

# The Lessons of Chinese Economic Reform 中国经济改革之经验

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Lawrence J. Lau (刘遵义)

香港中文大学 校长 与 蓝饶富与蓝凯丽经济学讲座教授  
及  
斯坦福大学 李国鼎经济发展学讲座荣休教授

中国改革开放 30 年暨孙冶方诞辰百年纪念经济理论研讨会

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Phone: (852) 2609-8600; Fax: (852) 2603-5230

Email: [LAWRENCELAU@CUHK.EDU.HK](mailto:LAWRENCELAU@CUHK.EDU.HK); WebPages: [HTTP://WWW.CUHK.EDU.HK/VC](http://www.cuhk.edu.hk/vc)

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Lawrence J. Lau (刘遵义)

President and Ralph and Claire Landau Professor of Economics  
The Chinese University of Hong Kong

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Kwoh-Ting Li Professor in Economic Development, Emeritus, Stanford University

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# An Outline

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- ◆ The Chinese Economy Today
- ◆ The Fundamental Importance of Domestic Savings
- ◆ The Role of Openness
- ◆ The Introduction of the Market System and Enterprise Autonomy
- ◆ Reform without Losers in Transition
- ◆ Directions for Further Reform
- ◆ Concluding Remarks

# The Chinese Economy Today (1)

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- ◆ China has made tremendous progress in its economic development since it began its economic reform and opened to the world in 1978. China is currently the fastest growing economy in the World—averaging approximately 10% per annum over the past 30 years.
- ◆ Between 1978 and 2007, Chinese real GDP grew fifteen-fold, from US\$228 billion to US\$3.42 trillion (2007 prices) (4th largest economy in the world) and real GDP per capita grew more than ten-fold from US\$236 to US\$2,571. By comparison, the U.S. GDP (approx. US\$13.84 trillion) and GDP per capita (approx. US\$45,671) were respectively 4 and 18 times the comparable Chinese figures in 2007.

# The Chinese Economy Today (2)

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- ◆ China is one of the very few socialist countries that have made a successful transition from a centrally planned to a market economy.
- ◆ The private (non-state) sector accounts for more than 70 percent of GDP and an even greater percentage of employment in 2007.

# The Chinese Economy Today (3)

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- ◆ Despite its rapid growth, China is still a developing economy in terms of its real GDP per capita. An economy is generally considered to be developed if its GDP per capita exceeds US\$10,000 (if we take into account inflation, this threshold probably should be higher).
- ◆ It will probably take another 20-25 years before China joins the ranks of developed economies, achieving a per capita real GDP of US\$10,000, and a further 20-25 years before China reaches the same level of real GDP per capita as the United States, some time around the middle of the 21<sup>st</sup> Century (bear in mind that in the meantime, the U.S. economy will continue to grow, albeit at rates much lower than those of China).

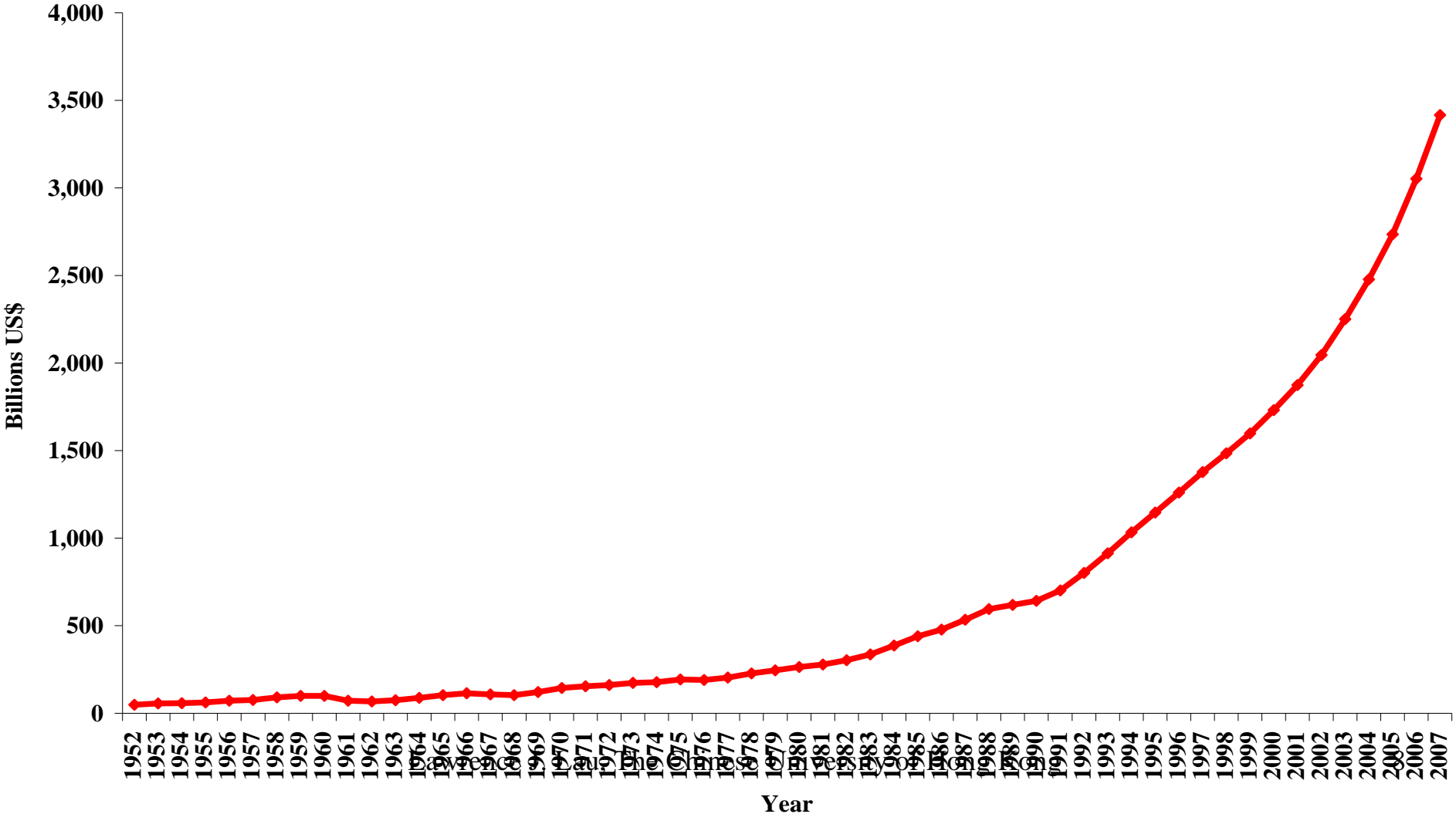
# The Chinese Real GDP and Real GDP per Capita: Past, Present and Projected Future

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	1978	2007	2020
	US\$	(2007 prices)	
Real GDP (trill.)	0.228	3.42	8.00
Real GDP/capita	236	2,571	5,500

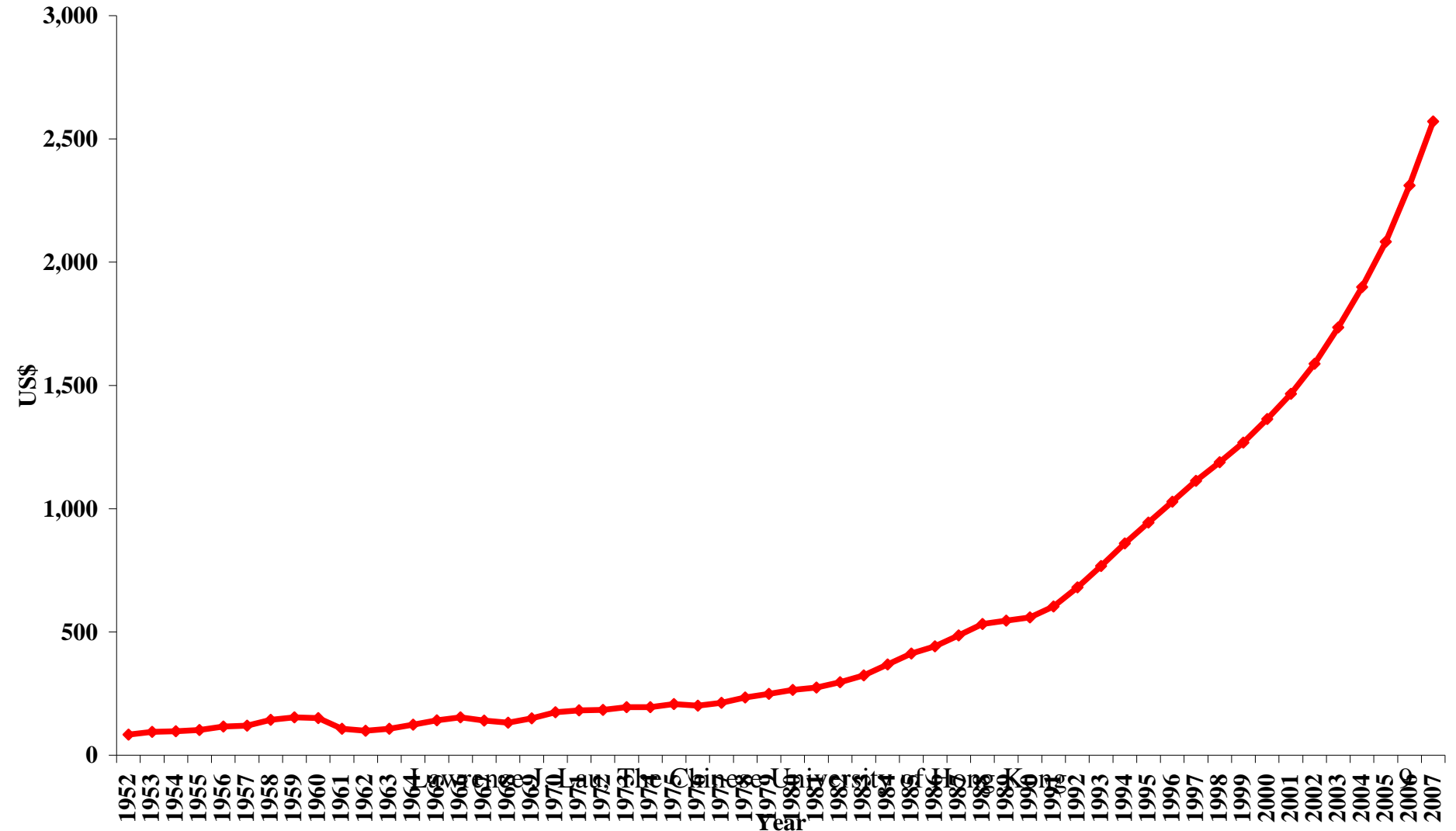
# Chinese Real GDP, 1952-2007

Chinese Real GDP, in 2007 prices



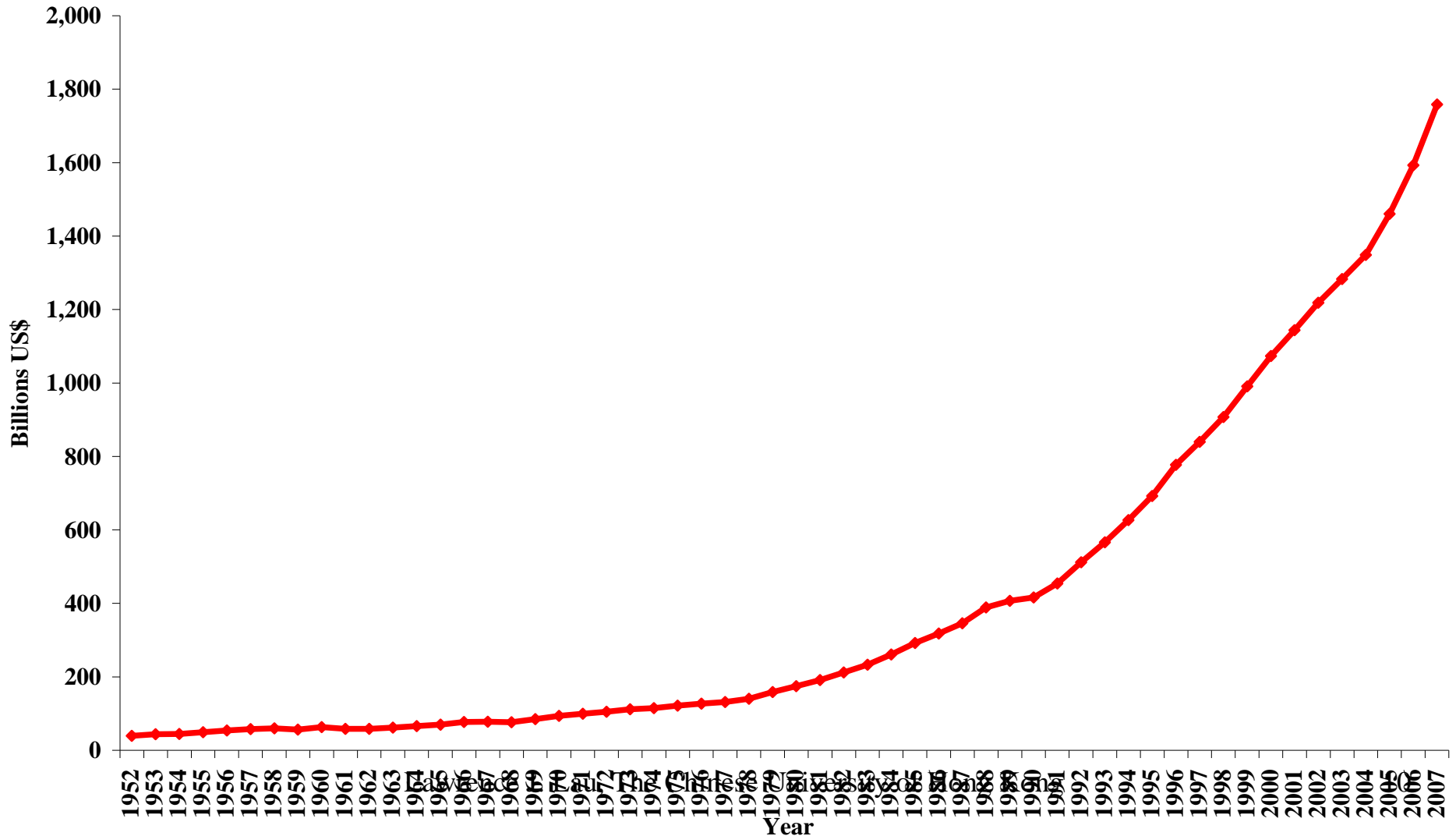
# Chinese Real GDP per Capita, 1952-2007

