate markets for government bonds). As well, the market lacks “sufficient diversity of maturity dates,” efficient clearing and settlement processes (increasingly needed with growing market participation by institutional investors), and “a truly independent and authoritative bond rating system” (Bottelier 2004). Increasingly, the government and other market participants recognize the advantages of a competitive bidding system for bond issuance and trading.

To summarize, the very high savings of the Chinese people provide a ready source of liquidity through vast deposits in the banking system. There seems considerable scope to channel some of those funds directly to enterprises and to well-managed sub-national governments through appropriate debt instruments, given that some potential borrowers are probably inherently more credit-worthy than the banks through which the funds are otherwise intermediated. Policy makers should be investigating ways in which more active bond markets can begin to raise the efficiency of the capital markets, and to encourage sub-national governments to access the bond markets for investment capital.

**Land Markets**

The Chinese Constitution divides land into two types: urban state-owned and rural collectively-owned. Correspondingly, there are two land usage systems and two land registration systems. For urban state-owned land, usage rights can be transferred from the

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\(^{37}\) Responsibility for regulation and supervision of the market for government bonds is divided between the Ministry of Finance (for new issues), the PBC (for trading in the interbank market) and the CSRC (for trading in the stock market).
state to the land users in one of two ways: by administrative transfer, or by remising the user rights at an agreed price. The market for the second kind of transfer is termed the “first tier land market,” in which prices are determined by negotiation, bidding or auction. The government is the only supplier, but competition can exist on the demand side when prices are set by bidding or auction.

There have been two major reforms in the first tier land market. In 1990, the State Council issued the “Temporary Regulation on Urban State-owned Land Usage Right Remising and Transfer,” which allowed ownership and use of the land rights to diverge.³⁸ Land rights began to be transferred at an agreed price for a specified period. In 2002, the State Council issued the “Notice for Enhancing the Management of State-owned Land Assets,” which allowed the Ministry of Land and Resources to invite public bidding for and auctions of land-use rights in the transfer of state-owned land. The public must be notified in advance of the government’s intention to sell those rights, and the price paid for them must be made public.³⁹ The result was an immediate, abrupt increase in transactions in the first tier land market, as shown in Table 8. In 2002, the number of market-based transactions increased from below five percent of the total in prior years to more than 21 percent. The value of the market-based transfers exceeded 55 percent of the value of all transactions, which indicates the efficiency gains from allowing the market to price land use rights.

Table 8: Land Transactions in the First Tier Market, 2002

<table>
<thead>
<tr>
<th></th>
<th>Number of cases</th>
<th>Area (million sq. meter)</th>
<th>Value (billion yuan)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Transactions at market price</td>
<td>25,900</td>
<td>181</td>
<td>96.855</td>
</tr>
<tr>
<td>Total transactions</td>
<td>123,000</td>
<td>833</td>
<td>174.795</td>
</tr>
<tr>
<td>Market/total (%)</td>
<td>21.1</td>
<td>21.7</td>
<td>55.4</td>
</tr>
</tbody>
</table>

Source: Ministry of Land and Resources, P.R.C.
Note: Market price includes price set by bidding and auction.

³⁸ Ministry of Construction, PRC: www.con.gov.cn/law/other/2000111602.00.htm
³⁹ See http://home.sinohome.com/home/5249.htm
Once the land usage rights are in non-state hands, they can be traded freely in the “second tier land market,” and rented out or mortgaged at prices determined by market competition. Before 1999, holders of land-use rights acquired by administrative transfer had to pay fees before the rights could be sold or leased to others. In 1999, the Ministry of Land Resources waived the fee requirement where that would help to promote reform of SOEs and the development of the land market. However, governments retain the right of eminent domain, and can reacquire usage rights from firms or individuals ahead of schedule, where needed, for example, to accommodate investments in urban infrastructure. Governments also can adjust transfer prices agreed between market participants, where they deem such an action desirable to moderate fluctuations in land usage prices.

Given the remaining capacity of governments to intervene, the land markets must still operate under considerable uncertainty, which might have been exacerbated by the regulations issued by the Ministry of Land and Resources early in 2003. In what seems to be an attempt to offset a potential “bubble” in the real estate market, notification has been given to the responsible units at sub-national level to control strictly land development for the building of commercial housing and other commercial uses. In particular, the notification requires the examination of land used for constructing high-tech parks. Those parks that have been built in violation of overall land-use planning will have their land use rights rescinded, irrespective of how they are designated. Localities cannot arbitrarily revise their land-use plans to accommodate such parks.

