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## Catching up with America

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### THE HURDLES OF 2002 IN CHINA'S RACE TO CATCH UP

In *Australia and the Northeast Asian Ascendancy*, I noted that the powerful sustained growth that had propelled first Japan and then Hong Kong, Singapore, Taiwan and Korea from poverty into the ranks of the medium or high-income economies seemed inexorable only in retrospect (Garnaut 1989). Along the way, the path of growth was strewn with barriers, many of which at the time had seemed as if they might be the one that brought the whole process to an end. In the end, at each hurdle the domestic interests that favoured growth turned out to be strong enough to break through, and rapid growth continued until the productivity and income frontiers of the reasonably rich countries had been reached, first of all by Japan in the early 1970s. So it was likely to be with China. And in China's case, too, there would be great challenges to sustained growth along the way. No-one could be sure in advance that a particular hurdle would not turn out to be too great for the polity and the society to overcome, although each time there would be powerful tendencies for continuity in the growth process.

China is at present above what an informed observer would see as one of the biggest hurdles—or two big hurdles piled on top of each other. The first of the joined hurdles has been recession in China's main trading partners and sources of investment in 2001, amidst fears that it would stretch an indefinite period into the current

year. The second, piled on top, is China's entry into the World Trade Organization (WTO) in December 2001.

The rapid expansion in China's external trade and investment has been a major factor in its sustained growth. Continued growth has underpinned far-reaching and increasingly radical reform to convert an inward-looking centrally planned economy into an internationally-oriented market economy. Mainland China's external trade and investment is concentrated strongly in the Asia Pacific region—with its immediate neighbours in East Asia, and across the Pacific in North America, particularly the United States. In the Asia Pacific region as a whole, the year just passed, 2001, has been the weakest for growth in output and trade since China's reform era began in 1978 (PEO 2001). The Asia Pacific downturn is deeper than in the depths of the East Asian financial crisis in 1998 because, this time, it extends to the United States and its North American partners. Indeed it has had its centre in the United States. The effects of United States recession have been expanded by its being focused first of all in the high technology and wider electronics industries, inputs into which had become the major export commodities of a number of East Asian economies, most notably Taiwan, Singapore and Malaysia. Recession elsewhere has compounded Japan's continuing economic weakness.

At this difficult time for China's external trade and investment, China was at last admitted into the WTO in December 2001. This concluded a long process of China exploring the possibility of, and then seeking, membership of the WTO, stretching back to discussions between the then Ministry of Foreign Trade and Technical Cooperation and the Australian Government, and the Australian provision of technical assistance on what was involved, in 1986. As described in chapters 6, 8, 9 10 and 11 of this book, China's entry into the WTO is no mere formality. China's accession agreements embody commitments to further far-reaching trade and investment liberalisation. On a number of important matters, the commitments go beyond those of any other member at the time of WTO entry or in the Uruguay Round. The implementation of these commitments, commencing immediately and continuing over a number of years, would intensify structural change throughout the economy (see especially chapters 2, 5 and 7). These changes compound the ongoing challenges to the viability of the surviving state-owned enterprises (chapter 3), of unemployment (chapter 12), and dispersion in income distribution (chapters 4 and 12).

Is the hurdle of WTO entry in an Asia Pacific recession so high that 2002 becomes the year in which the sustained strong growth since reforms began in 1978 comes to an end or, as in Southeast Asia with the financial crisis in 1997–98, moves to a lower trajectory? How should we see the 2002 hurdles in the long process of China's catching up with the productivity and incomes of its more prosperous neighbours in East Asia and of its other economic partners amongst the developed countries?

This chapter outlines the long-term path of growth in China and some of the hurdles that could bring it to a conclusion before the frontiers of global productivity and incomes have been reached. It explains why, if the hurdles can be cleared and the process continues for a long period, catching up with the world's advanced countries takes less time than would be suggested by the application of growth rate differentials to current per capita incomes as measured conventionally in the national accounts and converted into a common currency at current exchange rates. It then outlines the ways in which subsequent chapters expand understanding of the contemporary challenge to growth.