Chinese Real GDP per Capita, in 2007 prices



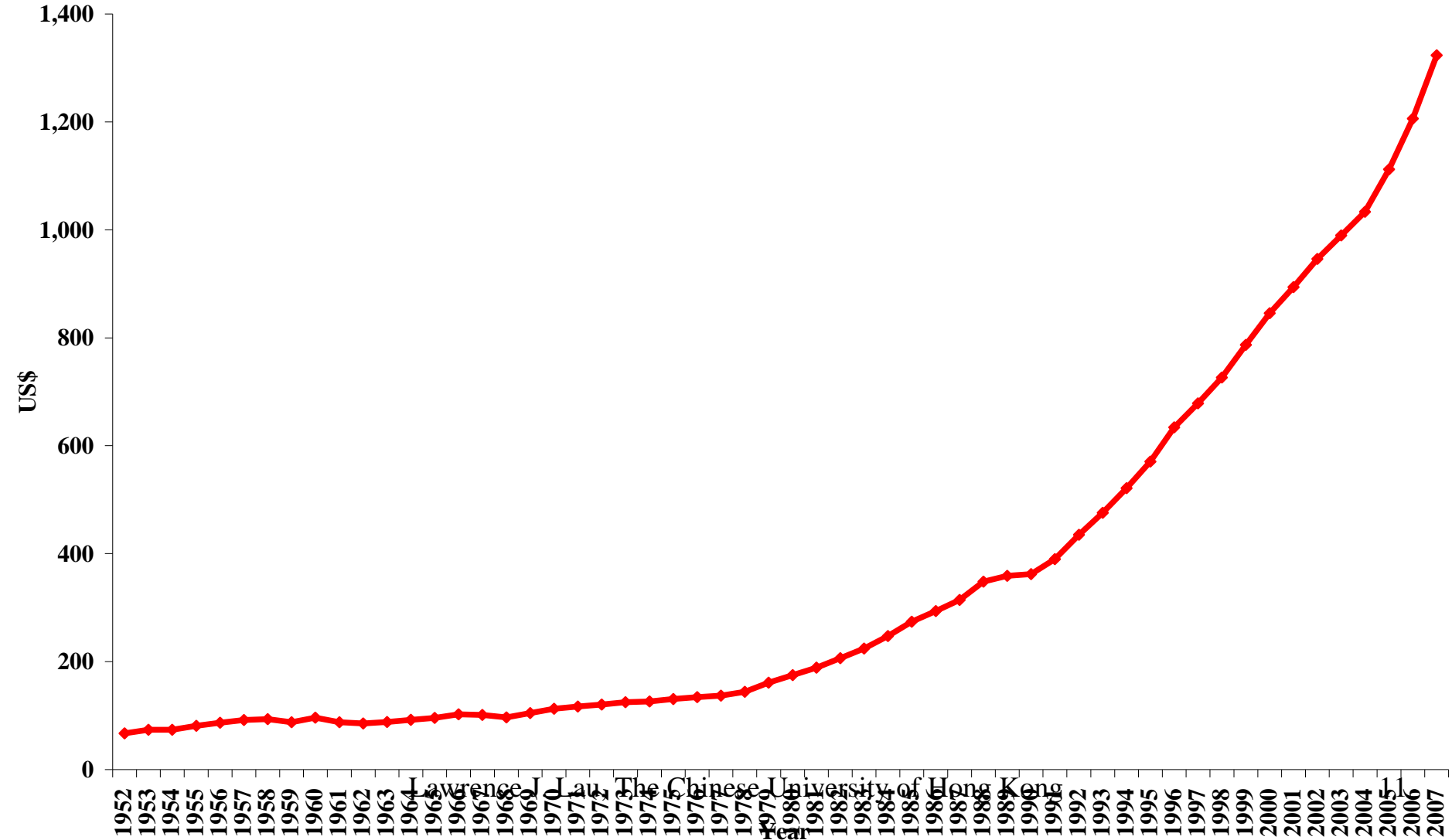
# Chinese Real Consumption, 1952-2007

Real Consumption, in 2007 prices



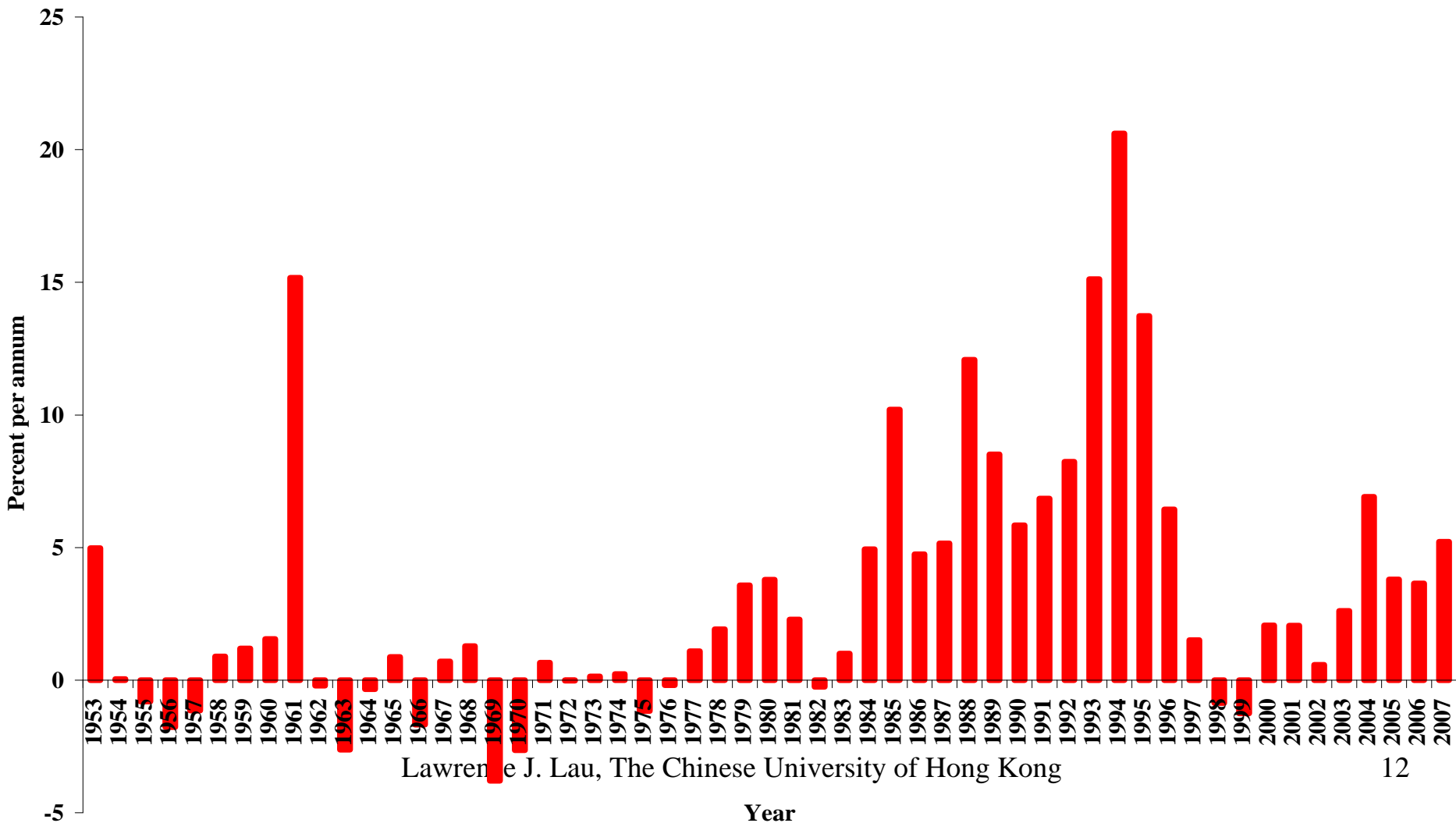
# Chinese Real Consumption per Capita, 1952-2007

Real Consumption per Capita, in 2007 prices



# Rate of Inflation-GDP Deflator, 1952-2007

Annual Rates of Changes of GDP Deflator



Lawrence J. Lau, The Chinese University of Hong Kong

# The Chinese Economy Today (4)

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	Growth Rates	
	percent per annum	
	Period I	Period II
	1952-1978	1978-2007
Real GDP	6.15	9.79
Real GDP per Capita	4.06	8.61
Real Consumption	5.05	9.12
Real Consumption per Capita	2.99	7.95
GDP deflator	0.50	5.38

# Factors for Chinese Economic Growth

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- ◆ Chinese economic growth during the past 30 years has been underpinned by three factors:
- ◆ (1) A consistently high domestic savings rate greater than 30 percent on average and occasionally approaching 45 percent—this means, among other things, the Chinese economy can finance all of its domestic investment needs from its domestic savings alone, and does not have to depend on foreign capital or foreign loans;
- ◆ (2) An unlimited supply of surplus labor—as long as the primary sector (agriculture and mining) produces approximately 10% of the GDP but employs almost 40% of the labor force, there is no shortage of and no upward pressure on the real wage rate of entry-level unskilled labor;
- ◆ (3) A huge domestic market of 1.3 billion consumers with pent-up demand for housing and transportation and other consumer goods and services (education and health care), enabling the realization of significant economies of scale in production and in innovation based entirely on internal demand.

# The Chinese Advantages in Innovation

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- ◆ In addition, China has the advantage of relative backwardness:
  - ◆ The ability to learn from the experiences of successes and failures of other economies;
  - ◆ The ability to leap-frog stages of development (e.g., the telex machine, the VHS video players, the fixed landline phones); and
  - ◆ The possibility of creation without destruction (e.g., online virtual bookstores like Amazon.com do not have to destroy brick and mortar bookstores which do not exist in the first place).
- ◆ The large potential domestic market enables active Chinese participation in the setting of product and technology standards and sharing the benefits of such standard-setting.
- ◆ An abundance of scientific and technical manpower the cost of which is a fraction of the cost in developed economies.

# Chinese Economic Growth Has Benefitted the World

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- ◆ Moreover, Chinese economic growth has not been at the expense of the Rest of the World. It has not been a zero-sum game. Almost every country has benefitted from China's economic progress and its opening to the world. For example:
  - ◆ The consumers in the developed economies are able to enjoy low and stable prices for their everyday light-manufactured consumer goods.
  - ◆ China has become the most important export destination country for and runs a trade deficit with almost every other country and region in East Asia, including Japan.
  - ◆ China has become a major donor of development aid and assistance to developing countries, especially those in Africa.

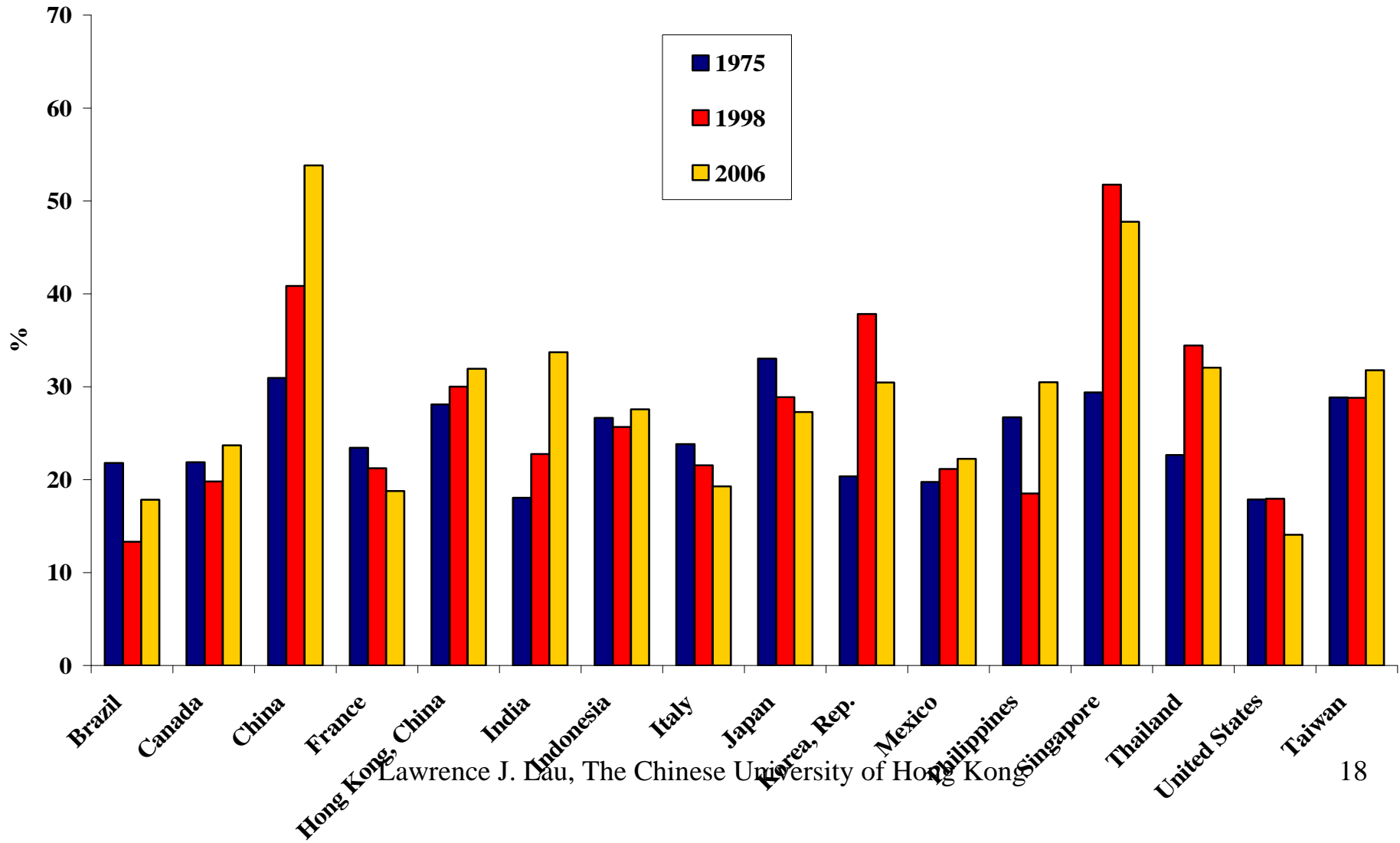
# The Fundamental Importance of Domestic Savings

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- ◆ Chinese economic growth over the past quarter of a century has been mostly driven by the growth of inputs, principally tangible capital (structures, equipment, and physical infrastructure) and not by technical progress or growth in total factor productivity. This experience is not unlike those of other East Asian economies such as South Korea and Taiwan and even Japan at a similarly early stage of economic development.
- ◆ This is sometimes referred to as  
**“Working Harder but not Working Smarter.”**
- ◆ The growth of tangible capital accounts for the bulk (90 percent) of the measured economic growth in China. The tangible capital stock has been growing at approximately 15 percent per year.

