POLICY BRIEF

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Introduction

China's economic growth has averaged 9½ per cent over the past two decades. The rapid pace of economic change is likely to be sustained for some time. These gains have contributed not only to higher personal incomes, but also to a significant reduction in poverty. At the same time, the economy has become substantially integrated with the world economy. A large part of these gains have come through profound shifts in government policies. Reforms have allowed market prices and private investors to play a significant role in production and trade.

Further notable challenges remain: to provide a firm framework for private sector activity; to maintain a stable macroeconomic environment; to reform the financial system; to reduce regional inequalities by reforming fiscal transfers.

The private sector is driving growth and can be strengthened further

The scope of private ownership has become substantial, producing well over half of GDP and an overwhelming share of exports. Private companies generate most new jobs and are improving the productivity and profitability of the whole economy. The government has restructured the state-owned business sector, resulting in a massive loss of jobs. Still, a large part of the state sector remains to be restructured; policies to facilitate this process have been identified and are being expanded. The performance of the business sector could be strengthened more through a further modernisation of the business framework and better enforcement of laws in the economic sphere, especially those for intellectual property rights.

A more flexible exchange rate would support a stable macroeconomic environment

While fiscal policy has been run in a stabilising fashion, the outcome of monetary policy has been considerable volatility of inflation. Greater flexibility of the exchange rate would allow the authorities to guard against any further increase in inflation in both product and asset markets, more easily adapt monetary policy to domestic concerns, and allow market forces to

This policy brief presents the assessment and recommendations of the 2005 OECD Economic Survey of China. A draft of this Survey was prepared by the Economics Department. The Economic and Development Review Committee, which is made up of the 30 member countries and the European Commission, held a special seminar to discuss this survey with the participation of the Chinese government. It was revised following the discussions in this seminar, and is issued under the reponsibility of the Secretary-General.

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determine bank interest rates to a greater extent. The change in the exchange rate arrangements announced in July 2005 is a step in that direction.

Further reforms are needed in the financial sector

Until five years ago, lending policies led to the accumulation of a considerable quantity of bad loans. The recapitalisation of more than two-thirds of the banking system to eliminate this historical burden is almost complete and the cost to public finances of completing the exercise, while substantial, appears to be manageable. Wide-ranging reforms have improved the capacity of banks to make market-based lending decisions. Overall, these policies appear to have been successful, as new loans have been of much higher quality, even using the new, more realistic, classification system for non-performing loans. Further progress will require a continued focus on improving governance and increasing private ownership. Policies designed to expand and further deregulate capital markets would improve the allocation of capital, lower the risk of further waste of savings, and minimise systemic risk.

Solid public finances could permit tax and expenditure reforms

Rapid growth of revenues and control of expenditure has put public finances in a sound position. As a result there is scope to move towards less discriminatory taxation of different types of companies and activities, while maintaining low marginal tax rates. Expenditure on health and education both in rural areas and for migrants in urban areas could also be strengthened, but achieving this objective may require an overhaul of fiscal relations between different levels of governments. Such spending would help reduce inequalities but would need to be complemented by further labour market reforms. Additional reductions on the restraints to migration would help to facilitate a more rapid pace of urbanisation that could help to reduce income inequalities, especially if public services are guaranteed to newcomers and if those who leave rural areas do not lose their land-use rights. Increased urbanisation would need to be accompanied by policies designed to lower the high level of pollution in an efficient, economic fashion. ■

Why has growth been so rapid?

The pace of economic change in China has been extremely rapid since the start of economic reforms just over 25 years ago. Economic growth has averaged 9½ per cent over the past two decades and seems likely to continue at that pace for some time. Such an increase in output represents one of the most sustained and rapid economic transformations seen in the world economy in the past 50 years. It has delivered higher incomes and a substantial reduction of those living in absolute poverty. The size of the economy, when measured at market prices, now exceeds that of a number of major European economies and may be exceeded by only three OECD member countries in five years' time. While average incomes are still below those in other middle income countries, there are large parts of the country that have reached the income levels seen in some developed East Asian countries just one generation ago and are proceeding along a similar rapid catch-up path. Many industries have become completely integrated into the world supply chain and, on current trends, China could become the largest exporter in the world by the beginning of the next decade. Underlying this growth there has been a profound evolution of economic policies that has transformed the efficiency of enterprises.