The notification also prohibits enterprises and individuals from occupying farmland for the purpose of developing commercial housing. To avoid turmoil in the real

40 On March 14, 2004, the tenth National People’s Congress in its second session approved an amendment to the third paragraph of Article 10 of the Constitution of the PRC. It formerly read: "The State may, in the public interest, requisition land for its use in accordance with the law." The revision reads: “The State may, in the public interest and in accordance with the provisions of law, expropriate or requisition land for its use and shall make compensation for the land expropriated or requisitioned.” This amendment indicates a concern at high levels to convey greater certainty to the value of land-use rights. See http://english.peopledaily.com.cn/constitution/constitution.html
estate market, the government guidelines require that authorizations granted for the building of commercial apartments and office buildings should be controlled, and authorizations granted for the construction of villas be suspended. The notification urges local land and resources departments to supervise closely the use of authorized land to prevent a handful of land developers from occupying large tracts of land, thereby wasting precious land resources and negatively impacting the real estate market. Meanwhile, work on cadastral registration and land management work should intensify, so that essential real estate information can be reliably supplied to the country’s financial institutions.

The evident buoyancy of the urban housing and property markets suggests that land markets are functioning to some degree, despite the evident concerns of authorities to ensure that land is not misused. Real estate developers must be securing sufficiently reliable title to land ownership or lease to persuade bankers that mortgage financing is secure. One can question, however, whether rights to land use are recognized universally. One can also question whether they are so well established that they can be used reliably, for example, by farmers as collateral for borrowing, or be sold by SOEs as a way to reduce their liabilities, or by governments as a way to capitalize pension funds to benefit their employees.

In comparison with the urban market, the market for rural collectively owned land is underdeveloped. As the Household Responsibility System was introduced in 1979-1983 the collective farms were dismantled and rights to use parcels of land were allocated to individual farming households. The land recipients could keep residual income (earned by producing and selling more than the plan required), but their land-use rights were only for a 15-year term. Land was not privatized, and local leaders reserved the right to reallocate land based on concerns of equity or efficiency. Although land rights were subject to uncertainty, they were secure enough to provide farmers with greater incentive to work harder and otherwise increase productivity.

Many local officials have reallocated land among households before the end of the stipulated 15-year tenure period. Brandt and his co-authors (2002) conclude that reallocations generally have increased productivity, as they have tended to shift land-use rights away from households with a lower marginal productivity of labor in favor of those
with a higher, but they have also hindered the development of land rental markets.\footnote{Brandt, Loren, Jikun Huang, Guo Li and Scott Rozelle (2002) “Land Rights in China: Facts, Fictions, and Issues,” China Journal 47 (January 2002): 67-97} Furthermore, the lack of more secure tenure probably reduces farmers’ willingness to invest in such longer-term land improvements as irrigation and drainage. They also suggest that, although administrative reallocation has tended to raise productivity, a free land market would have done so much more quickly and efficiently.

Brandt, Rozelle and Turner (2003) find evidence that local officials are often motivated by rent-seeking along with a desire for greater efficiency and/or equity when they reallocate land rights.\footnote{Brandt, Loren, Scott Rozelle and Matthew A. Turner (2003) “Local Government Behavior and Property Right Formation in Rural China” Working Paper, circulated.} The development of free markets in land-use rights is hindered by the social problems that would result if some families lost most or all of their land to more productive households. Free markets for land use are likely to prove infeasible as long as the opportunities to earn a living off the farm are so limited. As well, complementary markets, especially credit markets, are still underdeveloped, limiting the extent to which a free rural land market can emerge.

There are laws and regulations that specify conditions under which rural land can be converted to commercial use, providing certain examination and approval processes are followed, including the payment of compensation by those acquiring the land-use rights to the collective land owners and former users. But the share of rural land entering true market circulation has been quite low. Nevertheless, even though local leaders at village or township level retain considerable authority to allocate and reallocate land use rights to households, rental markets in land-use rights are becoming more common. Brandt and his co-authors (2002) find that rental markets are found more frequently in villages that have younger leaders and smaller grain quotas. They note as well that both administrative reallocation and rental of land use rights “are positively correlated with growth in off-farm (employment) opportunities.”\footnote{The insert in italics is ours. Brandt et.al. (2002) conclude that “a solid empirical basis does not currently exist for making an assessment of the impact of the land system on efficiency, equity, and overall development of China’s rural sector.”} We conclude that in both urban and rural areas, markets in land-use rights are still significantly underdeveloped.
IV. Remaining Challenges

In their evaluation of China’s progress in transition to a market economy, Yingyi Qian and Jinglian Wu (2003) assert that the core issue among the many reform challenges that China still faces “is to establish a system of free and competitive enterprises wherein the nature of the government-business relationship is changed to one at arm’s length.” This sound conclusion impresses as the pre-condition for the elimination of the remaining fragmentation of China’s markets, since the incentive to tilt the playing field in favor of local firms will persist if the interests of local officials and local businesses remain conjoined.

The greater efficiency made possible by the improved incentives embodied in the household responsibility system and its descendants contributed greatly to accelerating China’s growth, and growing competition in fair and open markets remains the best approach to ensuring that efficiency continues to improve. Entry into the WTO will heighten the competitive forces that are essential if China’s regions are to specialize according to their international comparative advantage and so form an integrated domestic market in which resources are allocated to their most productive uses.