# The National Savings Rates of Selected Economies

National Savings Rates of Selected Countries and Regions



# The Fundamental Importance of Domestic Savings

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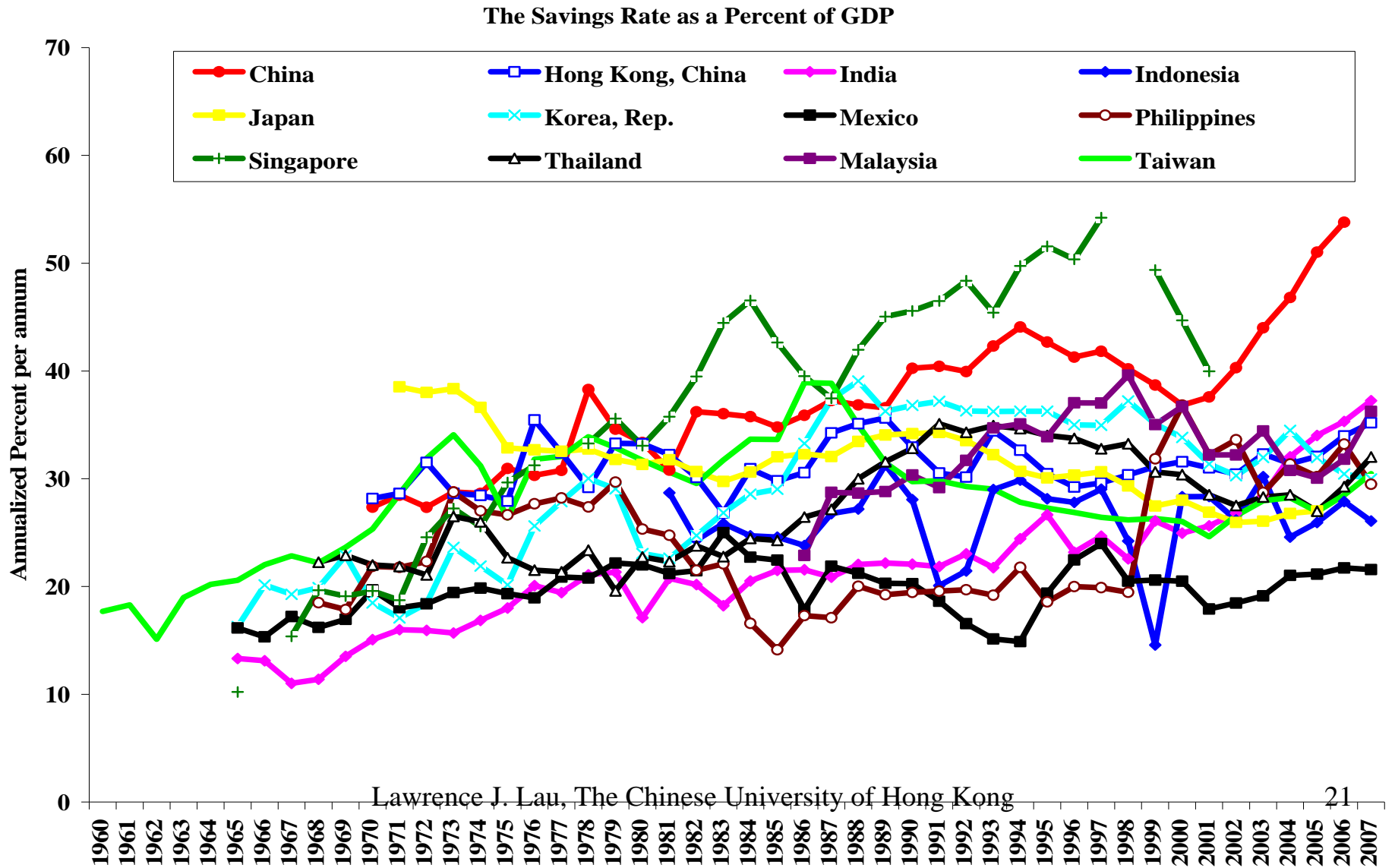
- ◆ The bulk of the gross domestic investment in China is financed by domestic savings. Foreign direct investment accounts for less than 10 percent of gross domestic investment in China. While helpful, foreign direct investment and foreign loans alone cannot sustain the rapid economic growth of China.
- ◆ This underscores the fundamental importance of domestic savings in Chinese economic growth--without the domestic savings financing the investment, the growth of the tangible capital input would not have been possible; and without the growth of the tangible capital input, the growth of real output would not have been possible.

# The Advantages of a High Domestic Savings Rate

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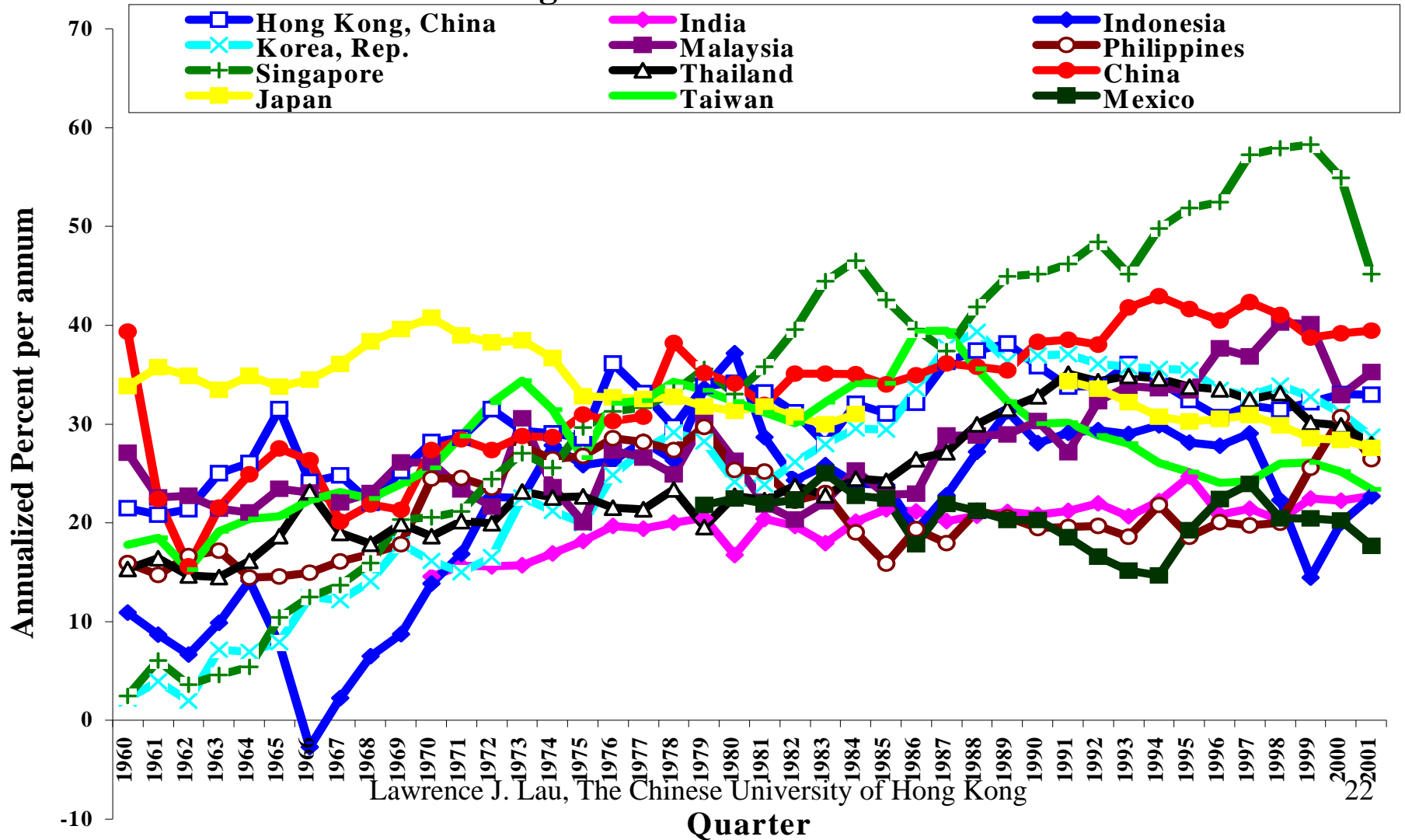
- ◆ Except for a short early start-up period in the early 1950s, the Chinese domestic savings rate has always been high, on the order of 30 percent. In recent years, it has even exceeded 40 percent.
- ◆ A high domestic savings rate makes possible a high domestic investment rate. In addition, it has other advantages.

# The Savings Rate as a Percent of GDP: Selected Countries and Regions



# The Savings Rate as a Percent of GDP: Selected Countries and Regions

The Savings Rate as a Percent of GDP



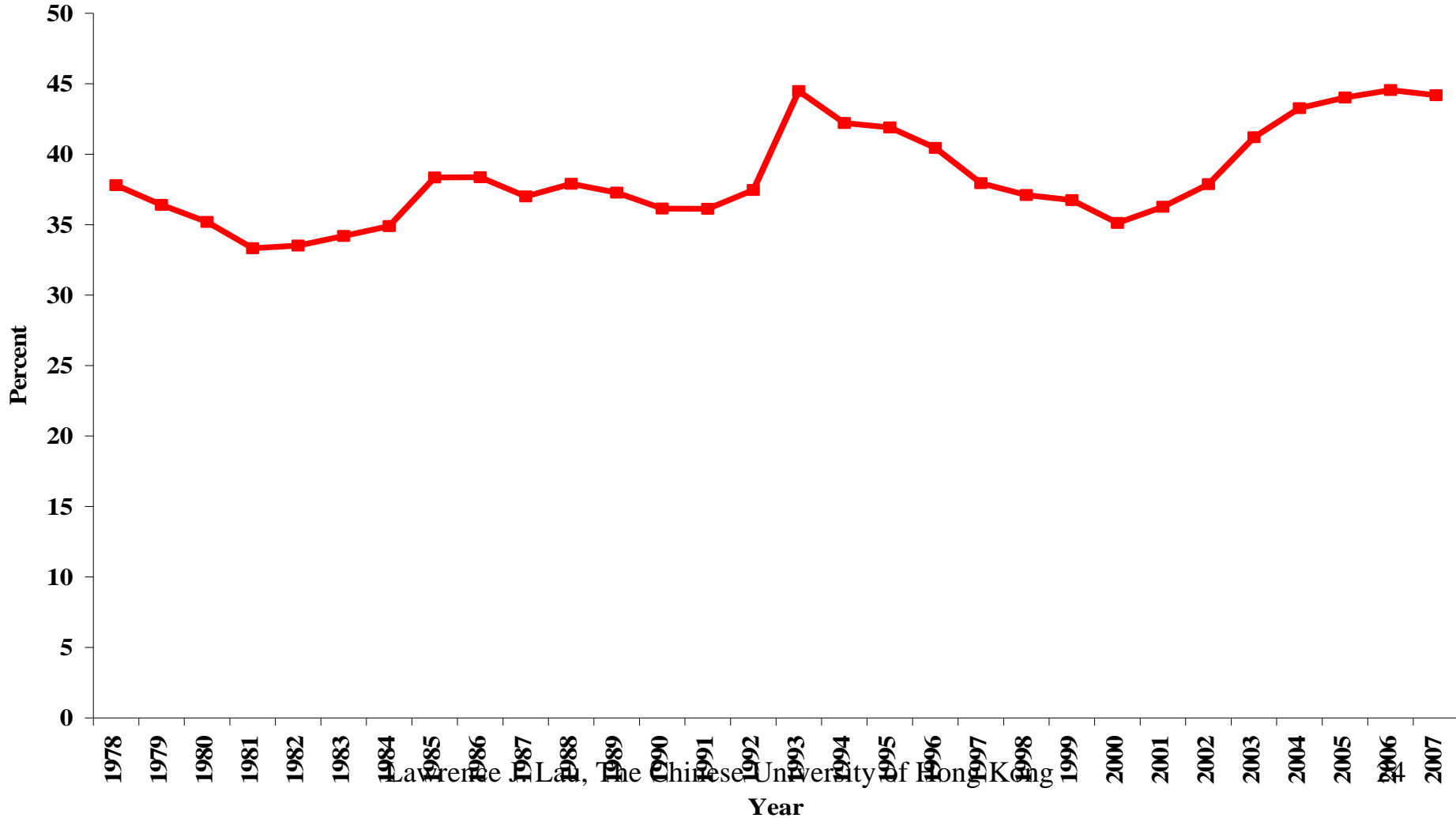
# The Advantages of a High Domestic Savings Rate

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- ◆ A country with a high savings rate does not need to rely on foreign savings—does not need to borrow abroad and bear the potential risks of a large, and often interruptible, foreign-currency denominated debt.
- ◆ With new resources being made available each year from new savings, enabling new investments to be made, the necessity of restructuring and redeploying existing investment is greatly diminished (thus making it more possible to avoid creating losers).
- ◆ Moreover, with a high domestic savings rate, the non-state sector (which is generally more efficient) can grow without significant, possibly socially disruptive, large-scale privatization.

# China's Gross Domestic Investment as a Percent of GDP

China's Gross Domestic Investment as a Percentage of GDP



Lawrence H. White, The Chinese University of Hong Kong

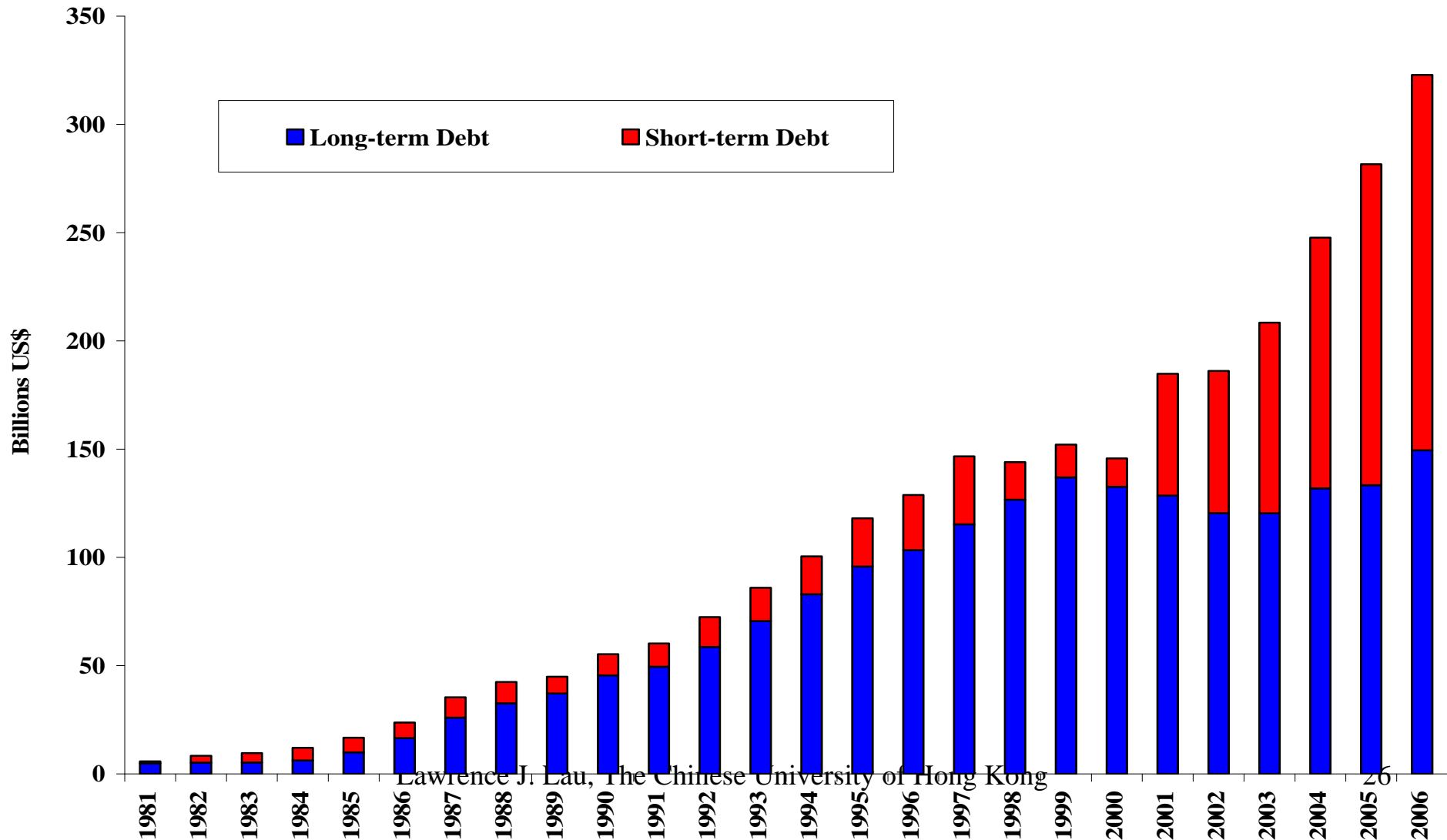
# The Advantages of a High Domestic Savings Rate

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- ◆ Latin American economies are the chronic sufferers of a low domestic savings rate. They are therefore forced to augment their domestic savings by borrowing abroad in foreign currency. But loans have to be repaid sooner or later. When that happens, economic growth cannot be sustained; and often currency crises will result.
- ◆ The low domestic savings rate in Russia made it necessary for Russia to privatize and restructure, a process which resulted in approximately a decade of declining real GDP and the creation of many losers.