This extraordinary economic performance has been driven by changes in government economic policy that have progressively given greater rein to market forces. The transformation started in the agricultural sector more than two decades ago and was extended progressively to industry and large parts of the service sector, so that price regulation was essentially dismantled by 2000. While price controls were being abolished, the government introduced a pioneering company law that for the first time permitted private individuals to own limited liability corporations. The government also rigorously enforced a number of competition laws in order to unify the internal market, while the business environment was further sharpened by allowing foreign direct investment in the country, reducing tariffs, abolishing the state export trading monopoly and ending multiple exchange rates. The momentum towards a freer economy has continued this decade with membership of the World Trade Organisation resulting in the standardisation of a large number of its laws and regulations and the prospect of further tariff reductions. In addition, fundamental changes were made to the constitution in 2004, stressing the role of the non-state sector in supporting economic activity in the country and protecting private property from arbitrary seizure. In 2005, regulations that prevented privately-owned companies entering a number of sectors of the economy, such as infrastructure, public utilities and financial services were abolished. Overall, these changes have permitted the emergence of a powerful private sector in the economy.

The government has also introduced wide ranging reforms into the state-owned sector that dominated the economy in the early 1990s. State-owned enterprises have been transformed into corporations with a formal legal business structure and many have been listed on stock exchanges that were created in the early 1990s. Since 1998, a policy of letting small enterprises go and restructuring large companies has been successfully pursued, with the number of state-controlled industrial enterprises falling by over one half in the following five years. Employment contracts were made more flexible, leading to job reductions in the industrial sector of over 14 million in the five years to 2003. This process was aided by the creation of unemployment and welfare programmes that transferred the burden of compensating redundant workers from enterprises to the state. Finally, in 2003, the government rationalised its control over state-controlled enterprises further by creating an agency charged with exercising the government's ownership rights and boosting the performance of these enterprises.

These reforms have improved the framework for mobilising the resources generated by one of the highest rates of savings in any economy – the gross saving rate approaches half of GDP – generating a particularly rapid increase in the capital stock, although such estimates can only be approximate since there are no official estimates either of the capital stock or of constant price estimates of expenditure components of GDP, the absence of which complicates interpretation of economic trends. Investment has, in part, served to raise the assets available to each worker in the business sector, so boosting the annual growth of labour productivity to 8½ per cent in 2003. It has also been used to create an increasingly urban society – a movement that has gone in step with a flow of people from the land into the service and manufacturing sectors of the economy. Since workers in agriculture have low productivity, such a movement has boosted growth considerably.

In parallel with the growth of physical assets, the government has pursued a policy of raising the education qualifications of young people. It launched a programme to give all children nine years' education, moving recently to ensure that all rural areas achieve this goal by 2006. Higher education has also been transformed. In the five year period to 2003, the number of students joining higher education courses has risen by 3½ times, with a strong emphasis on technical subjects. As a result of these policy initiatives, the average quality of the labour force has also been improving significantly, with new entrants to the labour force having almost three times as many years of schooling as those who are retiring. Finally, government initiatives have freed the urban labour market, with the wages for educated staff being pushed up by the growing influence of a market economy.

Indeed, the changes in government polices have created a largely market-oriented economy in which the private sector plays a key role. Precise measurement of the size of the private sector is difficult, but a definition which considers as private all companies that are controlled neither by state nor collective shareholders suggests that the private sector was responsible for as much as 57% of the value-added produced by the non-farm business sector in 2003. Even amongst larger companies in the industrial sector, the private sector produced over half of value-added in 2003 and that share appears to have risen even further in the following two years. Overall, between 1998 and 2003, the progressive evolution in government policies allowed a fivefold rise in the output of domestically-owned private companies and a threefold rise in the output of non-mainland controlled companies; by contrast, the output of the state sector rose by just over 70% in this period.