## HURDLES IN A LONG RACE

What are the natural end points of the rapid growth that was established in China by the beginning of internationally-oriented reform in 1978 and sustained after that by the deepening of reform and integration into the international economy? What are the hurdles that would have to be cleared if growth were to be sustained until China's average productivity and living standards were near the global frontiers?

Deng Xiaoping in 1980 laid out what then seemed to all foreign observers to be an unrealistically ambitious goal, to quadruple Chinese output by the end of the century. Perhaps it should not have been seen as unrealistic, as this feat had been achieved in the preceding decades by four of China's Northeast Asian neighbouring economies, commencing with Japan in the 1960s and 1970s. But then again, China in the immediate aftermath of the Cultural Revolution was not an obvious candidate for membership of the group of high-growth East Asian economies that had been attracting international attention and some admiration.

A while later Deng added that the next goal, after the first quadrupling of production, would be to take China to the living standards of the middle-income countries half way into the twenty-first century. In 1986, in Beijing, I asked Deng what he

meant by China catching up with the middle-income countries half way through the next century. Did he mean reaching the levels in the 1980s of the middle-income countries (then conventionally including Northeast Asia's newly industrialised economies, Hong Kong, Taiwan and Korea)? Or did he mean the levels in the mid twenty-first century of what were then the middle-income economies? Deng said that it was the former that he had in mind. By 2050, China would have the standard of living of Taiwan, Hong Kong and Korea in the 1980s. He added that he hoped that by then the Chinese people would be satisfied.

That was high ambition for a country which had until a short time before contained a majority of the world's poor people, and which was then only a few steps down the uncertain path onto which it had been led by the durable elder statesman. But in a way it was also a very low ambition, for, if the quadrupling goal were met on time, it would mean that by the mid twenty-first century, China, unlike the other Northeast Asian economies, would have experienced the cessation of rapid growth long before it had reached the global economic frontiers. The second goal as elaborated by Deng in 1986 also ascribed low ambition to the Chinese of the twenty-first century, for it contemplated their satisfaction with living standards that were way below the levels of the most prosperous parts of the world community at that future time.

Deng's high ambitions for the first twenty years of reform were realised several years ahead of time. It now seems that, barring a fall at one of the hurdles in China's path, the long-term goals were wildly and unrealistically low.

Why would we expect the end point of economic growth in China to be significantly below the average incomes in the world's most successful economies? The average ability of the Chinese people in matters related to economic performance is not obviously lower than the average of Australians or Americans. Nor is there any reason to expect the material ambitions of Chinese to falter a long way short of Americans' ambitions. It would be surprising if one day China did not have about the per capita income of the United States, give or take one quarter or one third to take account of differences in preferences, demographic structures, and the myriad institutional detail that can affect productivity at the margin. (The qualification on demographic differences is far from trivial, as the sharp decline in fertility in China after 1978 means that the Chinese population will age more and more quickly than that of the United States through the middle decades of the twenty-first century.) The difference in population

size means, of course, that the Chinese economy will be larger when its per capita income is only one quarter or (given the stronger twenty-first century population growth that is anticipated in America) one third that of the United States.

How long it takes to get there is a different matter. I suggest that it will not take as long to catch up as most observers would expect, so long as China continues to meet the demanding conditions for sustained strong growth that I describe in this section.

Chinese output, as measured by the official agencies and accepted by the Washington-based international institutions, has averaged a bit below 9 per cent per annum over the reform period. This is above the 7.2 per cent per annum that doubles output each decade, which was the focus of Deng's early exposition and has continued *de facto* as something like an official target. Growth could ease a bit from the high average levels of the past quarter century without quibbles about its continuation at a rapid rate. It has become conventional to query the Chinese growth statistics, but they are not wildly misleading. Problems of measurement outside the main centres and of valuation elsewhere raise some doubts at the margin, as they do in all developing countries. But there is not much doubt that real output has been growing at a rate that doubles output each decade.

What will it take to maintain strong growth, at something approaching the average rate of the past quarter century? It takes high levels of investment, and in a country as large as China a high proportion of investment will need to be funded from domestic savings. This seems a relatively easy condition for China to meet, with its extraordinarily high domestic savings rate, supported by its attractions to foreign direct investment. It takes flexibility in the structure of the domestic economy and the allocation of resources to productive uses, which in turn require effective markets for labour, capital, goods and services. This is the core agenda of past and prospective economic reform, and the subject of a majority of the chapters in this book.