# Composition of External Debt—Short-Term (Less Than a Year) vs. Long-Term: China

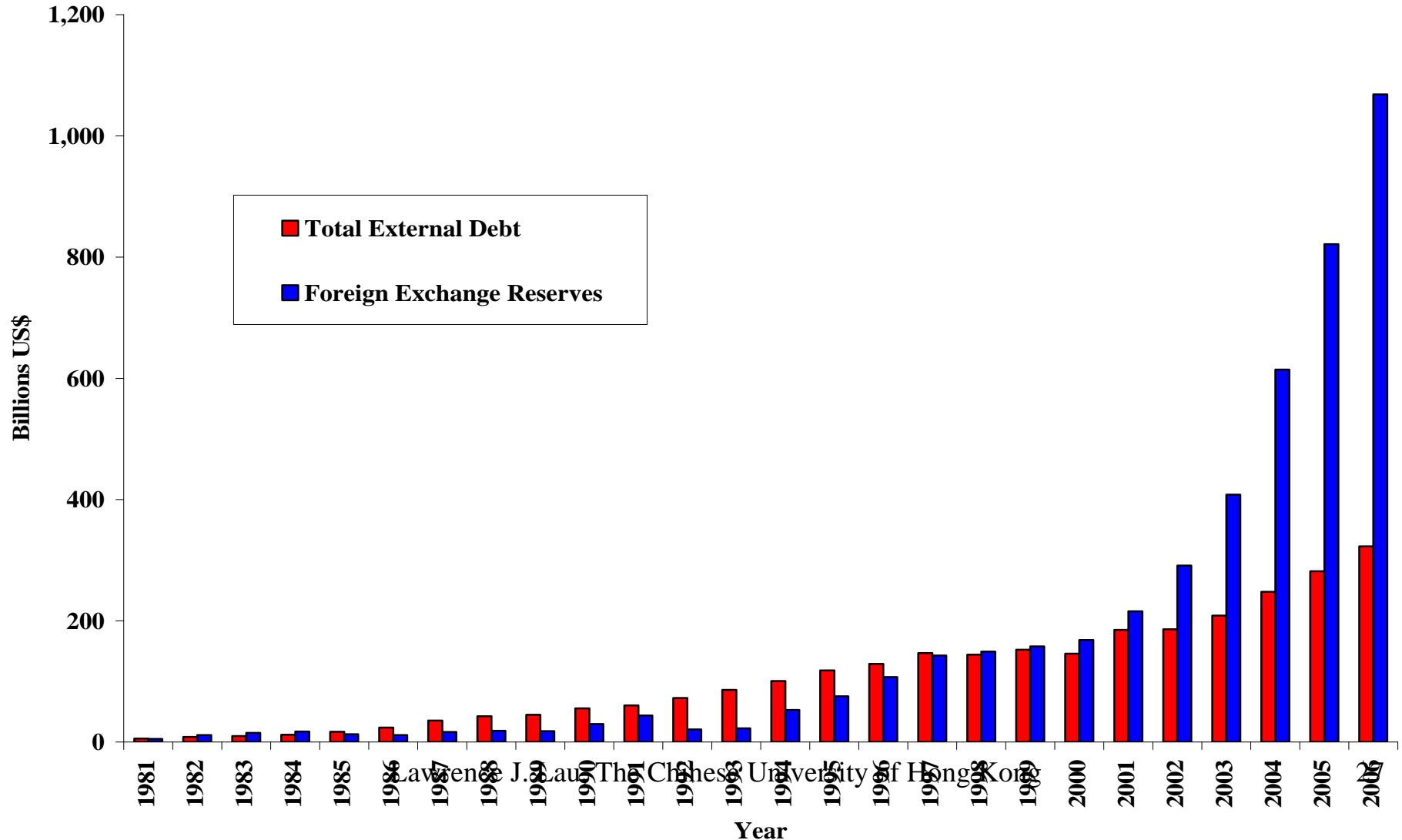
Stock of External Debt: China



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# External Debt and Official Foreign Exchange Reserves: China

China's External Debt vs. Foreign Exchange Reserves



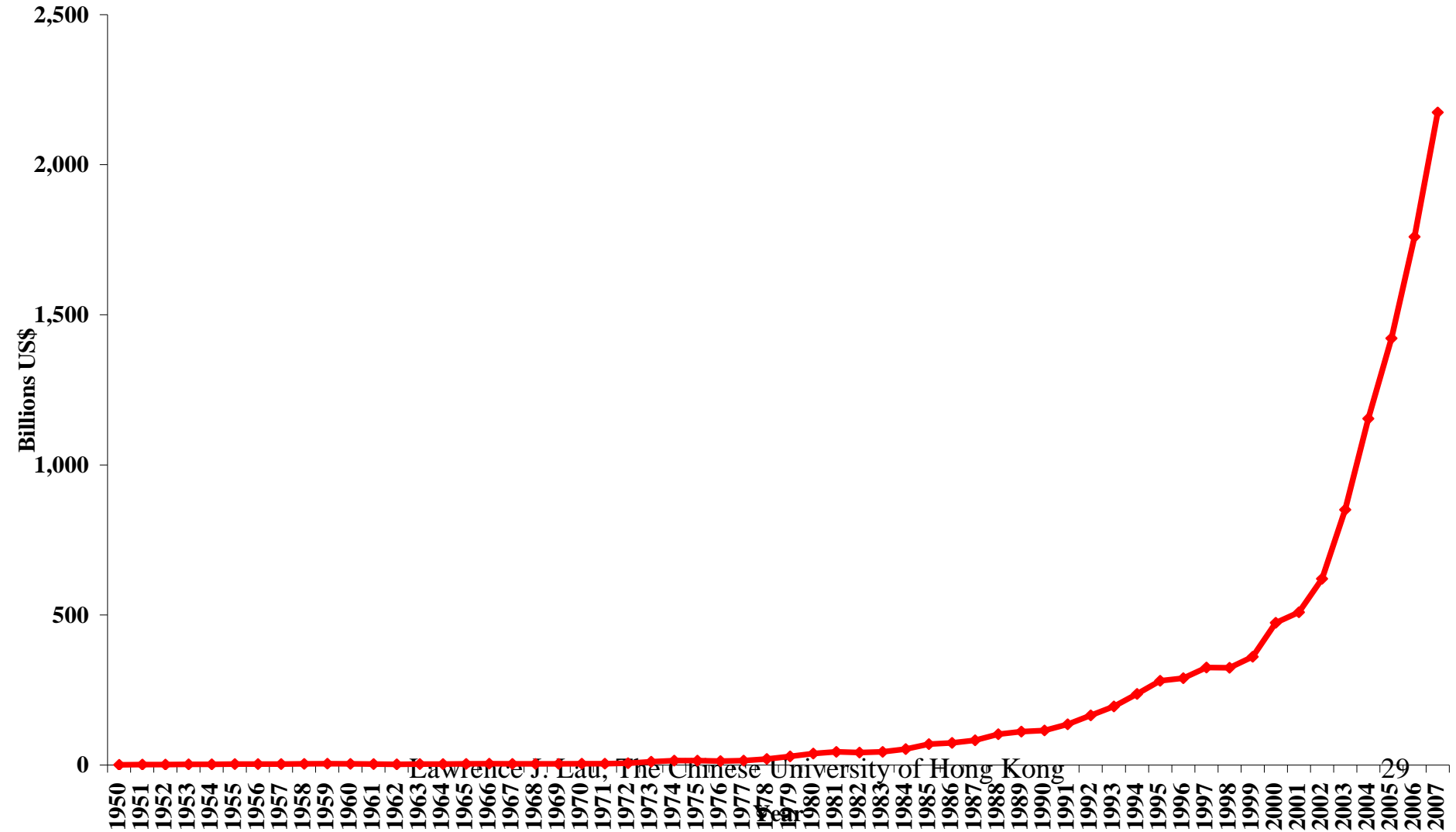
# The Role of Openness

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- ◆ But simply having high domestic savings and investment rates, and hence a high rate of growth of the tangible capital input, is not enough to guarantee good economic performance. The Chinese economy prior to the beginning of its economic reform in 1979 and the former Soviet Union are two examples that a high rate of tangible capital accumulation does not guarantee a high rate of economic growth. This is where openness of the economy becomes important.
- ◆ One can distinguish between external openness and internal openness. On external openness, one can further distinguish between trade and capital flows, and on the latter, between long-term and short-term. In the Chinese case, external openness is limited to trade and long-term capital flows (including foreign direct investment).
- ◆ Openness, external or internal, has three implications. First, it allows the free flow of resources—both goods and factors (free entry and exit). Second, it promotes competition. And third, it facilitates the transfer of technology (defined broadly to include business models and methods).

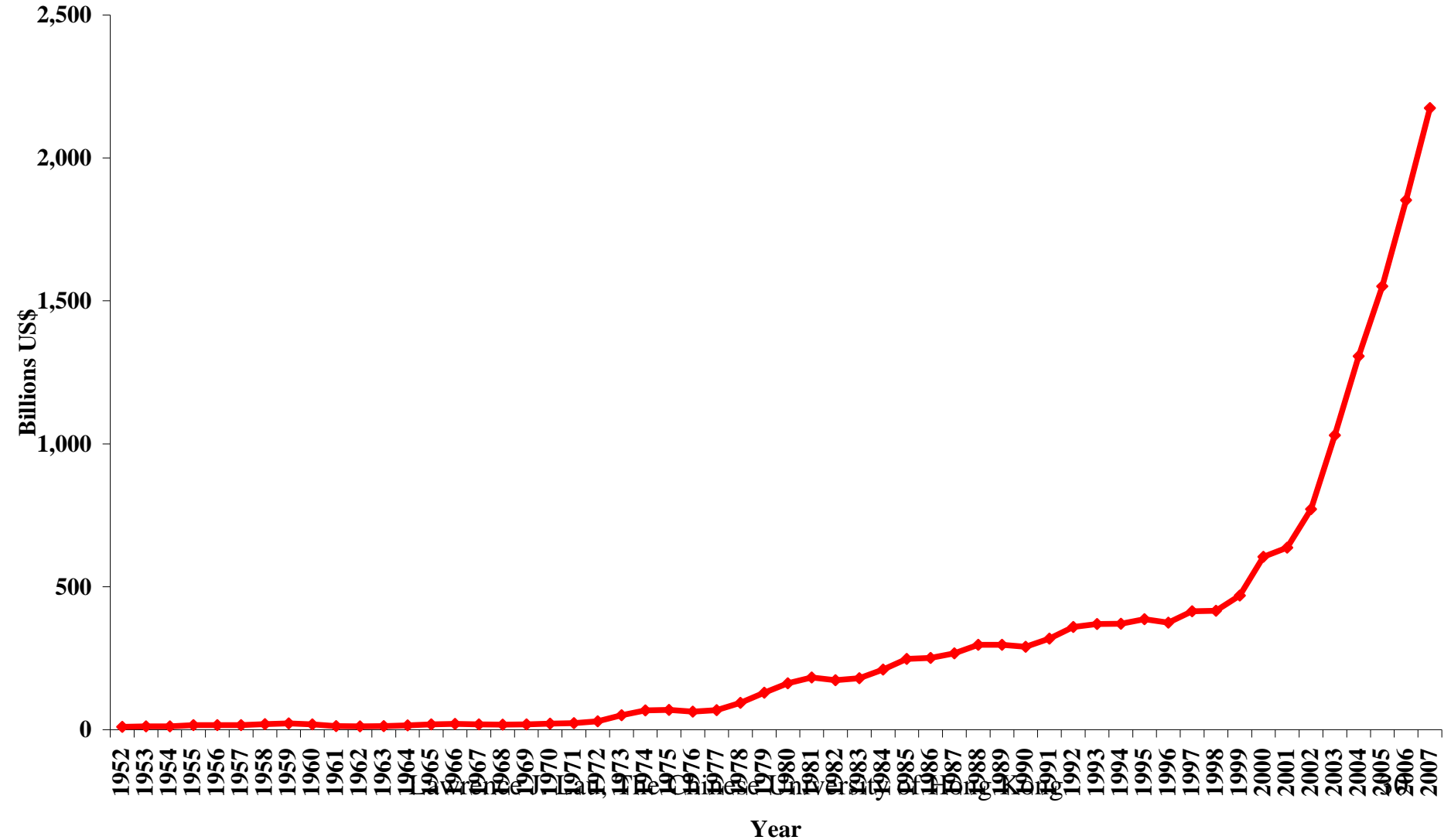
# Total International Trade, 1950-2007

Total International Trade



# Real Total International Trade, 1950-2007

Real Total International Trade, in 2007 prices



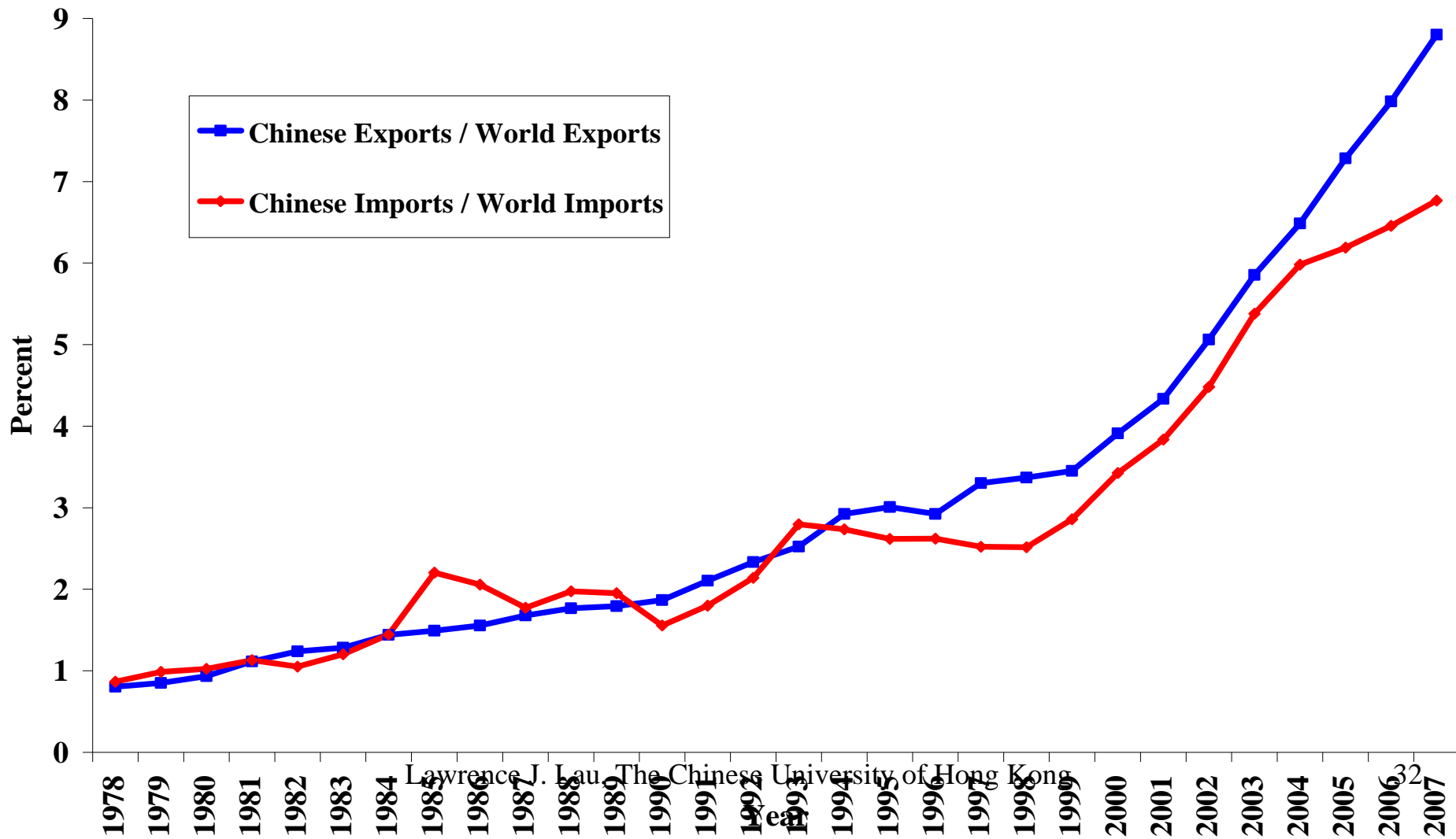
# China in the World Economy: The Changing Pattern of World Trade