The growth in private output has also been the result of the higher productivity of most companies in the sector. The sharper incentives facing the private sector companies have resulted in them using less capital and labour to produce output than state companies. Overall, the aggregate productivity of private companies in the industrial sector is estimated to be almost twice that of enterprises controlled directly by the state. The profitability of private companies has also risen considerably and, by 2003, they were earning a 15% rate of return on their physical assets. Such a high level of competitiveness has resulted in the private sector accounting for three-quarters of all exports in 2003. While the bulk of these exports are made by foreign-controlled companies, the domestically-owned private sector managed to quintuple its exports in the five years to 2003, as more small and medium sized enterprises were granted export licences. Overall, the growth in private sector ownership has had a very favourable impact on real incomes and macro-economic activity, boosting the level of multifactor productivity in the industrial sector by close to 10% in five years. With the decision in 2005 to allow private enterprises to establish businesses in many previously restricted areas, further improvement in multifactor productivity may be possible. ■

How could growth prospects be further boosted?

The growing importance of the private sector in supporting the economy makes it all the more important to further modernise the legal framework for business. The government is preparing legislation in three important areas: bankruptcy law, company law and the implementation of the constitutional amendment on property rights. The second draft of the bankruptcy law has now passed the legislature and is generally acknowledged to follow international best practice. The law should clearly establish the precise claims that employees have on assets, limiting payments to wages owing to employees and leaving other costs, such as redundancy and resettlement expenses, to social funds. Secured creditors would be more likely to lend to private companies under such circumstances. A new company law is under consideration. A reduction in the barriers to the formation of both limited and joint stock companies should be a priority. The upper limits on the number of shareholders in a limited company should be abolished, while at the lower end companies with one shareholder should be allowed. For both sorts of companies the minimum capital requirements needed for incorporation should be lowered. Such changes would facilitate the expansion of privately-owned companies. The revised company law should aim to improve corporate governance, notably offering better protection to minority shareholders in both quoted and unquoted public companies and defining the role of corporate bodies such as the supervisory board and the duties of directors. In addition, the proposed anti-monopoly law should cover a much wider range of anti-competitive activities than do current laws. Finally, rapid introduction of the laws to implement the constitutional amendment on private property rights should be envisaged.

Beyond the content of the law, though, there is a more substantial problem of giving force to economic laws. A relatively complete set of laws and regulations covering intellectual property rights is in force, having been updated in 2001. The focus of government policy in this area has now switched to the enforcement of these laws. Adequate protection of intellectual property is also of increasing importance to Chinese entrepreneurs. Weaknesses here may hold back the degree of innovation and product development of local companies. At present, in this and other areas, it can be very difficult to obtain judgements in court and even more difficult to obtain enforcement of the judgement. Such difficulties are not just felt by foreign enterprises. Chinese entrepreneurs feel that expansion across provincial borders is made difficult by the lack of objectivity of local judiciaries when it comes to trying cases involving the infringement of trade secrets, intellectual property rights and contract enforcement more generally. The solution would appear to require a series of steps. One might be to transfer some of the financing of courts to the central government; another would be increase the extent of specialisation of the courts (notably in the area of bankruptcy and intellectual property).

Reforms in the way that state-controlled firms are managed have improved performance but there remains significant scope for further improvement. In the industrial sector, the rate of return earned by state-controlled companies rose from 5% to 10% in the five years to 2003. Most of the increase in returns has, however, come from a minority of companies. Over 35% of all state-owned companies are not earning a positive rate of return and one in six has negative equity. For loss-making enterprises, the government has announced a four-year programme that will involve substantial additional restructuring. In some cases, asset sales may be possible in which case it is important to follow the regulations, issued in the spring of 2005, that ensure transparency in management buyouts. Within this framework, assets need to be valued on a forward-looking basis, supplementing valuations based on the acquisition cost of assets. Greater use could be made of the new property exchanges to ensure competitive prices are achieved for state assets. The government could also consider further sales of packages of distressed assets to companies with experience of restructuring, in order to supplement the efforts of the asset management companies. For quoted state-controlled companies, which earn returns on assets comparable with those of listed companies worldwide, the government has announced that there will be a progressive lifting of the non-transferability of state and local government owned shares, an initiative that could ease mergers and acquisitions. ■

How to ensure a stable macroeconomic environment?