The most important requirement for increased flexibility in the Chinese economy in the early stages of reform, and at the beginning apparently the most politically demanding and technically complex, was to change fundamentally the institutions of production. At the beginnings of reform these were overwhelmingly the People's Communes in the countryside and large state-owned enterprises (SOEs) in the cities. Reform of collective agriculture and state-owned businesses was the hurdle at which

reform to promote economic growth fell in most of the once centrally-planned economies. In the event, strong growth in the first two decades of reform in rural China, home in the late 1970s to 80 per cent of the Chinese population, was underpinned by two huge, rapid institutional transformations, both emerging spontaneously from rural communities and reinforced but not initiated by the central authorities: the replacement of the People's Communes by the household responsibility system (HRS) in agriculture; and the emergence of township and village enterprises as the main focus of industrial and services activity in the countryside. The SOEs have been more strongly resistant to reform, although, as discussed in chapter 3, there has been greater success in the period of more radical reform since the mid 1990s. The persistent problems of large dimension in the SOEs have not had fatal consequences for growth, however, because of one third dramatic transformation: the emergence of a large, dynamic private sector in an unfavourable regulatory environment from the mid 1990s (Garnaut et al. 2001; chapter 7, this volume). This powerful recent development shows promise of providing the structural flexibility for the next demanding stage of rapid growth in China, with the Government now giving some attention to the removal of artificial impediments to private sector development.

Sustained rapid growth requires a reasonable degree of economic stability supported by sound fiscal and monetary policy. The requirement is not perfect stability, but at least the avoidance of persistent high inflation and balance of payments and domestic financial crises. This condition cannot be met without the exercise of good judgment by people who understand complex macroeconomic relationships, at some distance in their day to day work from people whose main expertise is in the accumulation and exercise of political power. The analytical requirements to support sound judgment are considerable at times of change. There is also an element of good luck behind sustained macroeconomic stability, as the institutional underpinnings of a rapidly changing economy and society themselves change rapidly, in ways that affect unpredictably the influence of particular policy interventions on the economy. Cautious fiscal policy reduces the risk that ill fortune will lead to a major fracture in economic growth performance.

Sustained strong growth requires in high degree openness to foreign ideas, technology, management practices and trade. These can all be assisted by high levels of direct foreign investment. China so far has met this test. The requirements of openness (like the requirements of structural flexibility and efficiency in resource

allocation that have already been discussed) are more and more demanding as successful growth takes the economy closer to the international productivity frontiers. Openness is two-sided, with the requirements extending to access to other economies' markets for goods, services, capital, management practices and technology. Both sides of the requirements of openness are addressed substantially by China's entry into the WTO, which is a second main focus of the following chapters of this book.

Of the essential conditions for sustained growth, two others are more complex, and further from conventional economic analysis. Sustained strong growth requires political stability at home and in China's relations with its neighbours and with the world's superpower, the United States.

Deng Xiaoping famously saw political stability through the stress of radical economic reform coming first of all from the continued internal discipline and political hegemony of the Chinese Communist Party. This was the basis on which he secured the dismissal from high office of the two key leaders through the first and crucial decade of reform: General Secretary Hu Yaobang in the wake of the student demonstrations in Shanghai and elsewhere late in 1986; and former Premier and then current General Secretary Zhao Ziyang (together with Politbureau Standing Committee member Hu Qili) in the midst of the crisis focused on Tiananmen in 1989. This was the basis on which he proposed decisively the imposition of martial law on 17 May 1989 (contemporary communications corroborated in Nathan and Link 2001:175).

The authority of Deng Xiaoping and the then old leaders, and through them of the Chinese Communist Party, derived from their roles in the revolution that brought the Communist Party to power, in the defeat of the radical Maoist leadership after the death of Mao Zedong, and then in the early success of economic reform. Political legitimacy cannot forever depend on events that pass rapidly into history, through a new leadership that was not associated directly with them. The maintenance of political stability requires the continued delivery of rising living standards widely distributed through the population. It requires, as well, timely responses to the increased emphasis that Chinese, like people everywhere, place on personal freedoms and opportunity to influence policy decisions that affect their welfare, through the extension of education and knowledge, information about the realities of life in China and the rest of the world, and awareness of their own value as individuals that accompanies sustained economic growth over long periods.