Two recent surveys (IFC 2000, ADB 2003) of China’s domestic privately-owned firms point to the concerns that entrepreneurs express about the lack of consistency with which local officials interpret and implement policies, laws, regulations and rules governing the conduct of enterprises and the functioning of markets. China has begun the task of reformulating many of its laws and regulations to make them conform to WTO requirements. An associated burden is to educate officials at all levels in the way in which the new laws and regulations have to be interpreted and implemented under WTO rules. These changes create a general opportunity to make China’s institutions more “market friendly,” and to raise the consistency with which government officials implement policies that affect economic activity. In particular, the commitment under WTO to create a process enabling those who contend they are harmed by instances of protection of local markets to appeal to the central government clearly would be of equal or greater value for dealing with solely domestic disputes.
Institutional change in China has evolved in similar fashion to policy change, with gradual adaptation being the norm. Concerns about how effectively the legal system functions will be sharpened by the greater openness of the Chinese economy to foreign enterprise, and the probability that foreign firms will push for increased transparency in how Chinese courts deal with contractual disputes, bankruptcy, recovery of collateral, and so on. One way to reduce the parochial nature of local court decisions is the suggestion by Qian and Wu (2003) to introduce a “two-tier judiciary” in which cross-province circuit courts could have jurisdiction over disputes involving agents from two or more provinces. They regard such an institutional adaptation of the legal system as analogous to the similar changes brought about under (i) fiscal reform, with local and national tax bureaus replacing a single tax administration; and (ii) monetary reform, where the PBC established nine cross-provincial branches to replace a system in which every province had a branch of the PBC and local officials applied pressure to local branch managers to supplement liquidity in the local credit market.

A two-tier judiciary might be effective, in particular, in enforcing anti-trust legislation as it emerges, as well as inter-province commerce regulations that would prohibit many of the restrictions used by local officials in the past to protect local markets. Both the newly founded Ministry of Commerce and State-owned Assets Supervision and Administration Commission (SASAC) seem committed to promoting fair competition in a way that ensures the integration of the domestic market, at the same time ensuring that attempts to protect local markets do not cause China to contravene its undertakings under the WTO accession protocols.44

If a solution such as this were introduced to create impartiality in resolving legal disputes across provinces, complementary reform of the legal system within provinces would still be needed. There is a pressing need to streamline the functioning of the

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44 The Ministry of Commerce was formed from the union of the Ministry of Foreign Trade and Economic Cooperation and the Ministry of Domestic Trade in the government reforms emerging from the National People’s Congress of March 2003. It also took over some of the functions of the former State Economic and Trade Commission (SETC). The Xinhua News Agency reported on May 22, 2003, that the SASAC has taken over responsibilities for “the reform and restructuring of (SOEs and) the maintenance and appreciation of state assets value for those state-invested enterprises,” as stated by SASAC Director, Li Rongrong. The new agency inherits the former SETC’s role in these areas, as well as the Ministry of Finance’s former responsibility for management of state-owned assets, and the similar responsibilities of the former Work Committee of Enterprises of the CPC Central Committee and the Ministry of Labor and Social Security.
commercial and tax courts to ensure consistent and timely resolution of contract disputes between parties within provinces. A particular example is the need for more reliable and expeditious recovery of collateral in the event of loan defaults, especially to the commercial banks. The local courts also have to guarantee to private property the same degree of protection under law that is enjoyed by public property. An important example is intellectual property; increasingly, private companies report infringements of patents, copyrights and trademarks (ADB 2003).

The pressure on the court system to bring timeliness, impartiality and transparency to the settlement of legal disputes will be mirrored in the similar pressures on regulators to establish standards for the performance of regulated enterprises that will apply nationwide. The regulatory agencies that oversee the financial and capital markets, as well as those that oversee the provision of infrastructure services in such essential areas as power; telecommunications; road, rail, air and sea transport; and water supply, need to ensure that the service and other standards they introduce contribute to the integration of, for example, the national power grid, the inter-bank market, and long-distance freight hauling.

Besides improved legal and regulatory supporting infrastructure for markets, other institutional changes and complementary services also will help to improve market performance. Many analysts point to the inefficiency that still plagues China’s internal distribution chains, quite apart from any overt attempts by local officials to hamper free movements of goods into their markets. Nyberg and Rozelle (1999) identify many of the sources of inefficiency in marketing agricultural products. They note that improved marketing efficiency benefits both producers and consumers, as it enables middlemen to pay higher prices for farmers’ crops, while at the same time reducing prices to final consumers. The greatest benefits are likely to derive from eliminating state monopolies in procurement and introducing greater competition in wholesale and retail trading, including allowing small traders to procure products directly from farmers or farmer marketing cooperatives.

Competition would encourage improvements in transportation infrastructure and packaging, as well as specialized handling facilities for high-value, perishable products.

45 See especially Chapter 5 “The Development of Markets.”
Nyberg and Rozelle (1999) state: “Interprovincial barriers to trade in perishable and processed foods include inconsistent weighing, inspection and other procedures, and the lack of national standardized quarantine and phytosanitary inspection certificates and clearance documents.” They go on to describe the idiosyncratic behavior of inspection and control authorities at provincial borders, especially at borders with provinces that produce competing products. This underlines the need to quash local protectionist measures as a prerequisite for improving efficiency in distribution.