The growing importance of the private sector puts a premium on the maintenance of a stable macroeconomic environment – notably in the area of prices. Fiscal policy has been run in a stabilising fashion. The overall fiscal position is sound, and has allowed scope for counter-cyclical management: expenditure and deficits were allowed to expand in 1998, when external developments threatened to reduce the pace of economic expansion; and deficits were reduced, while expenditure was kept under control when revenues surged beyond budget expectations in 2004. Yet, the past decade has seen considerable volatility in the inflation rate, almost 8 times that in the United States and 4 times that in Western Europe. The annual rate of inflation, when measured by the GDP deflator, has moved from 6% in 1996, to slight deflation in 2002, before rebounding again in 2003 and 2004 and still registered a rate of 4¼% in the first half of 2005, though the consumer price index has slowed to a greater extent at the beginning of 2005 due to its high food content.

Such fluctuations suggest that domestic monetary policy has not always been successful in maintaining low and stable inflation. Rather, the existence of a relatively fixed rate of exchange against the dollar has exposed the economy to inflationary or deflationary impulses stemming from fluctuations in the effective exchange rate of the dollar. In the current cycle, the combination of a rising current account surplus and foreign direct investment inflows has led to a need to purchase dollar assets to stabilise the exchange rate. The Chinese authorities have been able to sterilise much of this inflow through changes in reserve ratios, open market operations and window guidance to restrain the growth of bank lending without raising interest rates. However, given that inflows amounted to 12½ per cent of GDP in 2004 and, in line with experience in other countries, central bank sales of securities may eventually disturb the portfolio balance of the private sector, putting upward pressure on interest rates. Although there are strict controls on capital inflows, there is a likelihood that, with increasing trade flows, the capital account may become increasingly porous and responsive to any such increase in interest rates, increasing the pressure for sterilisation. Moreover, reliance on window guidance to limit bank lending goes against the government's policy of increasing the use of market-based instruments to control monetary developments. Indeed, in line with this policy, the authorities have started to develop foreign exchange and derivative markets that would allow a redistribution of risks stemming from exchange rate fluctuations. Overall, a policy of allowing greater flexibility in the exchange rate would allow the authorities to guard against the risk of any further increase in inflation in both product and asset markets, to more easily adapt monetary policy to domestic concerns and to allow market forces to determine bank interest rates to a greater extent. The July 2005 revaluation for the currency, together with the associated change in the exchange rate arrangements, represents a step in this direction. ■

What reforms should be made to the financial system?

One concern of the authorities in moving to a more flexible exchange rate, perhaps overstated given the low exposure of banks to foreign lending, has been the weakness of the banking system, but significant reforms have now been undertaken in this area. Until 1995, banks paid considerable attention to national policies in determining the allocation of bank credit. As a result, banks accumulated around CNY 4 trillion of bad debts mostly as the result of loans made in the period up to 1999. Wide ranging reforms have been introduced since then. Banks have started to modernise their lending and risk management practices. Better risk weightings have been introduced by the banking regulator and the classification system for non-performing loans has been made more realistic. Foreign investors have been allowed to acquire stakes in 12 second-tier joint stock banks. Overall, these reforms appear to have been successful, as since 2000 the new loans made by banks seem to be of a much better quality. With a reform of the banking sector infrastructure in place, the government has embarked on a strategy of recapitalising the major banks and preparing to list them on the stock market. The process of establishing a sound banking system is now well advanced for two of the major banks and has started with a third.

Re-organisation of the remainder of the banking system is still needed and would be best accompanied by a growing marketisation of the banking sector. Almost 30% of the banking sector remains to be recapitalised. The process may take some time in the rural credit co-operative sector where there are a large number of small institutions with significant problems. Progress has been made in a number of pilot provinces where co-operatives have been converted into commercial banks. The companies set up to dispose of non-performing loans, previously owned by banks, are recovering about 20% of their face value and so eventually there will be a need for the government to provide for their refinancing. Taking this into account, the ultimate costs to the government budget of recapitalising the banks, though likely to be substantial, appear manageable. But recapitalisation only represents the first step in improving the banking system. Better governance is also needed. Amongst both the joint-stock banks and city commercial banks one possible route might be to involve the non-state sector to a greater extent than at the present, as there are only a couple of banks controlled by private interests, while limiting the participation of industrial and commercial groups. As to the major banks, policy should focus on improving governance; in particular by introducing a transparent recruitment process for appointments to senior management posts. Given that a move to private ownership and changes in management are likely to take time, the bank regulator will have a key role to play in ensuring that banks put adequate risk management tools into place.