This book is not about the domestic political conditions for sustained economic growth, but its discussion of inequality of income distribution between regions and individuals (especially chapters 4, 6, 9 and 12) are closely relevant to assessment of its prospects.

On international political stability, Chinese are much more aware than foreigners of the challenges of China's geographic location. China shares a long border with Russia, which still possesses the world's second most formidable military capacity, built around nuclear capacity. After a difficult first decade following the collapse of the Soviet Union, in which descent into domestic political instability and economic anarchy at times seemed possible, Russia now seems to be making progress on strengthening domestic political and economic institutions. But there is a sense in which the risk of instability in Russia remains a risk to China. To the east of the Russian border is the world's last surviving Stalinist state, with considerable conventional military capacity and nuclear aspirations, recently described by the President of the United States as a source of terrorist threat to the international community. On its borders to the west there is Mongolia, and then Chinese provinces with large Islamic communities adjacent to Islamic communities in Kazakstan, Uzbekistan, Tajikistan, Kyrgyzstan, Afganistan and Pakistan. On the Southern border is India, whose size inevitably makes it a rival for influence in the mainland of Asia, as well as Vietnam, Myanmar, Laos, Bangladesh, Nepal and Bhutan. And then close across the waters to the east are the economically strong countries of Japan and Korea. Taken together these are the world's most difficult frontiers, demanding at the best of times, and thought provoking at a time when state-backed terror is seen as a challenge to domestic order all over the world. China has seldom had less troubled relations than it has now with countries on its borders taken as a whole, but Chinese at least will continue to see risks to stability in their immediate international environment.

China's size and growing economic weight mean, inevitably, that its interests will from time to time bump into those of the United States, with its global interests. The risks of a destructive stand-off between China and the United States seemed large a year ago, but have been eased with sensible resolution to immediate problems. China's entry into the WTO provides a helpful international context for resolution of bilateral conflicts over trade. For the time being, the United States' identification of



the war against terrorism as its greatest strategic challenge and China's support on these matters has eased tensions.

Maintenance of productive working relations with the United States is necessary for continued economic as well as political liberalisation in China, and for sustained growth in China, as it is for world peace. The greatest tests will continue to arise over the status of Taiwan, where the formula for the outcome that is most satisfactory for Chinese on both sides of the Taiwan Straits remains unchanged through all the political noise of recent times. China can live with the formal *status quo* for a long time, so long as there is continued movement towards functional integration of the communities and economies across the Straits, as there has been since 1987. However, an overt move towards international recognition of Taiwan as an independent entity would destabilise any mainland leadership that was seen within China as being inclined to accept it, which would make military confrontation inevitable. There would be no overt movement towards Taiwan independence unless the Taiwan leadership thought that it had unlimited and unconditional support from the United States. This is why seven US Presidents, and Chinese leaders from Mao to Jiang, have in the end settled on the acceptance of an untidy formal *status quo*. It is important that they continue to do so until political and economic change on both sides of the Straits has created opportunities that cannot now be readily envisaged.

Finally, the environmental challenge to sustained economic growth in China should be acknowledged. Chinese, like people everywhere, have been giving higher priority to domestic environmental amenity as incomes have increased. China's capacity to deal with accumulating domestic environmental problems has been expanding with economic growth, and, with the usual lags in human political response to new challenges, China are using this capacity with increasing effect. The higher environmental hurdles in the path to sustained growth are global, with the raising of Chinese living standards towards those of the developed countries. Economic prosperity everywhere will require China to contribute its part to workable global management regimes.

### CATCHING UP TAKES LESS TIME THEN YOU THINK

If China continued to clear the many hurdles in the path of sustained rapid growth, how long would it take for it to reach the productivity levels and living standards of

the developed economies? This section explains why, in other East Asian economies, it has taken less time than would be expected from simple comparison of growth rate differentials and differences in average output at the starting point. It then discusses the relevance of these comparisons to China.