**Standards and Information**

Information lubricates the engine of competitive markets, and there is scope for much greater disclosure of market relevant information in China. The ADB (2003) identifies deficient information as one of the three principal resource constraints on private enterprises (along with access to finance, and to senior management and technical skills). An important area where the need for better information intersects with the need for better market-supporting infrastructure is in the provision of high quality grading, standardization and certification services. Chinese companies that sell into global markets increasingly see the value in seeking ISO9000 or comparable certifications of product quality. China needs similarly reliable domestic standards, uniformly applied and recognized nation-wide, to certify the integrity of the product to the consumer.

Certification of quality adds value to a diverse range of goods and services. In the case of professional services, such as accounting, medicine, legal services, and engineering or architectural consultancies, associations of the practitioners often certify that their members are qualified to provide the relevant service. In issuing licenses to prospective suppliers of professional services, Chinese officials could increasingly draw on professional associations to assess the qualifications of applicants. In the longer term, this might allow self-policing associations to establish codes of behavior and service standards for licensed members.

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46 Many examples of the role that information plays in efficient markets are available in McMillan (2002). In particular, see chapter 4.
In agriculture and food handling services (restaurants, supermarkets) much of the certification activity is designed to ensure that consumers are supplied with healthful products: standards of hygiene and storage and other practices are such that shoppers can be confident that they do not put their health at risk in consuming the product. But beyond simple considerations of the wholesomeness of products, there is still scope for certifying differences in quality (in rice and wheat, meat, cotton fiber, edible oils, etc.) that justify differences in price. China needs to train many more skilled product graders who can establish reliable standards, so consumers will be assured that identification labels mean what they say. Misrepresentation of standards should be punished under law in the same way that infringements of copyright and other proprietary assets of firms are. Nyberg and Rozelle (1999) contrast the open access to information in the United States with the situation in China, where “market information has historically been collected as input for government policy decision rather than to help markets perform more efficiently.” The problem in China is not so much that information doesn’t exist, but that so little effort goes into making it available in a useful form to market participants. Referring to enterprises’ access to information, the ADB (2003) recommends that to improve the availability and quality of information the priorities are (i) to coordinate the responsibilities of different agencies to collect and distribute information; and (ii) to improve the dissemination of information on policies and regulations, internal and external markets, access to technology, availability of training services, and so on. With adequate education of producers and consumers, the Internet is a potentially highly efficient way to inform people about all aspects of participation in markets. Introducing complementary markets can provide additional information to enhance overall market efficiency. The development of forward and futures markets could play this role, especially in agriculture. But for these markets to develop and flourish, there needs to be competition in procurement of agricultural commodities so that large suppliers and large users can make a market. The emergence of chain distributors and such ubiquitous franchises as McDonalds can be expected to create pressures for reliable quality products and secure supplies over time. In turn, that will encourage vertical supply linkages built on longer-term contracts to supply products of appropriate
quality to final users and retailers. Increasing competition in the capacity to supply supermarkets, department stores and their like should be a source of substantial efficiency gains in the Chinese economy.

**Financial and Capital Markets**

Better information, greater transparency, and complementary service provision have a major role to play as well in improving the functioning of financial and capital markets. High on the priority list is reliable adherence by listed firms to the disclosure provisions of the CSRC. Attempts by the CSRC to encourage better disclosure of real performance seem to have achieved only limited success. Companies have to demonstrate three years of profitable operation before they can be listed on the stock exchanges, which presumably creates incentives for some firms to report profits that otherwise might be hidden to avoid taxes. And the CSRC requirement that firms must pay dividends to stockholders for three consecutive years before they are eligible to make a public issue of additional equity has led many firms to distribute what amount to derisory dividends where none were paid out previously (Lau and Wang 2003). The need is for a culture emphasizing that firms have to comply with the intent rather than the letter of market regulations: overall, public confidence in the published annual reports and balance sheets of listed firms can hardly be high.

With the emergence of institutional investors and professional fund managers, one can expect that many more stock analysts will be hired by brokerage houses and merchant banks, and their analyses of the inner working of listed companies over time should do much to provide better information to the investing public. Reputable rating agencies would have valuable contributions to make to develop further the market for corporate and sub-national government bond issues, as they begin to be authorized. Another important source of information to facilitate the development of the debt market will be provided by the emergence of a yield curve for different maturities of Central Government debt – the “risk-free” debt instrument. Establishing a yield curve will require the Ministry of Finance, the PBC and the specialized financial institutions to issue a wider range of maturities for their instruments and to allow (at least, the bulk of) their
issues to be placed according to free bids in regularly scheduled auctions for the securities. That requires greater willingness to allow flexibility in the determination of all domestic interest rates, as well as to continue to phase out the practice of effectively placing Government bond issues with the state-owned banks. It also requires active secondary markets, which argues for many more bondholders who will seek advantage in trading bonds in the secondary market. Increasingly, institutional investors can be expected to play an active role. A result of deeper, more active bond markets would be an improved capacity of the PBC to conduct monetary policy through open market operations.

