Congressional Research Service

Report 97-932

China's Economic Development: An Overview

Wayne M. Morrison, Economics Division

October 10, 1997

Abstract. Many analysis predict that China's economy will likely continue to experience rapid growth in the near future, especially if economic reforms are expanded and deepened. As a result, the importance of China as a U.S. trading partner could be greatly enhanced. U.S.-Chinese economic relations have been a major issue in the annual congressional debate on extending China's most-favored-nation (MFN) status, as well as congressional oversight of the Administration's policy towards China's application to join the World Trade Organization (WTO).

97-932 E
October 10, 1997

CRS Report for Congress

Received through the CRS Web

China's Economic Development: An Overview

Wayne M. Morrison
Specialist in International Trade and Finance
Economics Division

Summary

Since the initiation of economic and trade reforms in 1978, China has been one of the world's fastest growing economies. According to Chinese data, real GDP grew at an average annual rate of 10% between 1979 and 1996, increasing the real size of the Chinese economy by five times its 1978 level and substantially raising Chinese living standards. Much of China's recent economic growth has been driven by a high rate of capital accumulation and large productivity gains, both largely the result of economic reforms. Foreign investment and trade have played a major role in China's economic growth. U.S.-China commercial relations have sharply expanded; China is now the 4th largest U.S. trading partner. Many analysts predict that China's economy will likely continue to experience rapid growth in the near future, especially if economic reforms are expanded and deepened. As a result, the importance of China as a U.S. trading partner could be greatly enhanced. U.S.-Chinese economic relations have been a major issue in the annual congressional debate on extending China's most-favored-nation (MFN) status, as well as congressional oversight of the Administration's policy towards China's application to join the World Trade Organization (WTO).

Introduction

China's rapid rise as an economic and trade power has been of great interest to U.S. policymakers, especially because such growth has led to a substantial increase in U.S-China economic relations (as well as friction over a number of issues). The prospect of future high levels of Chinese economic growth could have important ramifications for U.S. economic interests. An overview of the causes of China's rapid growth is useful in understanding the implications of China's future economic development.

China's Economy Prior to Economic Reforms

Prior to 1978, China maintained a relatively centrally planned, or command, economy. Most of the country's production (industry, agriculture, etc.) was directed and controlled by the central government which set production goals and controlled prices for nearly all goods and services. The Chinese government sought to make China's economy relatively self-sufficient. As a result, it limited trade to obtaining only those goods which could not be produced domestically. During the 1960s and 1970s, the central government mobilized domestic savings and undertook large-scale investments in physical and human capital in order to support rapid industrialization. China's massive investment in heavy industry helped produce an average annual GDP growth rate of about 5.3% from 1960-1978. However, China's economic policies kept the Chinese economy relatively stagnate and inefficient, mainly because these policies provided little or no profit incentives for firms and farmers, competition was virtually nonexistent, and price and production controls caused widespread distortions in the economy. China's investment in heavy industry generally came at the expense of agriculture, which lagged in production for much of the 1960s and 1970s.

China's Economic Reforms

Beginning in 1978, China launched several economic reforms, including the introduction of price and ownership incentives for farmers and the establishment of four special economic zones in China for the purpose of attracting foreign investment, boosting exports, and importing high technology products. Additional reforms, which sought to decentralize economic policymaking in several economic sectors (especially trade), followed in stages. Economic control of various enterprises was given to provincial and local governments which were generally allowed to operate and compete on free market principles, rather than under the direction and guidance of state planning. Additional coastal regions and cities were designated as open cities and development zones, which allowed them to experiment with free market reforms and to offer incentives to attract foreign investment. In addition, state price controls on a wide range of products were gradually phased out or eliminated.

The Results of Economic Reforms

China's economic reforms are largely credited for spurring the rapid economic growth that has since occurred. Between 1979 and 1996, real GDP grew at an average annual rate of 10% (**see table 1**); since 1991 it has averaged 11.7%.[1] In real terms, China's economy in 1996 was more than five times its 1979 level. China's real per capita GDP doubled by 1987 and doubled again by 1996, indicating a substantial increase in Chinese living standards. According to the World Bank, China's economic growth raised nearly 200 million people out of extreme poverty.

Table 1. China's Average Annual Real GDP Growth: 1960-1996

Time Period	Average Annual Real GDP
1960-1978 (pre-reform)	5.3
1979-1996 (post-reform)	10.0
1990	3.8

[1] These are official Chinese government estimates. Some economists, however, question the accuracy of China's real GDP growth data, arguing that it may be somewhat overstated.

