**Demystifying the Chinese Economy**

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**Summary:**

When China began its transition from a planned to a market-oriented economy in 1979, it was a poor, inward-looking country with a per capita income of US$ 182, less than one-third of the average in Sub-Saharan African countries, and a trade dependence (trade-to-GDP) ratio of 11.2 percent. China's economic performance since then has been miraculous. Annual GDP growth averaged 9.9 percent over the 30-year period, and annual growth in international trade, 16.3 percent. China is now a middle-income country, with a per capita GDP of US$ 4,260 in 2010, and more than 600 million people have escaped poverty. Its trade dependence ratio has reached 65 percent, the highest among the world's large economies. In 2009 China overtook Japan as the world's second largest economy and replaced Germany as the world's largest exporter of merchandise. China's car market is now the world's largest, and Shanghai has been the world's busiest seaport by cargo tonnage since 2005. The spectacular growth over the past three decades far exceeded the expectations of anyone at the outset of the transition, including Deng Xiaoping, the architect of China's reform and opening-up strategy.

In his presentation Dr. Justin Lin attempted to provide answers to six related questions:

- Why was it possible for China to achieve such extraordinary performance during its transition?

- Why was China unable to attain similar success before its transition started?

- Why did most other transition economies, both socialist and non-socialist, fail to achieve a similar performance?

- What costs does China pay for its extraordinary success?

- Will China sustain a similar dynamic growth in the coming decades?

- Can other developing countries achieve similar economic performance?

A developing country such as China, which started its modernization drive in 1949, potentially has the advantage of backwardness in its pursuit of technological innovation and structural transformation. A latecomer country in the catching up process can borrow technology, industry, and institutions from the advanced countries at low risk and costs. So if a developing country knows how to tap the advantage of backwardness in technology, industry, and social and economic institutions, it can grow at an annual rate several times that of high-income countries for decades before closing its income gap with those countries.

However, China possessed the advantage of backwardness long before the transition began in 1979 and the reason it did not grow as rapidly before then was because resources were misallocated, the incentives were distorted, and the labor-intensive sectors in which China held a comparative advantage were repressed. As a result, economic efficiency was low, and the growth before 1979 was driven mainly by an increase in inputs.7 Despite a very respectable average annual GDP growth rate of 6.1 percent in 1952–78 and the establishment of large modern industries, China was almost a closed economy, with 71.3 percent of its labor force still in traditional agriculture. In 1952–78 household consumption grew by only 2.3 percent a year, in sharp contrast to the 7.1 percent average growth after 1979.

China succeeded where many other transition economies failed because it adopted a pragmatic, gradual, dual-track approach where the government first improved incentives and productivity by allowing workers in the collective farms and state-owned firms to be residual claimants and to set the prices for selling at the market after delivering the quota obligations to the state at fixed prices (Lin 1992). At the same time, the government continued to provide necessary protections to nonviable firms in the priority sectors and simultaneously, liberalized the entry of private enterprises, joint ventures, and foreign direct investment in labor-intensive sectors in which China had a comparative advantage but that were repressed before the transition. This transition strategy allowed China both to maintain stability by avoiding the collapse of old priority industries and to achieve dynamic growth by simultaneously pursuing its comparative advantage and tapping the advantage of backwardness in the industrial upgrading process. In addition, the dynamic growth in the newly liberalized sectors created the conditions for reforming the old priority sectors.

Nevertheless, this gradual, dual-track approach to transition is also double-edge sword. While it enables China to achieve enviable stability and growth in the transition process, it also creates a number of structural problems, particularly disparities in income distribution, consumption and savings, and external accounts. For example, when the transition started in 1979, China was a relatively egalitarian society. With rapid growth, income distribution has become increasingly unequal.

China will continue to have the potential to rely on the advantage of backwardness and maintain dynamic growth for another 20 years or more but will also need to increasingly become an innovator in its own right. There are also some new sectors, such as green technology, which are important for China’s sustainable growth. China has the potential to be a leader due to its large domestic market. With foresight, China will be able to gradually shift from absorbing the existing technology to become an indigenous innovator of new technology for driving its growth.

There are clearly useful lessons that can be drawn from China's experiences over the past three decades. Every developing country has the opportunity to accelerate its growth if it knows how to develop its industries according to its comparative advantage at each level of development and if it can tap the advantage of backwardness in its technological innovation and structural transformation. In the reform process it is desirable for a developing country to remove various distortions of incentives to improve productivity and at the same time adopt a dual-track approach, providing some transitory protections to nonviable firms to maintain stability, but liberalizing entry into sectors in which the country has comparative advantages. Such an approach can improve the resource allocation and tap the advantage of backwardness. By adopting such an approach, other developing countries can also achieve stability and dynamic growth in their economic liberalization process.

**Discussion:**

The discussion focused on issues related to China's ageing society and the decline of the public health system, the role of consumption in spurring growth in the Chinese economy, the role of reverse engineering in the rise of China's manufacturing industry, and the devaluation of the yuan. Dr Lin pointed out that even as China aged, the levels of nutrition in the country have gone up allowing for longer life expectancy. He argued that China was far from a consumption-based economy at this stage and that reverse engineering was a common feature in all developing economies. He also pointed that Western views on the devaluation of the yuan were one-sided and inaccurate.

***Brief Bio:***

Dr Lin, Chief Economist and Sr. Vice President of the World Bank, is a world renowned development economist and an authority on the Chinese economy. Prior to coming to the World Bank, he was the founding director of the China Center for Economic Research at Peking University (1994-2008) and is the author of 17 books including the *Chinese Miracle* (1996), *State-Owned Enterprise Reform in China* (2001), and *Economic Development and Transition* (2009). He is a fellow of the Academy of Sciences for the Developing World and a corresponding fellow of the British Academy of Sciences. He gave the Annual WIDER Lecture earlier this year in Maputo.