Commercial banks would benefit from greater freedom to determine lending and (perhaps some time later) deposit rates, but judgments of their performance based on the scrutiny of stock analysts, rating agencies and others would be likely to be harsh. Little information is available about the loan experience of the banks and, although the business publications are rife with speculation about the share of non-performing loans in the banks’ portfolios, there are no authoritative figures, and few believe the official pronouncements. Bank governance and performance would likely improve with more public disclosure of the banks’ loan experience. Loan committees might acquire considerably more backbone in resisting the blandishments of officials seeking support for down-at-heel SOEs and other pet projects if the results of such decisions were given more publicity.

At the same time, banks might finance more private firms if they were free to charge interest rates that would compensate for transactions and monitoring costs, and risk, and if they could recover collateral quickly and at reasonable cost in the event of loan default. They would be aided in making credit decisions by the introduction of an effective credit information system, covering enterprises and individuals, under the oversight of the PBC.\footnote{In its \textit{Annual Report 2003}, the PBC announced one of its priorities for 2004 is to improve the credit information system as a contribution to the stability of the financial system. The Report (pages 82-84) notes that “the credit reporting industry is still in its preliminary stage,” at the same time noting important improvements as well as the urgent issues for action.} Such a system could supply to banks and enterprises specific information about the borrowing status, loan servicing records and credit standing of prospective clients. A related institutional development would be the introduction of a
collateral registration system that would allow banks to determine whether assets offered as collateral for loans were unencumbered or had already been pledged to secure loans (ADB 2003).

Besides securities, markets for other assets also would perform better if more expertise in asset valuation were available. Specialists in valuing assets could help in the disposition of state-owned assets where that would be desirable either to improve the economic return on those assets, or to raise the revenues needed to capitalize pension and other funds, and so finance the contingent liabilities of China’s governments to workers and retirees. Officials would be less reluctant to approve the transfer of public assets to private hands if they had assurance that the prices paid conform to an expert’s view of the intrinsic value of the asset and if, by publicizing the appraised value of the assets before disposing of them, officials could thereby deflect accusations of malfeasance in the transfer.

Open auctions could play a much bigger role in establishing working markets for assets. They have been used to a limited extent already: to a greater extent in issuing some Government bonds and in allocating exploration blocks to minerals interests, and to a lesser extent in allocating user rights to urban land, and in placing SOEs under private ownership. Auctions of Government securities will facilitate the conduct of monetary policy as the capital market develops, and will comprise the principal mechanism for issuing corporate securities through under-writers, who themselves will compete to provide their services. Open auctions of real assets against a disclosed reserve price have great appeal as a transparent way to dispose of public assets efficiently.

V. Conclusions

How well do Chinese markets function? Where will further market liberalization have the biggest impact in raising efficiency and promoting faster growth? What are the main impediments to reforms and how can they be removed? We draw some tentative conclusions, and advance some hypotheses.
First, by any reasonable criteria, China’s progress in re-establishing markets has been highly successful, as demonstrated in particular by the spectacular growth of the economy over a quarter century. Aided by very large inflows of foreign direct investment, China has adopted the East Asian model, linking its economy to the international economy and building a highly competitive export sector. This has served both to demonstrate the advantages of market-oriented policies and to raise the productivity of resource use throughout the economy. Although China has irrevocably committed to establishing a market economy, the situation has yet to progress to the point where markets are entrusted, with minimum encumbrance, to allocate goods, services and factors of production. The Government reserves the right to intervene when market-determined outcomes are not to its liking, even where the better (meaning more market friendly) policy might be to liberalize further rather than to re-impose administrative controls.

Our review suggests that market development has progressed most in the goods markets, with services next, and factor markets still lagging. Despite the significant cracks that now exist in the “iron rice bowl,” the integration of labor markets, especially, still has far to go – within provinces between the rural and urban work forces, and nationwide. The announcement that the hukou system will be largely phased out in coastal provinces over the next five years might portend a welcome increase in the mobility of rural labor. In turn, that would help the agricultural work force to adjust to the WTO-induced changes in agricultural output and trade. Markets for both capital and land seem to function to a degree, with considerable progress in their development in the past decade, but both remain underdeveloped. In the case of land, there still seems more to do in providing adequate legal support for user rights.

Second, China’s markets, like markets everywhere, thrive where there is free and fair competition. Most Chinese entrepreneurs view their business environment as intensely competitive and, like enterprise owners everywhere, they seek shelter from competitive forces wherever possible. They are frequently successful in that endeavor, with officials of sub-national governments in particular taking steps to protect enterprises

48 This is the term given to the guarantee of life-time employment with associated benefits for the employees of SOEs.
that they regard as local. There is insufficient recognition in local government of the advantages of an integrated national market, and in turn a Chinese economy that is integrated with the global economy. The Central Government has repeatedly emphasized the need to eliminate protection of local markets, and thereby lends support to the notion that the internal Chinese markets would be more efficient if they were better integrated.