Broadening financial markets is a further crucial aspect of improving the allocation of capital. At present, such markets have a limited role and this generates a concentration of financial risk in the banking sector to a greater extent than in OECD economies. The equity market could be further developed, as the market value of freely tradable shares represented just 9% of GDP in 2004. Moreover, nearly all the quoted companies are state-controlled, while outstanding corporate bonds were equivalent to less than 1% of GDP in 2003. Share markets are unable to act as a market for control as the bulk of issued shares have restrictive covenants that, in theory, limit their transfer. The government is moving in the direction of liberalising the market, by easing restrictions on the sale of state-owned shares in quoted companies. At the same time, the pricing of initial public offers has been put on a more market driven basis, but the final decisions on which companies are listed are still made by the State Council. A freer procedure could be considered subject only to ensuring that issuing criteria have been met and that information disclosure has been adequate. In the corporate bond market, decisions on new issues are still determined administratively and are subject to industrial policy criteria. Here too a more neutral procedure could be considered. Such reforms would allow the developing private sector greater access to capital markets and make the markets more efficient, so helping to avoid the significant waste of savings represented by non-performing bank loans. Moreover, improved financial returns would benefit those saving for retirement. ■

Will population ageing generate a fiscal deficit?

A greater role for capital markets is all the more important given the rapid ageing that will occur in the population over the next two decades. Since the nationwide reform of 1997, the public pension system, which only covers 14% of the active population, has been a two-part system. The first part provides a basic flat rate pension while the second part provides a pension proportional to contributions, revalued by the bank deposit rate. This second part could, eventually, be developed into a fully-funded individual account system, with the balances invested in capital market instruments that would yield more than bank deposits. A trial reform in this sense has been launched in several provinces. At present, all contributions are needed to pay existing pension entitlements and so the pilot programme requires transfers from government revenues to meet the transition costs. A generalisation of such trials would likely require a reduction in prospective pension outlays in order to fund these costs and so avoid fiscal deficits. This could be achieved by equalising and raising retirement ages for men and women, phasing out early retirement schemes and bringing benefits from the second part of the system into line with life expectancy at retirement. In addition, the government is committed, in principle, to using part of the proceeds from selling participations in state-owned companies to create a fund to smooth the spending of the pension system. Such a policy has considerable scope for raising funds given that state assets are equivalent to 80% of GDP. Over the longer term, consideration will need to be given to widening the coverage of the pension systems to rural areas as, with increasing migration, traditional support systems for the elderly may function less well. ■

Is there room for tax reforms?

Public finances are in good shape. The reform of public finances introduced in 1994 has permitted a strong rise in government revenues with a larger part coming from indirect taxation rather than from levies on income. The management and transparency of public finances has also been improved. These reforms have provided a strong basis for restoring public expenditure after the crisis of the first half of the 1990s that was linked to the fall in profitability of state-owned enterprises. Between 1994 and 2000, public expenditure rose by almost 7 percentage points of GDP but is still fully 13 percentage points below the OECD weighted average. Such a difference is mainly due to low payments for both social security and debt interest. Indeed, apart from these two areas, public spending absorbs a similar share of GDP as in the OECD area. More recently, rapid growth of revenues and tight control over expenditure has been used to bring the overall budget deficit down to below 1% of GDP and to keep public debt stable at around 23% of GDP.

If government revenues continue on the buoyant path of the past few years, a number of reforms could be considered with the objective of reducing distortions. One change already envisaged by the government is the equalisation of the rate of company taxation for domestically and foreign-owned companies. The basic rate of corporate income taxation, at 33%, is in the upper quartile of rates in the world. On the other hand, foreign companies are taxed at a rate (15%) that is amongst the lowest in the world. The unified rate will need to be set at a competitive level for firms in China in order to encourage domestic capital formation, suggesting a unified rate close to that currently paid by foreign companies. At the same time, dividends paid to domestic shareholders could be exempted from any further taxation, so bringing the tax rates on risk capital more into line with the tax on government bonds. The government is testing the deductibility of VAT on investment goods in a number of provinces. If this change is generalised, it will be important to ensure that there is no discrimination in the tax treatment of investment in different industries. At the same time, the base of VAT could be widened to include all services, with consequent changes made to the business tax.