1991	9.3
1992	14.2
1993	13.5
1994	12.7
1995	10.5
1996	9.7

Sources: The World Bank, *World Development Report* (various issues); and DRI/McGraw-Hill, *World Economic Outlook, Second Quarter 1997,* p. B3-B4 and A3. Data are based on official Chinese statistics and should be interpreted with caution. Several economists believe Chinese real GDP growth rate data may be somewhat overstated.

The Rise in Foreign Trade

Foreign trade played a major role in China's economic growth. Total Chinese merchandise trade (exports plus imports) rose nearly 10-fold, from $29.7 billion in 1979 to $289.9 billion in 1996; China's ranking as a trading economy rose from 27th to 10th. China's exports over this period rose at an average annual rate of 15%. Exports as a share of GDP rose substantially as well, from 5.9% in 1979 to 19.2% in 1996.

The Growth in U.S.-China Commercial Relations

The growth in the Chinese economy has helped boost U.S.-China economic relations (**see table 2**). U.S. exports to China grew from $0.8 million in 1978 to $12.0 billion in 1996; imports grew significantly faster, rising from $0.3 billion to $51.5 billion. The importance of China as a trading partner grew considerably. China went from the 32nd largest U.S. export market in 1978 to 15th in 1996, and from the 57th largest source of U.S. imports to 4th. China in 1996 accounted for about 1.9% of U.S. exports and 6.5% of U.S. imports. China has become an important source for a variety of products for the United States, namely toys and games, footwear, textiles, and electronics. China has become an important U.S. export market for such products as aircraft, fertilizers, textile fibers, and machinery.

Table 2. U.S.-China Trade: 1978-1996

	U.S. Exports to China			U.S. Imports From China		
	Totals ($Billions)	U.S. Rank	As a % of total US. Exports	Totals ($Billions)	U.S. Rank	As a % of Total U.S. Imports
1978	0.8	32	0.6	0.3	57	0.2
1987	3.5	18	1.4	6.3	12	1.6
1996	12.0	15	1.9	51.5	4	6.5

Source: U.S. Commerce Department

Causes of China's Rapid Economic Growth

Economists generally attribute much of China's rapid economic growth to two main factors: large-scale capital investment (financed by large domestic savings and foreign investment) and rapid productivity growth. These two factors appear to have gone together hand in hand. Economic reforms led to higher efficiency in the economy which boosted output and increased resources for additional investment in the economy.

High Savings and Foreign Investment

China already benefitted from a high rate of savings at the beginning of the reform period. Domestic savings as a percentage of GDP stood at 32% in 1978 (nearly as high as Japan's at the time). Most Chinese savings prior to 1978 were generated by the profits of State-owned enterprises (SOE), which were used by the central government for domestic investment. Economic reforms, which included the decentralization of economic production, led to substantial growth in Chinese household savings (which now account for half of Chinese domestic savings).[2] As a result, savings as a percentage of GDP has steadily risen; it was 42.3% in 1996, among the highest savings rates in the world.

China's trade and investment reforms and incentives led to a surge in foreign direct investment (FDI) and have been a major source of China's capital growth. Annual utilized FDI in China grew from $636 million in 1983 to over $40 billion in 1996, making China, in recent years, the second largest destination of FDI after the United States. FDI accounted for nearly 13% of China's total investment in 1996. About two-thirds of FDI in China has come from Hong Kong and Taiwan. The United States is the third largest investor in China, accounting for about 8% of total FDI. Foreign funded enterprises have been responsible for a large part of China's export boom. According to Chinese data, the share of total Chinese exports produced by foreign funded enterprises has risen from 0.1% in 1980 to 40.9% in 1996.[3]

Productivity Gains

Several economic studies have concluded that productivity gains (i.e., increases in efficiency in which inputs are used) were a major factor in China's rapid economic growth. For example, the International Monetary Fund (IMF) estimated that from 1952 to 1978, capital accumulation accounted for 65% of China's output increase (productivity and labor input growth accounting for 18% and 17%, respectively). In contrast, between 1979 and 1994 (during the reform period), productivity growth accounted for nearly 42% of China's increased economic output, while increases in capital and labor inputs accounted for 46% and 13%, respectively. The IMF study concluded: "Although growth rates in both capital and labor inputs rose significantly in 1979-1994, the productivity growth differential appears to explain the bulk of the difference in output growth between

---

[2] The World Bank, *China 2020*, 1997, p.5.