When Deng Xiaoping was defining ambitions for future Chinese living standards in terms of those in East Asian middle-income economies in the mid 1980s, the comparators were at the beginning of an extraordinary period of rapid catching up with the world's advanced countries.

In 1985, Korea's per capita income in constant 1992 US dollars was around \$3,000. In 1996, on the eve of the East Asian financial crisis, it was almost \$11,000 in 1992 US dollars. Singapore moved from around US\$8,000 to the vicinity of US\$28,000 over the same period. For Hong Kong, the lift was from around US\$8,000 to the vicinity of US\$24,000. A minor part of these large gains in Singapore and Hong Kong, and more in Korea, was lost in recession and currency adjustments in the financial crisis. Part of the large relative expansion of the rapidly growing East Asian economies over this period can therefore be seen as reflecting unsustainable speculative boom conditions, but the major part has to be explained in other terms.

This was the most spectacular but not the only period of accelerated catching up with the world's developed economies. In Hong Kong, per capita incomes expressed in 1992 US dollars doubled between 1971 and 1973, from around US\$3,000 to about US\$6,000. Korean per capita GDP expressed in the same terms roughly doubled to US\$3,000 in three years from the mid 1970s. Singapore moved from around US\$4,000 to over US\$7,000 between 1971 and 1974.

These are the periods of most rapid catching up with the developed economies. They would be uninteresting if they were matched by other periods in which there were similarly spectacular relative declines. They could then be said to reflect merely the vagaries of the foreign exchange markets.

But they were not so matched. From 1971, when Singapore's per capita income expressed in 1992 US dollars was about US\$4,000, to 1998, when the effects of the financial crisis were strongest, Singapore per capita income converted into constant 1992 US dollars at the exchange rates of the day grew at almost one and a half times the average rate of growth of GDP in constant domestic prices. Between 1968 when Hong Kong's per capita income expressed in 1992 US dollars was about

US\$2,500, and 1998, Hong Kong's per capita income converted into constant US dollars at the exchange rates of the day grew almost 1.9 times the average rate of growth of GDP in constant domestic prices. In Korea the deviation between the two measurements of rates of growth is between those of Hong Kong and Singapore over the long period from 1965–98. Similar patterns can be found in the experience of Taiwan and, earlier, Japan.

The general story is that an economy that sustains rapid growth over a long period reaches a point or points at which its GDP converted in the US dollars of the day rises much more rapidly relative to the developed economies than the differentials in real growth rates would suggest.

Why is this so? And is it relevant to assessments of how many years of sustained rapid growth it would take for China to reach the world's frontiers of average output and living standards?

The resolution of a big part of the statistical puzzle lies in the manner in which standard ways of measuring GDP systematically underestimate the 'real' incomes of low-income countries. The standard way of calculating GDP in US dollars is simply to take national output as measured in the domestic currency in the national accounts, and to convert it into US dollars at the exchange rates of the year under consideration. In a poor country, while the prices of goods that enter international trade generally bear a reasonably close relationship to international prices in international currency, this is not the case for goods and services which are only traded within the country. The prices of 'non-tradables' tend to be lower in low-income developing countries where wages are low.

Wages of low-skill workers remain low for as long as labour remains abundant. In this early stage of development, rapid economic growth is associated with strong expansion in production and export of simple, labour-intensive products, and with expansion of modern sector employment. More and more people are attracted from agriculture into industrial and later services employment. This process continues until most of the economically surplus labour in the farm economy has been absorbed into the modern economy. At this point when labour begins to become scarce, the 'turning point in economic development', real wages begin to rise, sometimes rapidly. In East Asia this point has sometimes occurred at around US\$3,000 in 1992 US dollars, although it seems to have occurred at below this level in Korea.

There seems to have been further acceleration at higher incomes, perhaps US\$8,000.

Beyond the 'turning point', there is rapid structural transformation, with the old labour-intensive industries being replaced by more capital-intensive and technologically complex activities as the main loci of growth. Per capita income in international prices rises more rapidly than standard growth rates of real GDP would suggest. The rapidly growing middle-income economy catches up even more rapidly with the high-income countries.