To improve the performance of China’s markets, more of the right sort of competition is needed. We hypothesize that four broad types of government actions can heighten fair competition and improve the way in which Chinese markets work. In the approximate order in which they are likely to contribute to efficiency gains, they are:

- Phase out remaining barriers to the freedom of movement of goods, services and factors of production in the domestic markets
- Roll back the barriers to foreign participation in the Chinese economy in accordance with, but not limited to, the undertakings for accession to the WTO
- Compile and disseminate more information of all kinds to improve participants’ knowledge of China’s market environment, and
- Experiment in introducing more complementary markets (for example, forward markets, markets for derivatives) and market supporting services (rating agencies, specialists in grading products and valuing assets, marketing, communications, transport, handling and distribution services, and more)

Of course, these actions are complementary rather than exclusive, which is a major reason for suggesting that the ranking is approximate. Better internal logistics networks will contribute to a better-integrated domestic goods market, while foreign competition in providing supporting logistics, as well as in supplying goods, will help to lower costs and contribute to market efficiency. Similarly, better information about the availability of jobs and the conditions of employment, as well as the local housing market, education and health services, could be considered a prerequisite for integration of the labor market. And introducing complementary markets and services would help to generate considerably more useful information for market participants, thereby enhancing competition.
As in all Chinese reforms, further liberalization of markets inevitably will be gradual, which raises the question of how best to sequence new policy initiatives. In important areas: services of all kinds, agriculture, banking and enterprise reform, labor and land markets, credit and capital markets, what genius will be needed to design more of the transitional, “dual-track” types of policies that have served China so well? Has China progressed to a stage in market reform where the price of benefits for some is considerable pain for others, including sub-national governments, which must forego interventions dear to their hearts in the interests of greater economic efficiency?

Greater competition in providing services offers potentially large economic benefits because these are areas in which domestic suppliers are still woefully inadequate. But even if, for example, rapid penetration of China’s banking system by foreign banks would improve client services, the Government might well be unprepared to accept that development if it occurs because domestic banks are unable to compete on a level playing field. The current state of the portfolios of the SCBs as well as their fundamental lack of banking skills almost surely will result in the Government taking measures to delay its commitments under the WTO accession until the SCBs are better placed to take on the foreigners. Essentially, approaches need to be found that reap the benefits of early foreign entry as they convey breathing space to the SCBs to clean up their act.

China has already encountered challenges involving some of its commitments made to the WTO under the terms of accession. In 2003-04, both the United States and the European Union have begun to push more openly for reforms, in line with China’s WTO obligations, their actions probably prompted in large part by surging Chinese exports to their markets. In trade negotiations with China, agriculture, intellectual property rights and access to markets for services have been steady sources of contention, joined in 2004 by concerns about China’s exchange rate. Mainly, differences have been addressed through diplomatic channels, though the US has moved in 2004 to impose safeguard measures on some Chinese goods and filed a grievance with the WTO over taxes that it alleges harm US exports. Adjustments under WTO should be much more straightforward for China’s markets for goods than for services, and early problems with the former might be a harbinger of pressures that China’s Government could encounter in more sensitive areas during the further push towards freer markets.
In many areas, however, China should welcome the consequences of greater reliance on the markets. On occasion, the Government still exhibits a deep ambivalence to market outcomes, for example, in its directives to the SASAC (which is feeling its way in supervising 189 central-level SOEs) to improve the performance of its SOEs and at the same time to “strengthen(...) the role of the SOE-Party organization in all aspects of major decisions of the enterprises, including the appointment of key enterprise personnel.”\textsuperscript{49} Similarly, Premier Wen Jiabao (2004) promises reform of the grain distribution system, with all controls over market sales and purchases to be lifted, and China has agreed to significant opening of the agricultural sector as part of WTO accession. But in the same report, the Premier asserts that “grain production capability must be maintained and increased” and “acreage sown in grain crops will be expanded,” hardly indicating a willingness to allow the markets to determine outcomes.\textsuperscript{50} China would be no exception if it over-rides market forces in the interests of food security and other objectives in the agricultural sector, but the contradictory nature of official statements indicates the distance remaining to be traveled over undoubtedly rugged terrain before market reform is complete.

\textsuperscript{49} Communication from Hang-Sheng Cheng, President, The 1990 Institute, April 2004.
# APPENDIX

## Table A1: Composition of Gross Domestic Product

(% of Total)