[3] East Asia Analytical Unit, Australian Department of Foreign Affairs and Trade. *China Embraces the Market: Achievements, Constraints. and Opportunities*, 1997, p. 181.

pre-reform and reform periods."[4] A World Bank study made similar conclusions, estimating that China's (total factor) productivity grew by more than 3% annually from 1985-1994 (a rate described by the World Bank as "exceptional by international standards"), and attributed one-third of the increase in China's output to increased productivity.[5]

The improvements to productivity were largely caused by a reallocation of resources to more productive uses, especially in sectors which were formally heavily controlled by the central government, such as agriculture, trade, and services. For example, agricultural reforms boosted production, thus freeing workers to pursue employment in more productive activities in the manufacturing sector.[6] China's decentralization of the economy led to the rise of non-state enterprises, which tended to pursue more productive activities than the centrally controlled state-owned enterprises (SOEs). Additionally, a greater share of the economy (especially the export sector) was exposed to competitive forces. Local and provincial governments were allowed to set up and operate various enterprises on market principles, without interference or subsidies from the central government. One study by F.C. Perkins found that export-oriented firms in China have experienced significantly higher productivity growth than non-exporting firms and that nonstate-owned enterprises firms have experienced higher productivity growth than the SOEs.[7] Perkins cites autonomy in decision making and exposure to freer domestic markets as the key factors in productivity growth by the non-SOEs. Competition is often a key factor in productivity growth because it forces firms to improve efficiency by adopting new technology and processes; it also forces inefficient firms to restructure (or exit the market), freeing resources for more productive uses.

The Future of Chinese Economic Development and Reforms

DRI\McGraw-Hill, a private economic forecasting firm, projects that China's real GDP growth will average over 9% annually through the year 2000, and about 7.5% thereafter, through the year 2015.[8] At these rates, China could more than double its GDP in less than 10 years. The continued growth of the Chinese economy and its trade flows will likely raise the importance of China to the United States as an export market and as a source of imports, although trade tensions will likely increase if China's markets remain relatively closed and if the bilateral trade deficit continues to expand sharply.

---

[4] Hu, Zuliu F and Khan, Mohsin S. *Why Is China Growing So Fast?* International Monetary Fund Staff Paper, Vol. 44, No.1. March 1997, p. 116.

[5] World Bank, *World Development Report*, 1996, p. 25.

[6] From 1978 to 1994 the proportion of the work force engaged in agricultural production dropped from 71% to 54%. A large share of agriculture workers found employment in locally controlled enterprises or foreign joint ventures.

[7] Perkins, F. C. *Export Performance and Enterprise Reform in China's Coastal Provinces*. Economic Development and Cultural Change, v. 45, April 1997, p. 502.

[8] DRI/McGraw-Hill. *World Market Reports*, July 1997.

Many economists argue that capital accumulation will remain an important factor in promoting rapid economic growth in China. China's high savings rate and ability to attract large FDI should enable it continue expanding the growth in capital per worker. However, the relative importance of productivity gains to increased output is likely to grow, and such gains will likely be largely dependent on the extent and pace of future economic and trade reforms. Exposing a greater share of the Chinese economy to market forces (such as liberalizing its trade regime) would likely lead to greater economic efficiency, and hence, higher output. The Chinese government's commitment to making substantial new economic reforms, however, remains uncertain. On the one hand, the Chinese government announced in September 1997 that it would significantly restructure its SOEs system, further reform its banking system, expand the rule of law, and cut average tariffs rates from 23% to 17%. Yet, many analysts remain skeptical over China's willingness to initiate significant new economic reforms, due to the government's stated fear of massive bankruptcies by SOEs, and stated plans to adopt protective industrial policies for certain "pillar industries," such as autos and electronics. China's offer of tariff reductions are viewed by some as insignificant in lieu of China's widespread appliance of non-tariff barriers and investment restrictions. Finally, past announcements of major economic reforms by the Chinese government have not always been followed by concrete actions.

Congressional Interest In China's Economic Development

China's rise as an economic power has been of interest to Congress in recent years, due in part to the rapid growth in U.S.-Chinese commercial relations. Several Members have expressed concern over the surge in the U.S. trade deficit with China ($39.5 billion in 1996), widespread Chinese trade barriers, and inadequate protection of U.S. intellectual property rights in China. Some Members have sought to link these (and certain other non-trade) issues to the renewal of China's most-favored-nation (MFN) status. Supporters of continued MFN treatment of China have argued that terminating it would undermine forces in China pushing for greater economic reforms, hurt certain U.S. exporting sectors, raise prices for several consumer products, and lock U.S. firms out of a potentially lucrative market. In recent years Congress has given greater attention to U.S. policy on China's application to join the World Trade Organization (WTO) to ensure that the Administration presses China to makes extensive economic and trade reforms (especially those which generate significant trade opportunities for U.S. firms) before obtaining membership. One bill in the 105th Congress, H.R. 1140 (Representative Gephardt), would require congressional approval prior to U.S. support of China's WTO accession.