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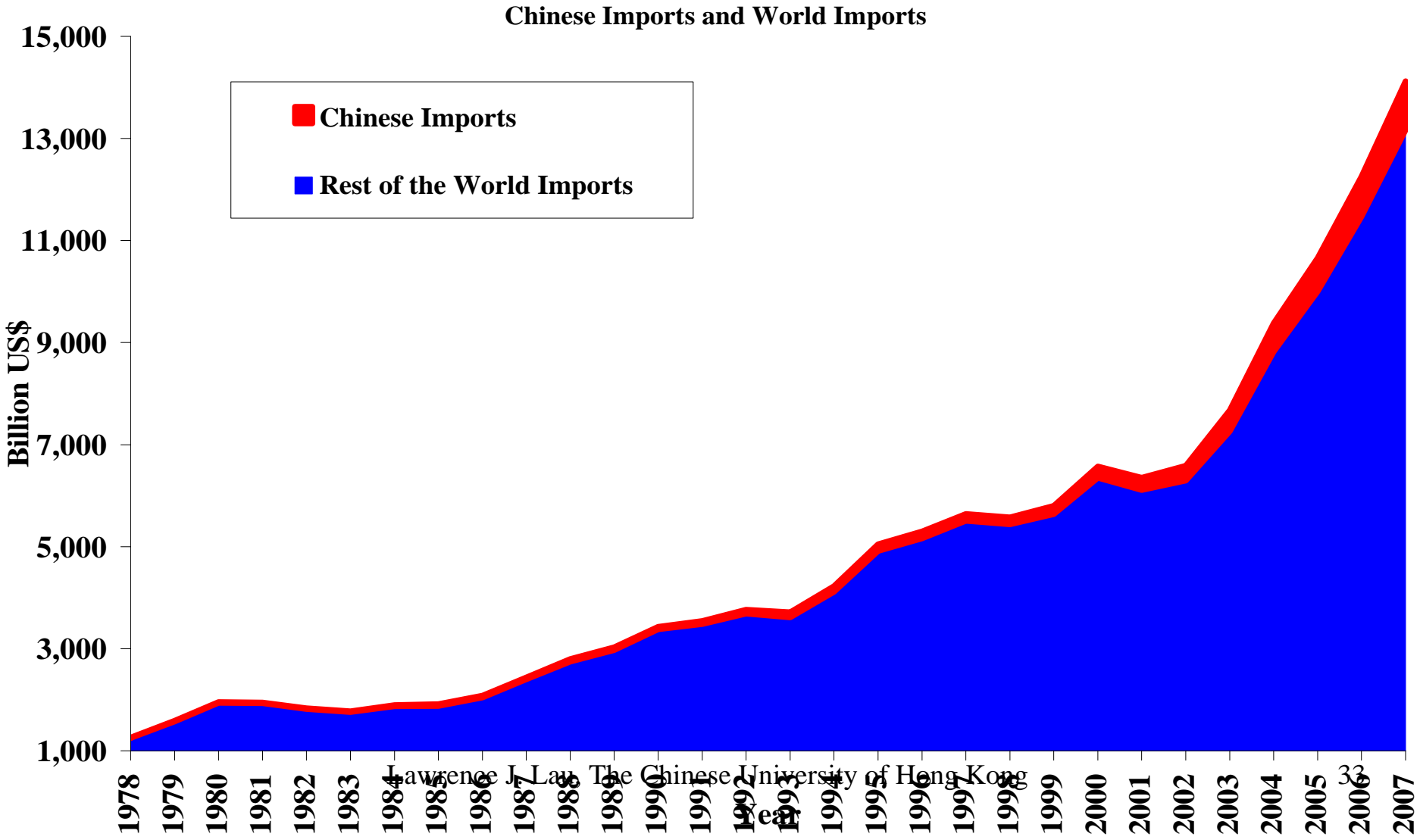
- ◆ Chinese exports and imports have risen from approximately 1 percent of world exports and imports in 1960 to approximately 10 percent of world exports and imports in 2007.
- ◆ China has overtaken Japan to become the largest exporting country in East Asia. China has also overtaken Japan to become the largest importing country in East Asia and the most important export market for almost all East Asian economies and runs trade deficits vis-à-vis almost every one.

# The Rising Ratio of Chinese Trade in Total World Trade

The Ratio of Chinese Trade to World Trade

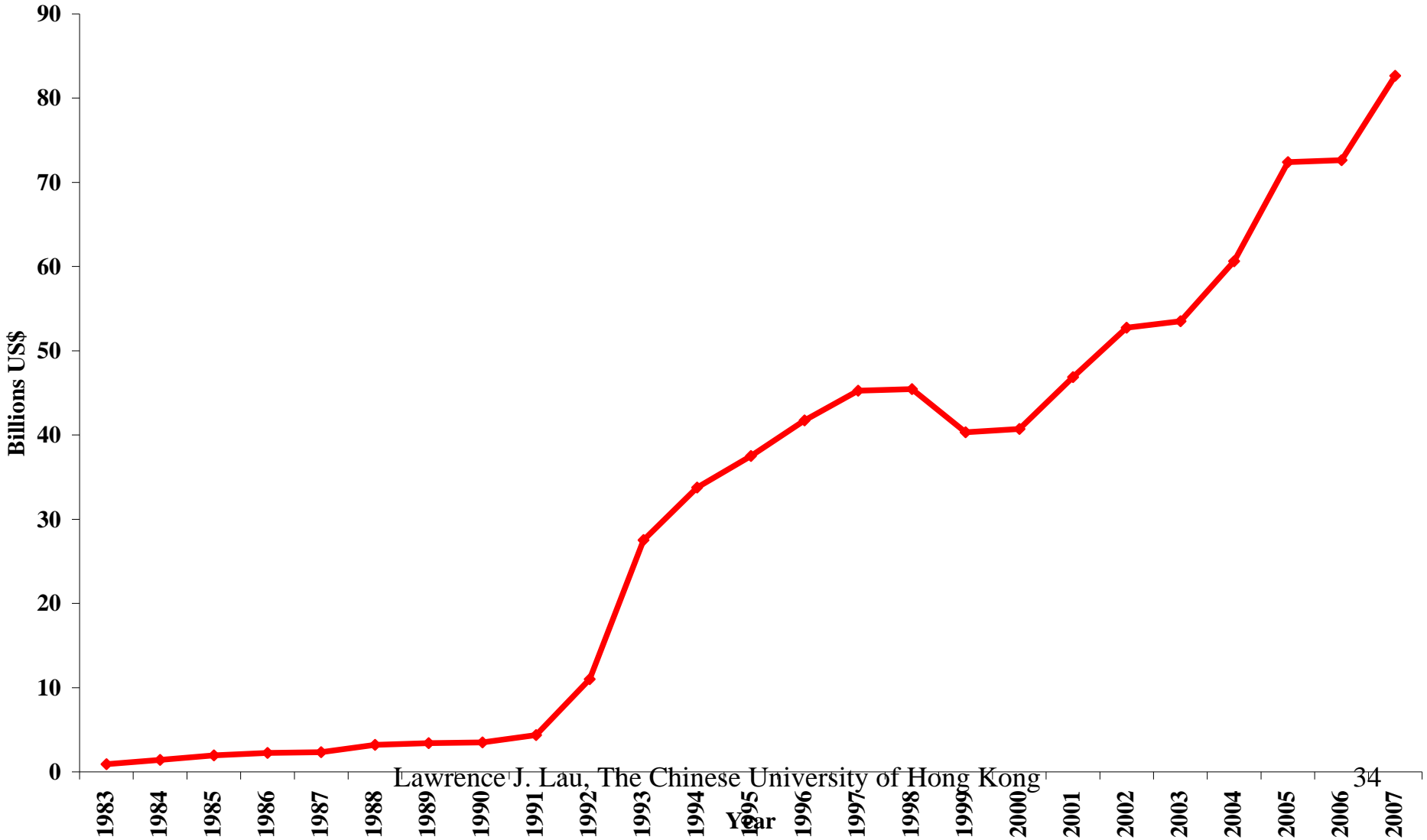


# Chinese Imports and World Imports



# Utilized Foreign Direct Investment, 1983-2007

Utilized Foreign Direct Investment



# The Role of Openness

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- ◆ It is the competition and the free entry and exit that assure minimal economic efficiency of the investment. In the long run, only the efficient enterprises will be able to survive in an open environment.
- ◆ One reason why the East Asian newly industrialized economies have been able to allocate its investment relatively efficiently is because of their export orientation. In the export sector, enterprises have to compete with other enterprises in the rest of the world and the assistance of their own governments has only very limited effects. They just have to be efficient to survive.

# The Role of Openness

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- ◆ Internal openness creates space for non-state-owned enterprises (initially Township and Village Enterprises) in China to grow and prosper. Non-state-owned enterprises tend to be more efficient not because they are necessarily run by smarter people, but because they tend to correct their mistakes sooner. Non-state-owned enterprises make their share of bad investments, however, they close down bad investments very quickly, unlike state-owned enterprises with their deep pockets and where the incentives are different and the enterprises are subject to only a soft-budget constraint.
- ◆ The effects of openness are magnified by the increasingly rapid rate of globalization, facilitated by the revolutionary advances in the information and communication technology.
- ◆ Chinese accession to the World Trade Organization (WTO) assures that on the margin there will always be potential competition in the large domestic markets, which may become dominated by one or a few large enterprises.

# Introduction of the Market System and Enterprise Autonomy

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- ◆ The free market system was introduced in China in the late 1978, first in the rural areas, and then in the early 1980s in the urban areas.
- ◆ At the same time, the households and firms were given the autonomy to produce and sell on the free market, once their obligations to the state had been fulfilled (the responsibility system).
- ◆ The free market and the autonomy of households and enterprises unleashed latent productive forces and made possible economic activities that did not exist before.

# Reform without Losers in Transition

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- ◆ So far, we have identified two factors responsible for Chinese economic success, but these are factors that are also common to the past successes of other developing economies. There is, however, one factor that is unique to the Chinese experience, and it is the explicit avoidance of the creation of losers in the process of economic reform.
- ◆ Most economic reforms create both winners and losers. While it is true that in the aggregate, the gains should outweigh the losses. The question is whether it is possible to redistribute the gains so that no one is worse off. In economic parlance, we ask whether there is a path of reform that is Pareto-optimal, or better still, Pareto-improving.

# Reform without Losers in Transition

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- ◆ The idea that existing people and new people should be treated differently (Xinren Xinbanfa, Jiuren Jiubanfa) is the unique Chinese contribution to the strategy of reform. It embodies the idea of “grandfathering”—whatever rights and privileges (and obligations) a person had before the reform, he or she would have the option of retaining the same.
- ◆ It is obvious that such a strategy helps to minimize opposition and preserve social stability.
- ◆ Moreover, such a strategy can often not only achieve Pareto improvement (that is, everyone is better off than before) but also full economic efficiency.
- ◆ “Reform without Losers” means win-win for all—a win-win strategy for reform has the best chances of success. Efforts must be made to identify feasible win-win reform strategies.

# An Example: The Dual-Track Approach Adopted in the Chinese Transition

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- ◆ The “Plan Track”--the pre-existing central plan remains and its rights and obligations continue to be enforced by the government.
- ◆ The “Market Track”--all markets are instantaneously open, with prices determined by supply and demand.
- ◆ Producers are given autonomy and incentive to plan their production and participate in the market, which is open to them, provided obligations under the plan are fulfilled.
- ◆ Consumers are completely free to plan their consumption and participate in the market, given allocated consumption goods and fulfillment of labor obligations.

# The Dual-Track Approach

## Adopted in the Chinese Transition (2)

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- ◆ Profits and losses (taxes and subsidies) of enterprises under the central plan remain the same before and after the initiation of economic reform.
- ◆ Differences between plan and market prices make feasible lumpsum transfers.
- ◆ Continued planned consumer goods deliveries enable the maintenance of the pre-reform standard of living as a floor.