<table>
<thead>
<tr>
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<tr>
<td>Primary Industry</td>
<td>30.1</td>
<td>28.4</td>
<td>27.1</td>
<td>20.5</td>
<td>16.4</td>
<td>15.2</td>
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<tr>
<td>Secondary Industry</td>
<td>48.5</td>
<td>43.1</td>
<td>41.6</td>
<td>48.8</td>
<td>50.2</td>
<td>51.1</td>
<td>51.8</td>
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<td>(Industry)</td>
<td>44.2</td>
<td>38.5</td>
<td>37.0</td>
<td>42.3</td>
<td>43.6</td>
<td>44.4</td>
<td>44.9</td>
</tr>
<tr>
<td>(Construction)</td>
<td>4.3</td>
<td>4.6</td>
<td>4.6</td>
<td>6.5</td>
<td>6.6</td>
<td>6.7</td>
<td>6.9</td>
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<tr>
<td>Tertiary Industry</td>
<td>21.4</td>
<td>28.5</td>
<td>31.3</td>
<td>30.7</td>
<td>33.4</td>
<td>33.7</td>
<td>33.7</td>
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<tr>
<td>(Wholesale, Retail Trade &amp; Catering Services)</td>
<td>4.7</td>
<td>9.8</td>
<td>7.7</td>
<td>8.4</td>
<td>8.2</td>
<td>8.2</td>
<td>8.0</td>
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<tr>
<td>(Transport, Storage, Post &amp; Telecommunication Services)</td>
<td>4.5</td>
<td>4.5</td>
<td>6.2</td>
<td>5.2</td>
<td>6.0</td>
<td>5.4</td>
<td>5.4</td>
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<tr>
<td>(Others)</td>
<td>12.2</td>
<td>14.2</td>
<td>17.4</td>
<td>17.1</td>
<td>19.2</td>
<td>20.0</td>
<td>20.3</td>
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</table>

Source: China Statistical Abstract 2003

Note: In 2003, China’s GDP was Rmb 11.7 trillion yuan, approximately $1.41 trillion.
Table A2: Composition of China's Merchandise Exports and Imports
(% of Total)

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<tr>
<td></td>
<td>Exp</td>
<td>Imp</td>
<td>Exp</td>
<td>Imp</td>
<td>Exp</td>
<td>Imp</td>
<td>Exp</td>
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<td><strong>Primary Goods</strong></td>
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<td></td>
<td></td>
<td></td>
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<tr>
<td>(food, etc.)</td>
<td>50.3</td>
<td>34.8</td>
<td>50.5</td>
<td>12.5</td>
<td>25.6</td>
<td>18.5</td>
<td>14.4</td>
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<tr>
<td>(minerals, etc.)</td>
<td>16.5</td>
<td>14.6</td>
<td>14.3</td>
<td>4.2</td>
<td>10.6</td>
<td>6.3</td>
<td>7.6</td>
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<tr>
<td>(other)</td>
<td>23.6</td>
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<td>26.1</td>
<td>0.4</td>
<td>8.4</td>
<td>2.4</td>
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<td><strong>Manufactures</strong></td>
<td>49.7</td>
<td>65.2</td>
<td>50.4</td>
<td>87.5</td>
<td>74.4</td>
<td>81.5</td>
<td>85.5</td>
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<td>(chemicals, etc.)</td>
<td>6.2</td>
<td>14.5</td>
<td>4.9</td>
<td>10.6</td>
<td>6.0</td>
<td>12.5</td>
<td>6.1</td>
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<tr>
<td>(light industrial, textiles, rubber, mineral, metallurgical)</td>
<td>22.1</td>
<td>16.4</td>
<td>28.2</td>
<td>20.3</td>
<td>16.7</td>
<td>21.7</td>
<td>21.9</td>
</tr>
<tr>
<td>(machinery &amp; transport equipment)</td>
<td>4.7</td>
<td>25.6</td>
<td>2.8</td>
<td>38.4</td>
<td>9.0</td>
<td>31.6</td>
<td>21.1</td>
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<tr>
<td>(miscellaneous and others)</td>
<td>15.7</td>
<td>4.3</td>
<td>25.2</td>
<td>10.3</td>
<td>39.1</td>
<td>39.1 a)</td>
<td>20.7</td>
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<tr>
<td><strong>Total (%)</strong></td>
<td>100</td>
<td>100</td>
<td>100</td>
<td>100</td>
<td>100</td>
<td>100</td>
<td>100</td>
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<tr>
<td><strong>US$ billion</strong></td>
<td>18.1</td>
<td>20.2</td>
<td>27.4</td>
<td>42.3</td>
<td>62.1</td>
<td>53.3</td>
<td>148.8</td>
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</table>

Source: China Statistical Yearbook 2002
Notes: a) Includes almost 19% of total products that were unclassified in 1990; almost all products were classified in 1980 and 2000.
   b) Includes almost 17% of total products that were unclassified in 1990; almost all products were classified in 1980 and 2000.
### Table A3: Number of Employed Persons at Year-End, by Sector
(millions of persons)