Conventionally measured GDP converted to US dollars is a reasonable indication of the international purchasing power of domestic incomes. For other purposes, however, conventional GDP tells us less than the 'purchasing power parity' or 'real purchasing power' measure of GDP. The 'purchasing power parity' measure does not systematically underestimate output of low-income countries. Therefore there is no accelerated catch-up with developed countries as real wages rise beyond the turning point in economic development. Neither is it affected artificially by policy-induced or temporary market-induced exchange rate mis-valuation.

How do we apply these insights to assessment of the period of sustained rapid growth that would be required for China to catch up with the developed economies?

To begin, we should use purchasing power parity measures of GDP as the starting point. China's purchasing power parity per capita income in 2000 was US\$3612. On the latest available World Bank data, per capita income in China is about one fortieth that of the United States in conventional terms (US\$856 compared with US\$35,101 in 2000), compared with one tenth in terms of real purchasing power (US\$3,612 compared with US\$35,101). The corresponding figures for Japan are US\$36,894 by conventional measures and US\$28,992 for real purchasing power (World Bank 2002).

The period of sustained 4.5 per cent differentials in growth in per capita income that would be required for China to catch up with average incomes in the United States is about 50 years when we, appropriately, use the purchasing power measure as the starting point.

Incidentally, in terms of conventional national income accounting, the sum of all Chinese incomes is now 11 per cent of American, and 23 per cent of Japanese. In purchasing power terms, the ratios are 46 per cent and 124 per cent.

It is not clear that the accelerated catching up with developed country incomes in

conventional terms after labour becomes scarce will occur over a relatively short period in China, as it did in Japan, Hong Kong, Taiwan, Singapore and Korea. China's huge population and land area and the geographic, policy and institutional barriers to internal trade and factor movements are causing labour to become scarce and wages of unskilled labour to rise rapidly in the advanced coastal provinces long before there are signs of labour shortage in central and western regions. The structural transformation that follows and then accompanies sustained rapid growth is occurring in the coastal regions while other parts of China retain strong comparative advantage in labour-intensive products.

China's accelerated catch-up can be expected to commence at a relatively low level of conventionally defined average incomes. There is no sign of it yet in the data if we compare only China and the United States, largely because the United States dollar, against which the Chinese yuan is pegged, has been exceptionally strong against almost all other countries over the last several years. But China's per capita income ranking against third countries has been rising more rapidly than is indicated by conventional growth rate differentials.

The same regional disparities that generate large differentials across Chinese regions and provinces in rates of growth and economic structure are discussed in chapters 4 and 12 as sources of widening income inequalities. This is a challenge for political cohesion around reform policies that support continued rapid growth. At the same time, the regional disparities cause Chinese growth to place less pressure for structural change on China's trading partners, which are faced by less concentrated competition and more widely differentiated opportunities for export to China than would be the case if China, like its smaller East Asian neighbours, were more deeply integrated domestically.

## GETTING OVER 2002

So is 2002 possibly the year in which the hurdle is too high?

Huang in chapter 2 suggests not. He notes that this is a year of generational leadership change, which exacerbates uncertainty but is likely to lead to leadership that is more closely knowledgeable about the necessary economic and political reform in the period ahead. Continued growth in urban incomes is essential to political

stability at a time of uncertainty, and will be delivered. China's macroeconomic environment is holding up well to the severe external shocks. Growth is slower, but not dramatically so. The greater risks are in the longer term, related mainly to domestic financial fragility. Deeper financial reform is the remedy, much hangs on whether the Chinese government implements the necessary change in time to forestall a major problem. Huang's views on the short-term are reinforced by recent evidence of early recovery in the US economy.

Other chapters highlight the extent of the long-term challenge to continued strong growth and to equitable income distribution that is inherent in recent economic trends and in the WTO commitments.

Wang in chapter 3 discusses the history of SOE reform, and notes the failure in the early reform years. There has been more progress in recent years of radical reform. SOE performance has been helped considerably by improvements in economic conditions beyond the firm, but there are improvements too from improved incentive structures, greater profit orientation leading to reduction in numbers of redundant employees and generally more efficient operations. Joint ventures with foreign and private enterprises have lifted performance.