# The Political Economy of the Dual-Track Approach

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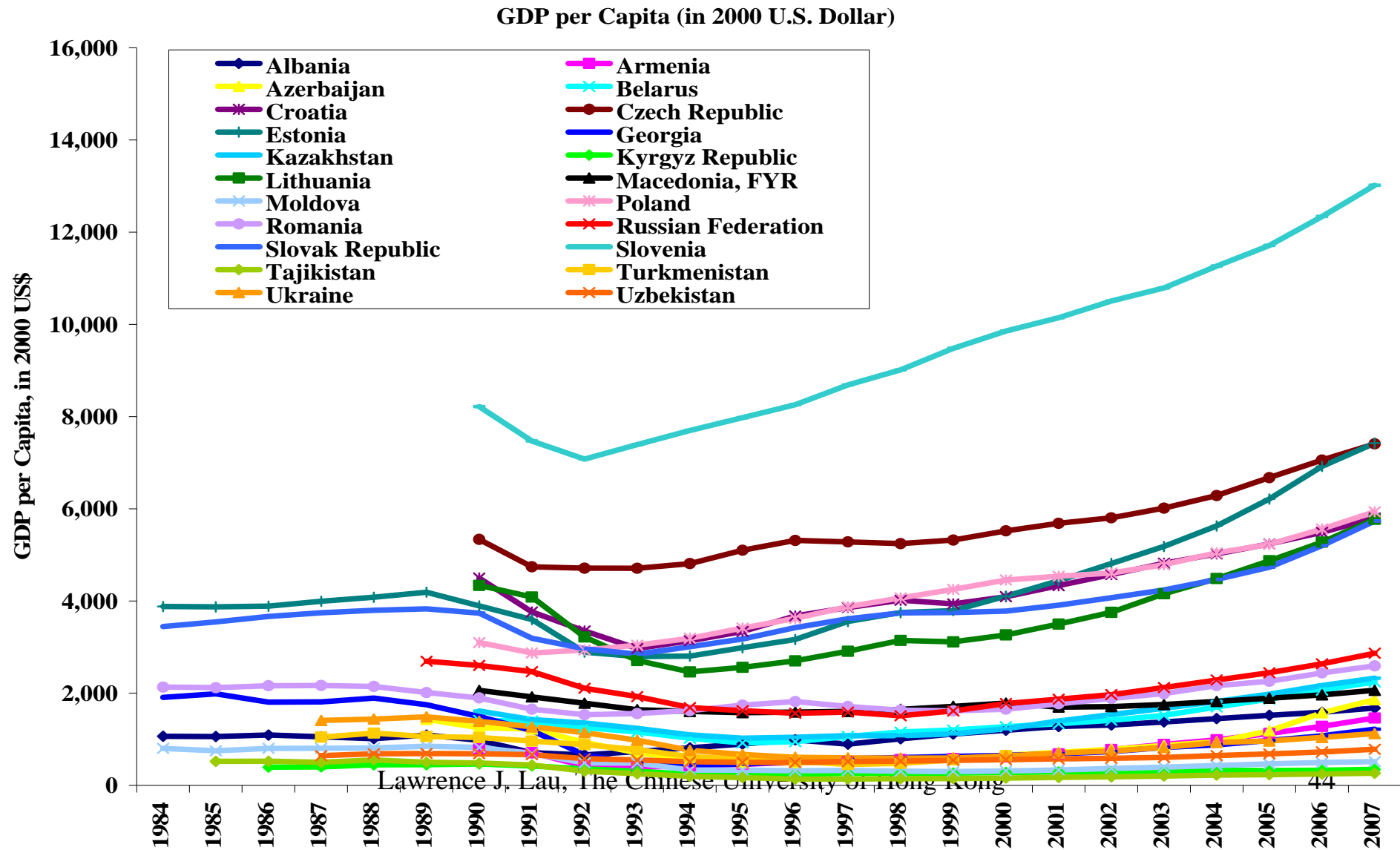
- ◆ No one is worse off, because everyone has the option of staying with the pre-reform arrangements. Thus, “Reform without Losers.”
- ◆ The “Vested Interests” are “Grandfathered.”
- ◆ The enterprises are granted autonomy and provided incentives on the margin.
- ◆ The markets are open to free entry and exit.
- ◆ New, reform-oriented “Vested Interests,” are created in the process.
- ◆ Such an approach minimizes opposition, maximizes support and preserves stability.
- ◆ With full market liberalization the dual-tracked approach also achieves full economic efficiency.

# Other Examples from the Chinese Experience

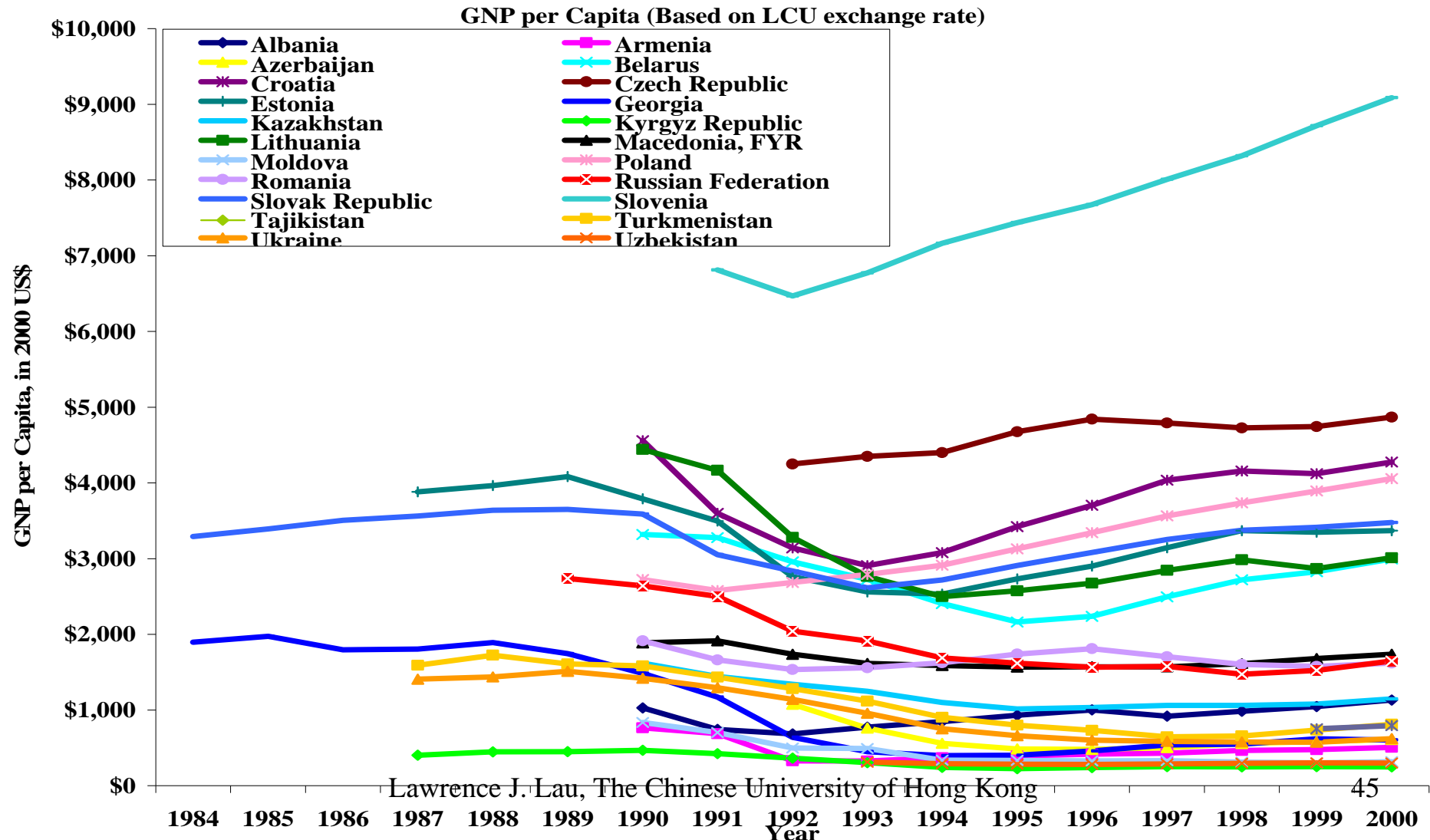
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- ◆ (1) Special economic zones and foreign direct investment
- ◆ (2) The foreign exchange reform
- ◆ (3) The tax reform

# Real GDP per Capita of Formerly Centrally Planned Economies

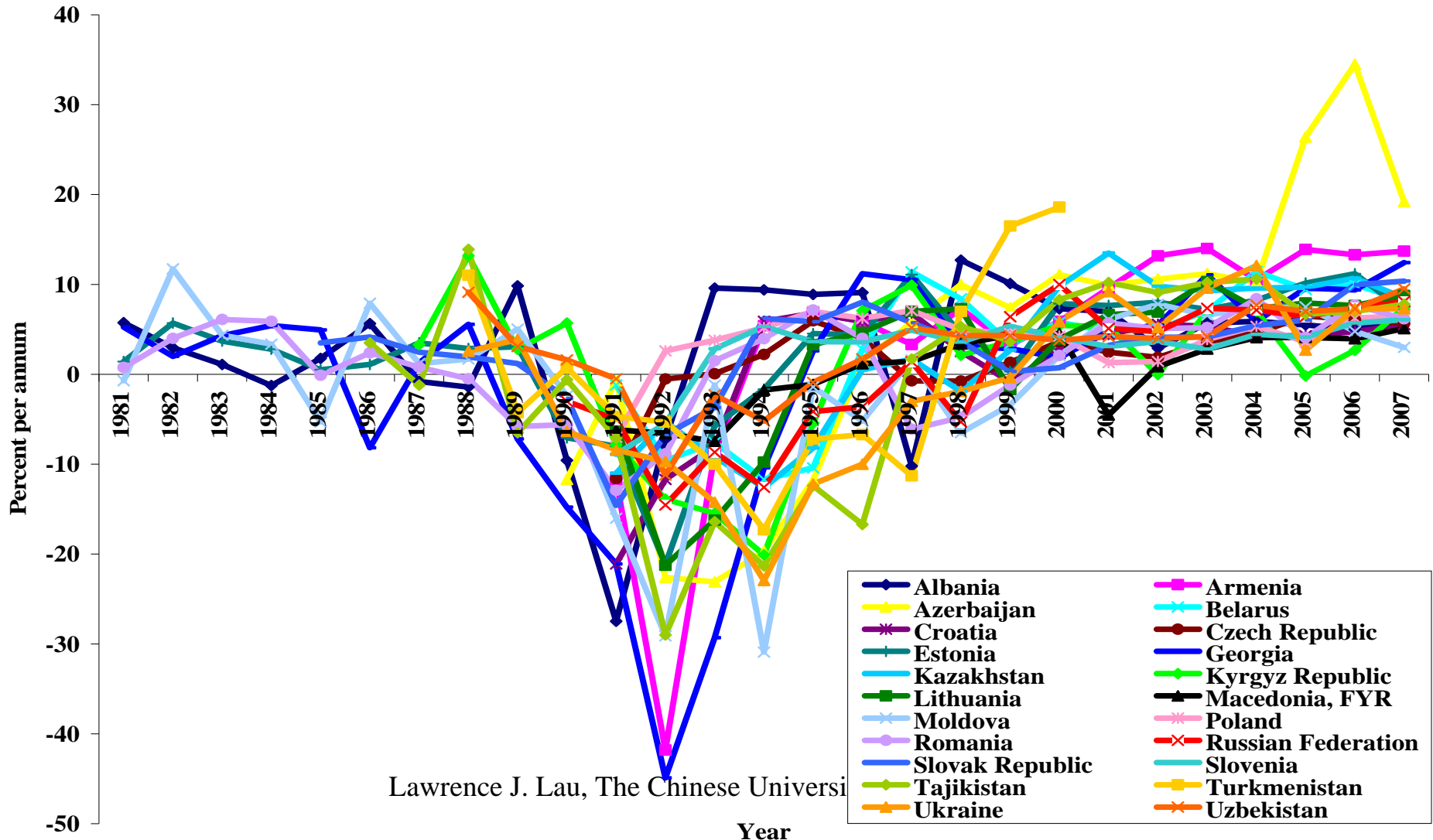


# Real GDP per Capita of Former Centrally Planned Economies



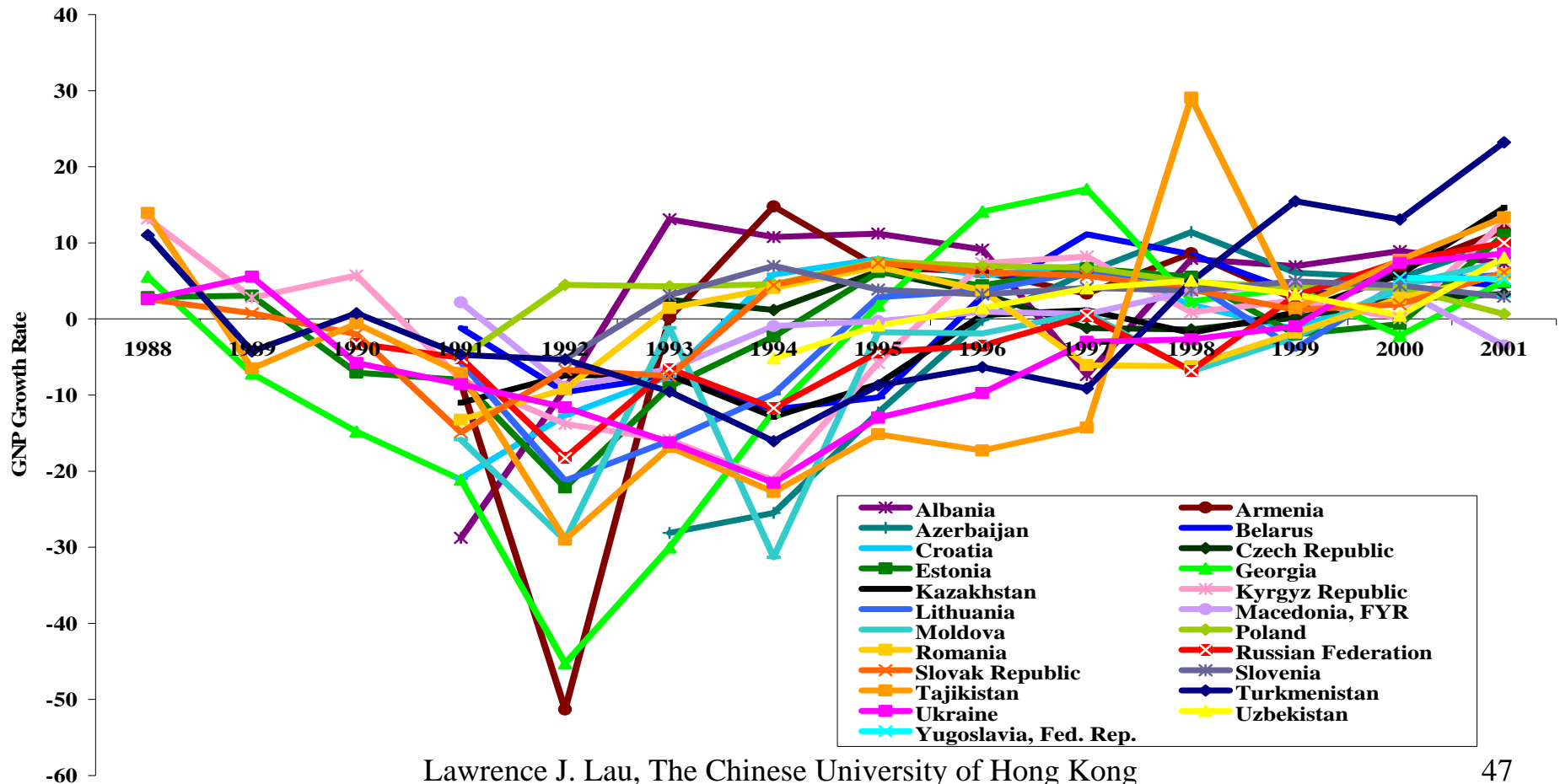
# The Rates of Growth of Real GDP of Former CPEs

The Rates of Growth of Real GDP (Based on GDP in 2000 U.S. Dollar)