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<tbody>
<tr>
<td>Farming, Forestry, Animal Husbandry and Fishery</td>
<td>291.2</td>
<td>311.3</td>
<td>341.2</td>
<td>330.2</td>
<td>333.6</td>
<td>329.7</td>
<td>324.9</td>
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<tr>
<td>Mining and Quarrying</td>
<td>7.0</td>
<td>7.6</td>
<td>8.8</td>
<td>9.3</td>
<td>6.0</td>
<td>5.6</td>
<td>5.6</td>
</tr>
<tr>
<td>Manufacturing</td>
<td>59.0</td>
<td>74.1</td>
<td>86.2</td>
<td>98.0</td>
<td>80.4</td>
<td>80.8</td>
<td>83.1</td>
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<td>Production and Supply of Electricity Gas and Water</td>
<td>1.2</td>
<td>1.4</td>
<td>1.9</td>
<td>2.6</td>
<td>2.8</td>
<td>2.9</td>
<td>2.9</td>
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<tr>
<td>Construction</td>
<td>9.9</td>
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<td>35.5</td>
<td>36.7</td>
<td>38.9</td>
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<tr>
<td>Geological Prospecting and Water Conservancy</td>
<td>1.9</td>
<td>2.0</td>
<td>2.0</td>
<td>1.3</td>
<td>1.1</td>
<td>1.1</td>
<td>1.0</td>
</tr>
<tr>
<td>Transport, Storage, Post &amp; Telecommunication Services</td>
<td>8.1</td>
<td>12.8</td>
<td>15.7</td>
<td>19.4</td>
<td>20.3</td>
<td>20.4</td>
<td>20.8</td>
</tr>
<tr>
<td>Wholesale and Retail Trade and Catering Services</td>
<td>13.6</td>
<td>23.1</td>
<td>28.4</td>
<td>43.0</td>
<td>46.9</td>
<td>47.4</td>
<td>49.7</td>
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<tr>
<td>Finance and Insurance</td>
<td>1.0</td>
<td>1.4</td>
<td>2.2</td>
<td>2.8</td>
<td>3.3</td>
<td>3.4</td>
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<tr>
<td>Real Estate</td>
<td>0.4</td>
<td>0.4</td>
<td>0.4</td>
<td>0.8</td>
<td>1.0</td>
<td>1.1</td>
<td>1.2</td>
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<tr>
<td>Social Services</td>
<td>2.8</td>
<td>4.0</td>
<td>6.0</td>
<td>7.0</td>
<td>9.2</td>
<td>9.8</td>
<td>10.9</td>
</tr>
<tr>
<td>Health Care, Sports &amp; Social Welfare</td>
<td>3.9</td>
<td>4.8</td>
<td>5.4</td>
<td>4.4</td>
<td>4.9</td>
<td>4.9</td>
<td>4.9</td>
</tr>
<tr>
<td>Education, Culture and Arts, Radio, Film and Television</td>
<td>11.5</td>
<td>12.7</td>
<td>14.6</td>
<td>14.8</td>
<td>15.6</td>
<td>15.9</td>
<td>15.6</td>
</tr>
<tr>
<td>Scientific Research and Polytechnic Services</td>
<td>1.1</td>
<td>1.4</td>
<td>1.7</td>
<td>1.8</td>
<td>1.7</td>
<td>1.7</td>
<td>1.6</td>
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<tr>
<td>Government Agencies, Party Agencies and Social Org.</td>
<td>5.2</td>
<td>8.0</td>
<td>10.8</td>
<td>10.4</td>
<td>11.0</td>
<td>11.0</td>
<td>10.7</td>
</tr>
<tr>
<td>Others</td>
<td>5.9</td>
<td>13.2</td>
<td>18.0</td>
<td>44.8</td>
<td>56.7</td>
<td>58.5</td>
<td>62.5</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>423.6</strong></td>
<td><strong>498.7</strong></td>
<td><strong>647.5</strong></td>
<td><strong>680.7</strong></td>
<td><strong>720.9</strong></td>
<td><strong>730.3</strong></td>
<td><strong>737.4</strong></td>
</tr>
</tbody>
</table>

Source: *National Bureau of Statistics of China, 2002*
Table A4: China’s External Sector: Selected Indicators
(unit: Billion Us Dollars or yuan per dollar)

<table>
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<tr>
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<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Goods Exports: F.O.B.</td>
<td>n.a.</td>
<td>25.11</td>
<td>51.52</td>
<td>128.11</td>
<td>249.13</td>
<td>266.08</td>
<td>325.65</td>
<td>438.5</td>
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<tr>
<td>Utilized FDI</td>
<td>n.a.</td>
<td>1.96</td>
<td>3.49</td>
<td>37.52</td>
<td>40.72</td>
<td>46.88</td>
<td>52.74</td>
<td>53.51</td>
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<td>Foreign Exchange Reserves</td>
<td>2.26</td>
<td>11.91</td>
<td>28.59</td>
<td>73.58</td>
<td>165.57</td>
<td>212.17</td>
<td>286.41</td>
<td>403.25</td>
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<tr>
<td>RMB Exchange Rate (annual average)</td>
<td>1.50</td>
<td>2.94</td>
<td>4.78</td>
<td>8.35</td>
<td>8.28</td>
<td>8.28</td>
<td>8.28</td>
<td>8.28</td>
</tr>
</tbody>
</table>


Note: Exchange rates reported here are official rates. Between 1988 and 1993, China had a dual exchange rate system where the official exchange rate coexisted with a market-determined rate. China’s current unified, managed floating exchange rate regime based on market supply of and demand for foreign exchange came into existence in 1994. Between 1994 and 1997, the exchange rate (RMB/US dollar) appreciated from 8.7:1 to 8.3:1 under a managed float.
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