Jiang in chapter 4 notes that regional disparities contracted in the early years of reform, but have widened again since. The early reductions in inequality were associated with the concentration of early gains in agriculture. WTO entry will raise total incomes and, at first sight surprisingly, by more in rural than in urban areas. But the rural gains are mostly in industry in the richer, coastal provinces. The model used to draw these conclusions does not take account of the effects of WTO entry in encouraging capital inflow, the gains from which are also likely to be concentrated in the coastal provinces. The result is a worrying widening of the distribution of income between regions. This requires an effective policy response, which can be built around improving infrastructure for trade between coastal and inland areas, acceleration of reform in Central and Western provinces including in ways that would support off-farm development in the inland provinces, as well as resource transfers from wealthier provinces

Mei Wen in chapter 5 makes the important point that it takes time to build the institutional base for market exchange that is taken for granted in the long-developed economies. The development of markets had to start with changes in the

ideological environment between 1985 and 1991, with accelerated improvement of market institutions themselves from the early 1990s. The internet has been important in reducing transaction costs in market exchange. Diversification of ownership types, with township and village industries and then private firms playing important roles, has been important in improvement in markets. A significant component of productivity growth has come from the diversification of ownership. A level playing field between types of ownership is required to get the most out of this institutional change.

Wang in chapter 6 takes a closer look at the effects of WTO entry commitments on the agricultural sector. Commitments to liberalisation are expected to result in displacement of over 9 million farm workers in the land-intensive grain sector. Wang doubts that township and village enterprises can expand enough to absorb them. Overall consumer gains will be large, but to different people. The later discussion in chapter 9 suggests that the strong focus in chapter 6 on land-intensive agriculture in which China's comparative disadvantage is strongest has affected perceptions of the outlook for employment.

Song in chapter 7 observes how WTO entry will reinforce recent trends towards strong growth in the private sector. The reforms that have facilitated this growth have been modest in extent but considerable in their effect. There would be a large return from deeper reform, amongst other things to raise efficiency in the financial sector. More efficient financial markets are required to establish a more level playing field for different types of business ownership. The flourishing private sector has been a major force for improvement in markets and economic institutions more generally.

Findlay and Pangestu in chapter 8 describe the WTO commitments to truly radical liberalisation and internationalisation in the services sector. This will spur the development of more efficient community service obligations and regulatory arrangements, weaknesses in which have caused important problems.

Chen in chapter 9 examines how WTO entry is likely to expand further the high levels of inward direct foreign investment flows that have been a feature of Chinese development over the past decade. Chen throws a different light on some of the pessimism about the agricultural sector after WTO entry, noting the prospects for expansion of labour-intensive agricultural exports and for market pressures after WTO entry to push more labour-intensive industries inland.

Waller in chapter 10 and Hasenstab in chapter 11 examine the role of WTO entry in ongoing reform in the financial sector. For the liberalisation of foreign entry to the insurance sector to generate the potential benefits that are available to China, there will need to be regulatory reform and more generally an expanded role for the private sector. Hasenstab looks at Chinese financial reforms in a long perspective, seeing them as capable of moving Chinese financial markets to a place in the global big three. But major market imperfections remain. These require timely correction, and in the meantime China should take care with capital account liberalisation.

Finally, Meng addresses in detail the tendencies in income distribution over the period of reform. There have been two distinct periods. Reform was more gradual until the early 1990s. More radical reform since then has been associated with large increases in inequalities. The emergence of households with more than one person unemployed is a feature of recent structural change, that warrants priority in policy response.

Taken as a whole, the reviews of contemporary developments in subsequent chapters suggest that China is not going to be knocked off course by the challenges of 2002. This, through a period of great external weakness, will boost confidence in China's capacity to sustain growth over long periods, perhaps even to catch up with America.

The review has highlighted the growing challenges from widening income inequalities of many kinds, exacerbated by WTO entry. It has also identified the financial sector as requiring timely efforts in reform if it is not to be a source of risk to economic stability as well as a drag on efficiency in other parts of the economy. Tardiness on financial sector reform would, amongst much else, hold back the development of the private sector that has become important to wider economic and political development in many ways.

The clearing of the more conventionally economic hurdles would make more prominent the long-term challenges of internal and external political stability. Dealing with the long-term issues of income inequality and financial sector weakness would contribute to management of these wider challenges.