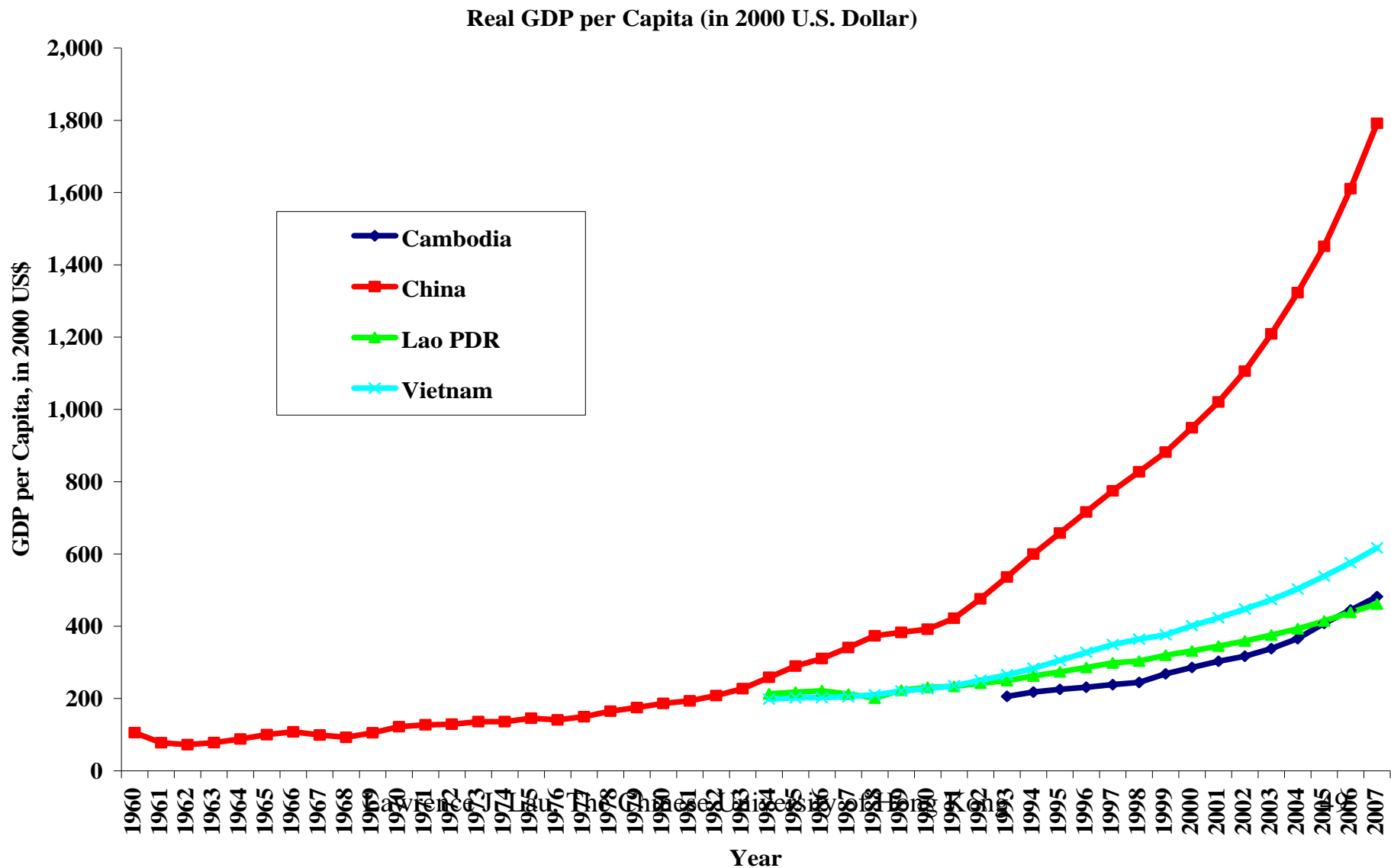
# The Rates of Growth of Real GDP of Former CPEs

GNP Growth Rate (Based on constant GDP)



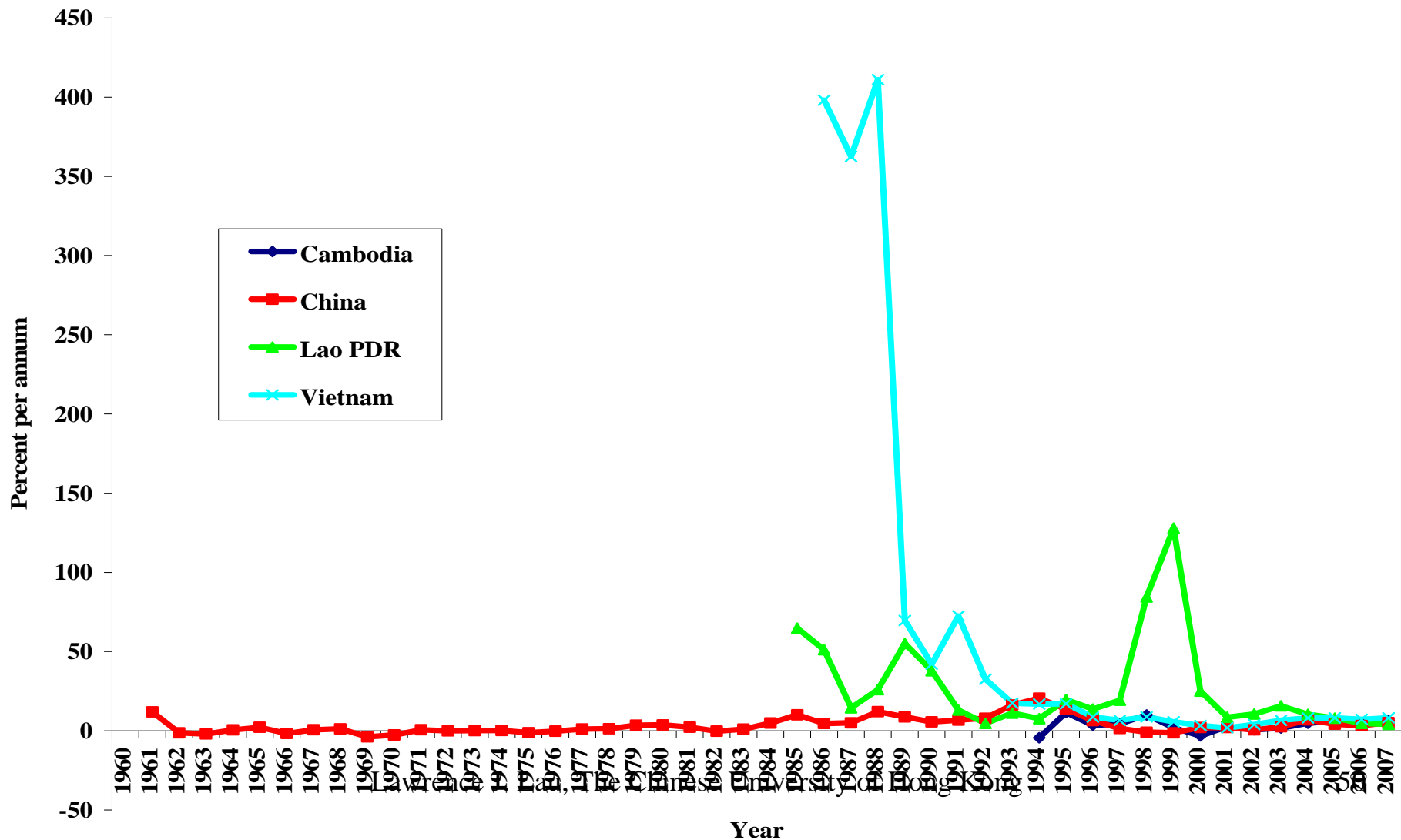


# Real GDP per Capita: Asian Centrally Planned Economies

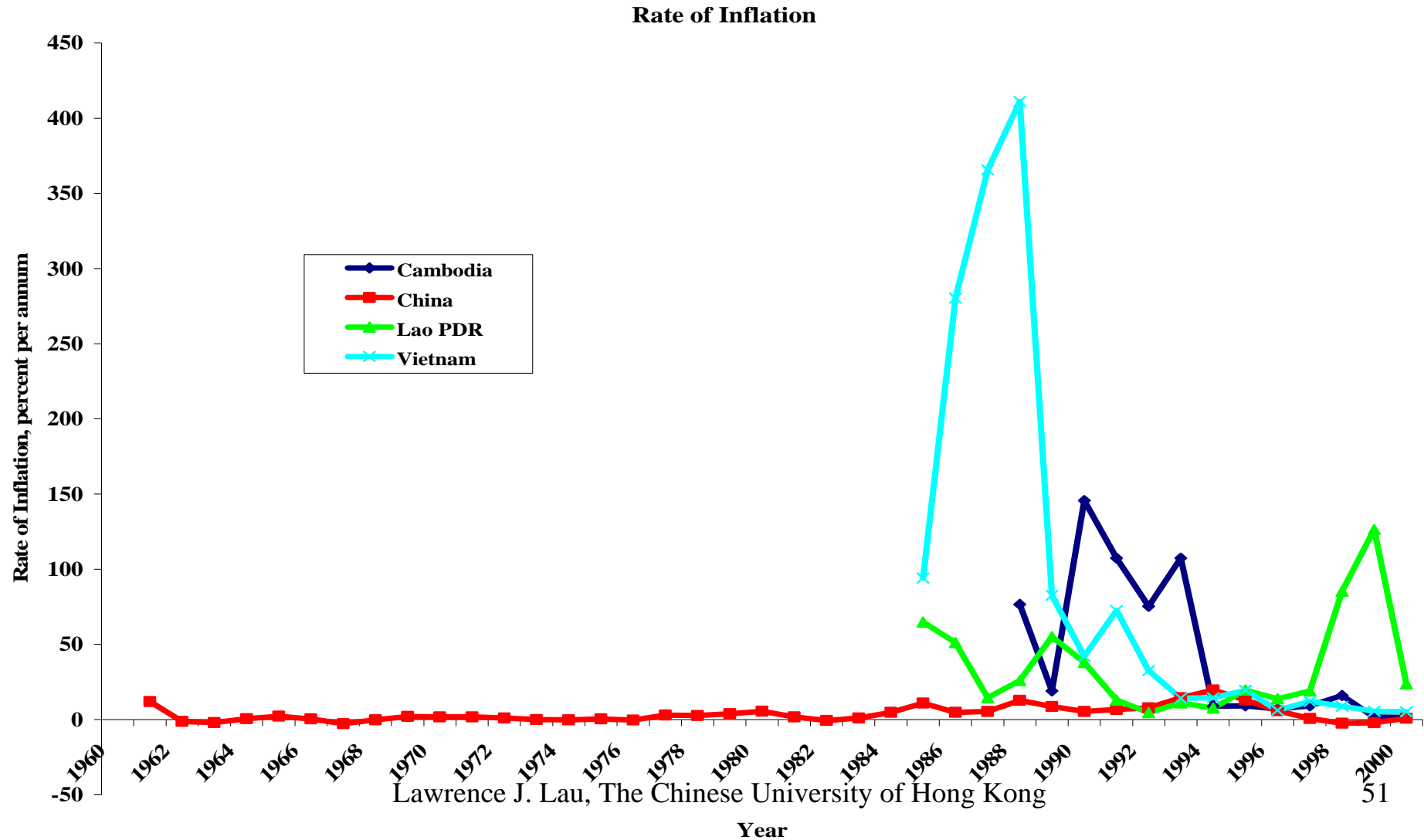


# Inflation: Asian Centrally Planned Economies

The Changes of Inflation Rates (GDP deflator, annual %)



# Inflation: Asian Centrally Planned Economies



# The Role of State Power

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- ◆ Continued enforcement of contracts (and rights and obligations under the plan) is necessary.
- ◆ Credibility of the state, and expectations thereof, affect enterprise (and household) behavior, and hence compliance with the plan (post reform).
- ◆ Multiple equilibria (outcomes) are possible, depending on the credibility of state enforcement.

# Directions for Further Reform--Perfecting and Regulating the Market System

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- ◆ Complementing the market—maintaining macroeconomic and microeconomic price stability (e.g., agriculture)
- ◆ Completing the markets--socially productive markets and socially counter-productive markets (examples: cotton, oil, and synthetic oil)
- ◆ Creating a market for long-term, fixed rate, owner-occupied residential mortgage loans
- ◆ Market regulation of monopolies and oligopolies
- ◆ Market standardization and certification—elimination of information asymmetry and moral hazard
- ◆ Regulating the use of leverage and controlling moral hazard
- ◆ Regulation of socially counter-productive speculation and volatility creation (market manipulation)
- ◆ Pricing externalities—pollution taxes, carbon taxes
- ◆ The market as a constraint on corruption

# China and the Environment--

## Early Awareness

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- ◆ Early awareness relative to other developed economies. China, with a per capita GDP of only US\$2,571, is to be congratulated for focusing on environmental quality at this stage of its economic development. The U.S. did not begin to clean up the air in Los Angeles until the 1970s, when its per capita GDP was already well in excess of US\$20,000. And Japan did not begin to clean up the pollution in Tokyo Bay and Osaka until the early 1970s when its per capita GDP was well in excess of US\$10,000.

# China and the Environment--

## Early Awareness

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- ◆ It is definitely true that the earlier an economy begins the environmental clean-up and protection process, the less costly, both monetarily and socially, it is.
- ◆ Enforcement of environmental protection laws on air and water against polluters.
- ◆ Promotion and encouragement of the use of renewable and non-polluting energy sources—solar energy, wind energy, and geothermal energy, co-generation.
- ◆ Promotion of a recycling economy (e.g., making an enterprise responsible not only for the quality of its products but also for their ultimate disposal).

# China and the Environment-- Prevention of Global Warming

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- ◆ All countries, developed and developing, must work out a formula for a fair sharing of the costs of preventing global warming.
- ◆ Simply setting a ceiling based on current usage is unfair and unreasonable as far as the developing economies are concerned. Any goal for controlling carbon emissions must involve both the developed economies reducing their emissions per capita and for the developing economies controlling the increases of their emissions per capita.
- ◆ Developing economies must price carbon fuels taking into account their external effects on global warming and adopt the latest most efficient technologies.
- ◆ China can contribute its part by providing leadership to craft such an agreement.

# Environmental Degradation

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- ◆ Energy consumption in China has been growing more slowly than real GDP until 2002.
- ◆ Energy efficiency, in terms of energy consumption per unit GDP, has actually improved significantly during the past two decades, until the last couple of years.
- ◆ It is, however, still considerably higher than those of the United States, Japan, and other developed economies. This is due, in part, to the lower price of energy to the end users; but also, in part, to the different sectoral composition of GDP originating—which in turn also depends on the domestic consumption patterns (e.g., the distribution between goods and services).

# Energy Efficiency

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- ◆ It is also affected by differences in life-styles: locational patterns, including residential patterns, densities, types of housing, types of transportation, temperature preferences, etc.
- ◆ It is also affected by the differences in the energy efficiency of the existing capital stocks of both the enterprises and the households—structure and equipment, housing, automobiles—which are legacies of the historical actual and expected prices of energy.
- ◆ But this also indicates considerable room for further improvements in energy efficiency in China.

# Directions for Further Reform-- Redistribution

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- ◆ The free market cannot perform the function of redistribution
- ◆ Redistribution through market subsidies, e.g., lifeline rates for electricity, urban transit fare subsidies
- ◆ Redistribution through income taxation
- ◆ Redistribution in kind (education, health care, environmental protection, public infrastructural investment and mass transportation)

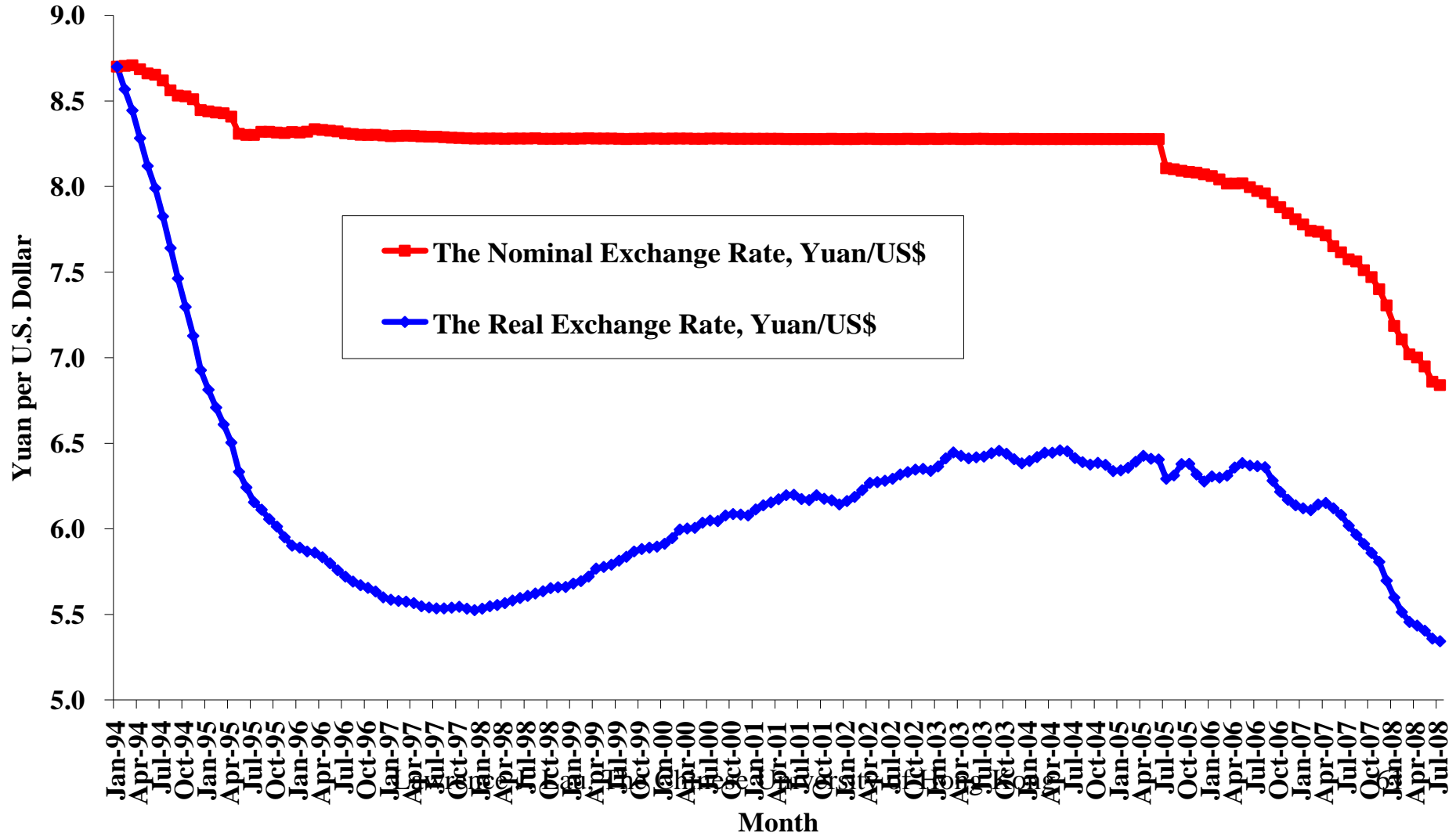
# Directions for Further Reform— The Renminbi

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- ◆ The level of Chinese official foreign exchange reserves, over US\$1.9 trillion, is more than adequate. Further increases in the level of foreign exchange reserves should be limited. This implies that various policy measures must be undertaken to reduce the net inflow of foreign exchange. These include:
  - ◆ (1) Monitoring the approval of foreign direct investment (FDI) and disallowing, for example, individual residential real estate investments;
  - ◆ (2) Alternative methods of financing foreign direct investment (FDI) as discussed above;
  - ◆ (3) Disallowing short-term foreign currency loans (most of which are for speculative purposes) and forcing state-owned enterprises to repay these loans immediately;
  - ◆ (4) Closer monitoring of over-invoicing and under-invoicing of trade flows and transfer pricing;
  - ◆ (5) Allowing outbound portfolio and direct investments (e.g., the establishment of the China Investment Corporation, a sovereign wealth fund);
  - ◆ (6) Allowing the raising of equity and debt by foreign enterprises in China.

# The Nominal and Real Yuan/US\$ Exchange Rates

The Nominal and Real Exchange Rates (1994 prices), Yuan/US\$



# The Renminbi

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- ◆ China reverted to a “managed floating rate” system for the Renminbi on July 21, 2005, with a modest revaluation of 2.1%. China operated a “managed floating rate” system since it unified its exchange rates and introduced current-account convertibility on January 1, 1994, when the exchange rate was 8.7 Yuan per US\$. The de facto pegged exchange rate system was actually adopted in July, 1997 in response to the East Asian currency crisis, by greatly narrowing the daily band of fluctuation to almost nothing around 8.28 Yuan per US\$.
- ◆ Since July 2005, the Renminbi has appreciated slowly and gradually. On May 15, 2006, the Renminbi exchange rate crossed the psychologically important barrier of 8 Yuan per U.S. Dollar. On January 11, 2007, it rose above 7.80 Yuan per U.S. Dollar, the same parity as the Hong Kong Dollar.
- ◆ Overall, the Yuan has appreciated almost 20% since July, 2005. For 2007 as a whole, the Yuan appreciated approximately 6.9%.

# The Renminbi as a Convertible Currency

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- ◆ The exchange rate is allowed to fluctuate within a daily band, originally set at 0.3% in either direction. The band has recently been widened to 0.5%.
- ◆ Revaluation, if any, is likely to continue to be gradual and modest but perhaps a little slower than in the previous two years. The Renminbi is likely to follow the Euro more than the US\$ in the near term.
- ◆ Convertibility of the Renminbi implies that Renminbi funds can be used to purchase foreign currency either from the market or from the central bank with practically no limit to the amount.

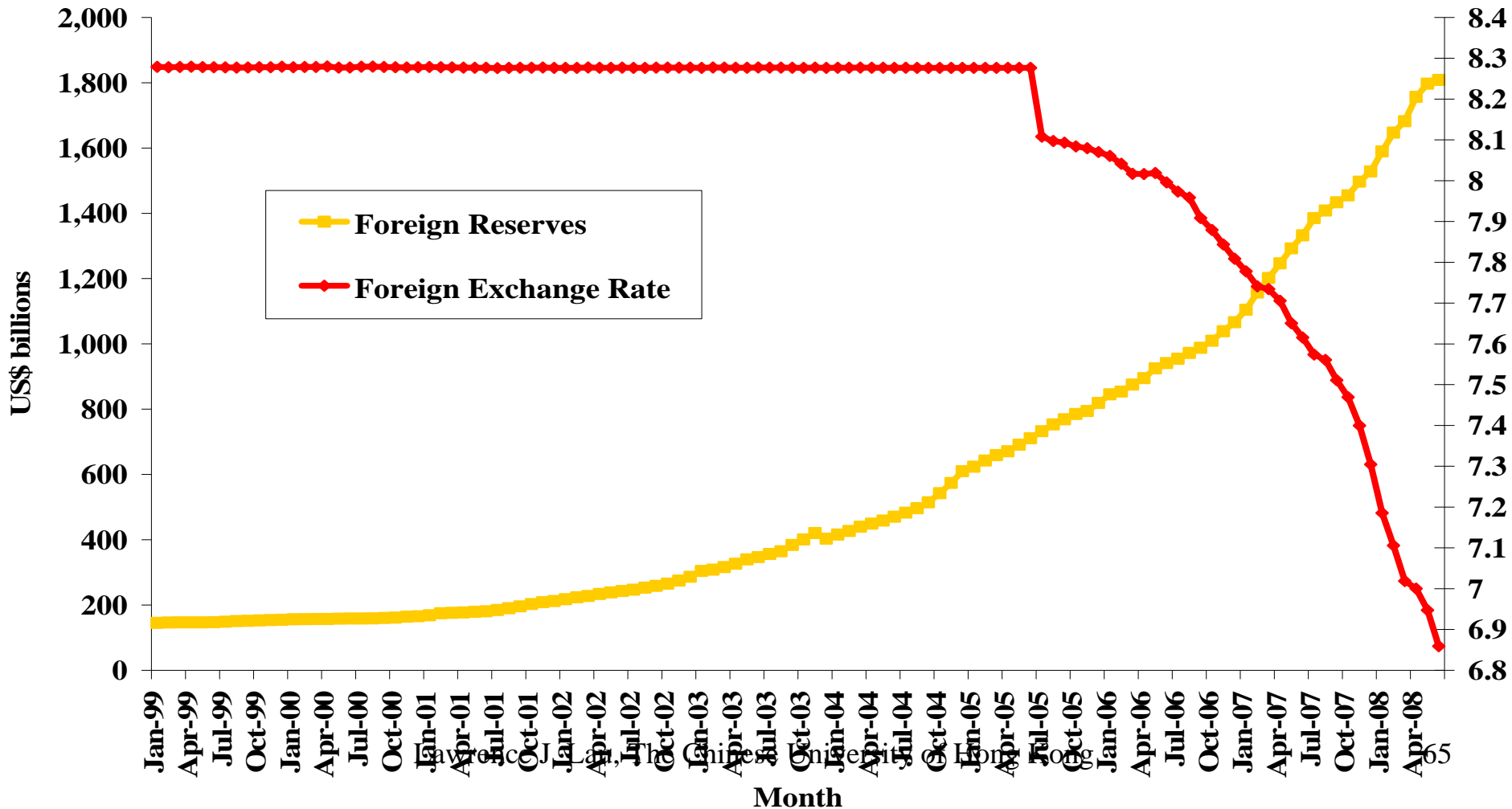
# The Renminbi as a Convertible Currency

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- ◆ Full convertibility is likely within ten years although its net impact on the exchange rate is uncertain. Many observers expect the Renminbi exchange rate to fall with the introduction of full convertibility, at least initially, because of the one-off effect of portfolio diversification and re-allocation and because of possible capital flight on the part of the wealthy Chinese private entrepreneurs.

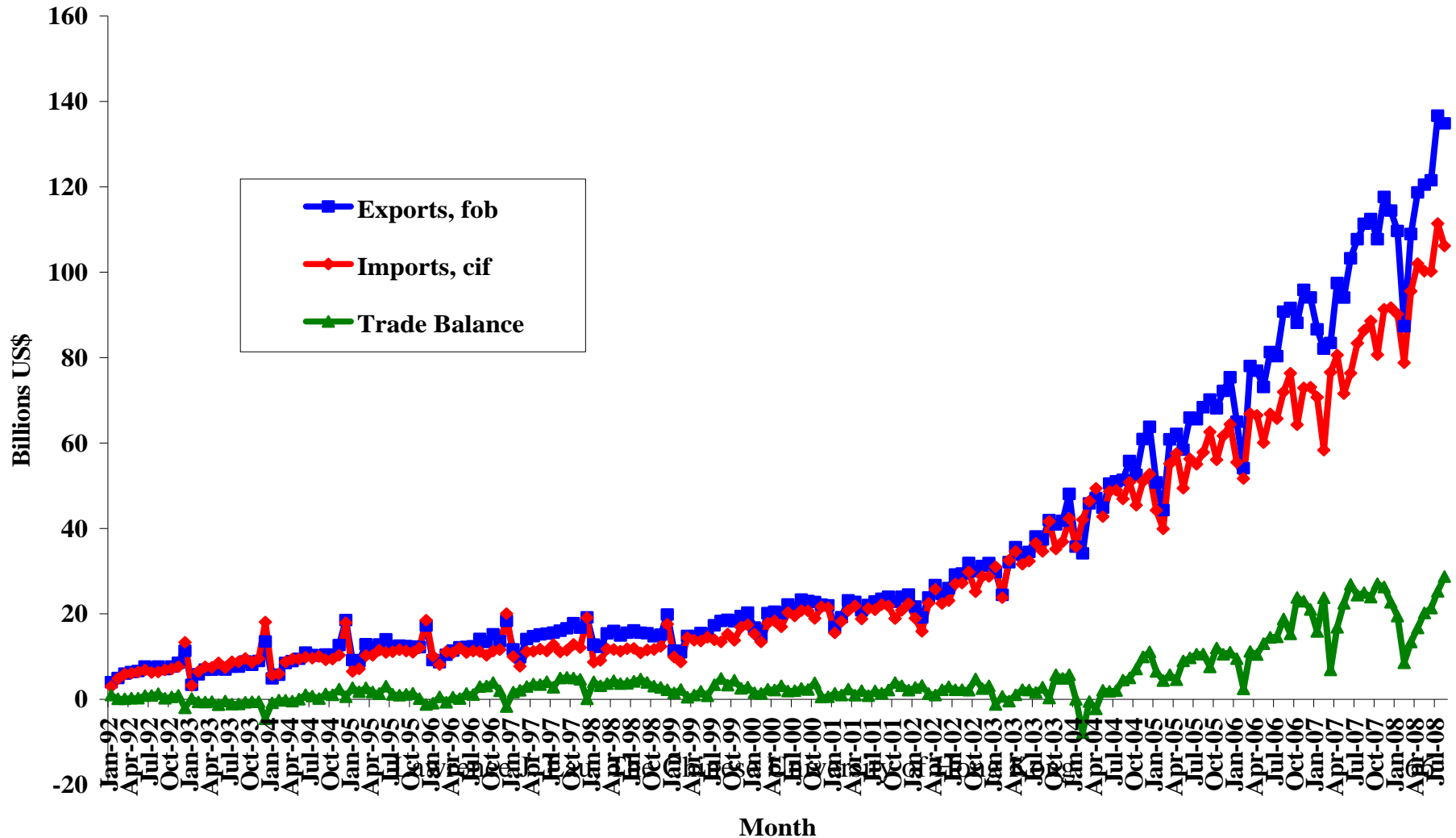
# Foreign Exchange Reserves and the Exchange Rate, End of the Month

The Level of Foreign Exchange Reserves and Exchange Rate (Yuan per US Dollar) at the End of Month



# Chinese Exports and Imports in US\$

The Level of Exports, Imports and Trade Balance of Goods at the End of the Month



# The Renminbi as a Convertible Currency

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- ◆ China has also revised its international trade policy recently and is no longer aiming at a trade surplus or further increases in its official foreign exchange reserves. Going forward, it will try to achieve basically balanced trade vis-à-vis the whole world, removing one source of pressure for appreciation of the Renminbi.
- ◆ The creation of foreign exchange, 创汇, is no longer an indicator of performance for officials.

# Concluding Remarks

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- ◆ It is the unique achievement of China that in its transition from a centrally planned economy to a market economy, it has managed to benefit everyone. The strategy of reform without losers maximizes support, minimizes opposition and promotes social stability. It means win-win for all.
- ◆ However, the time has come to (1) further perfect the market system by eliminating or limiting failures of the market such as asymmetric information, monopolies or quasi-monopolies and other anti-competitive practices, excessive leverage, moral hazard, and externalities; (2) design and implement redistributive mechanisms so that the gains from economic reform can be more widely shared; and (3) to introduce instruments for macroeconomic control including public expenditure and taxation, monetary policy, interest rate policy and exchange rate policy.
- ◆ State power is necessary in order to implement the reform effectively.