Over the medium term, some changes could also be envisaged to personal income taxation. In this area, the system has been kept simple, with few deductions and a flat tax on income from capital. At present, few people have sufficiently high incomes to pay the highest marginal tax rate of 45% and the average marginal tax rate is low. But, given rapid growth in incomes, this situation could change if allowances and thresholds remain without any indexation to wages or prices, as has been the case since 1980. A strong signal of the intention of the government to continue its support for private sector entrepreneurial activity would be to reduce top marginal income tax rates, a move that would cost little in revenue but would align China with a number of other transition countries that have found that a low tax rate encourages the declaration of income and improves incentives for economic activity. At the same time, an increase in thresholds below which income tax is not paid would help preserve equity. ■

Should public expenditure be re-oriented?

There has been a marked recovery in public expenditure, particularly in the area of investment, in the past decade. Public outlays on education and health are low relative to OECD countries and moreover have tended to favour better off groups in society. On the other hand, in recent years, total government-financed capital outlays, including direct capital formation and investment financed by capital transfers, have, on a national accounts basis, amounted to over 9% of GDP and helped create, *inter alia*, a freeway system. However, there is evidence that some of this investment has been wasteful, suggesting that some re-orientation of spending may be needed. The government has started to increase health and education expenditure but a further effort will be needed, especially in the poorer parts of the country as outlays are still low relative to needs. Achieving such a result may require another overhaul of fiscal relations between different levels of government. The reform of the mid-1990s has allowed a major increase in transfers from central to sub-national government that has helped stabilise inequalities in public spending across the country. However, health and education expenditure is undertaken at the lower levels of government which have inadequate sources of tax revenue and are dependent on transfers whose importance varies considerably across the country. Greater attention needs to be paid to aligning the revenues of local government to their expenditure mandates and to designing an equity-oriented national scheme for sub-national fiscal relations. ■

Can differences in regional incomes be reduced?

Increased fiscal transfers have helped lessen some of the inequalities in economic development but need to be complemented by further liberalisation of the labour market. Since 1999, polices have been in place to boost infrastructure and education spending in the poorest, western areas of the country with the objective of providing the conditions for faster growth. Programmes are also in place to reduce taxation and illegal fees in rural areas, so boosting incomes. Such programmes could be usefully complemented by efforts to create a national, or at least provincial, labour market. At the moment, it is difficult for workers and their families to permanently change their place of residence. Even for a temporary move, many permits are required and many local services, such as education and health are either not available to migrants or only available on unfavourable terms. Moreover, if a rural person moves permanently to a city, his rural landholdings are forfeited without compensation. The government has been reducing restrictions on movement but further relaxations would tend to reduce rural-urban income differentials.

Migration will bring increased urbanisation that will need to be managed carefully. At present, Chinese cities are more equally sized than those in other economies. Considerable gains in productivity might be achieved with larger cities and recent government reports have highlighted the benefit of creating three major agglomeration hubs, as well as a number of city belts on the coast and major rivers. However, policies with regard to land ownership tend to militate for relatively extensive urban development, as cities and towns retain most of the funds from the sale of land leases, leading the central government to curb excessive development during the current upswing. Following extensive privatisation during the past decade, a residential housing market has emerged, with the owner occupation rate approaching 70% in urban areas. Nonetheless, the short length of commercial and residential leases (40 and 70 years, respectively) may constitute a barrier to effective improvement of land, as property on the land reverts to the state at the end of a lease. In 2003, new legislation gave farmers the right to a 30 year lease on their land, but this law has not yet been fully implemented. Moreover, leased land may be subject to redistribution when household size changes. Longer leases might improve incentives for rational land-use.

In sum, the very wide urban-rural income differences mean that large-scale migration will continue one way or another. On the positive side, continued urbanisation will contribute to growth, and also to reduced inequality. But managing the process is complex and requires simultaneous reform in several areas: reduction in regulated barriers to migration; land-law reforms to underpin a more efficient urbanisation process; changes in fiscal relations among levels of government (particularly within provinces) to assure an adequate funding of health and education spending for the newly urbanised population; as well as proper incentives for urban governments to allocate resources to these ends. ■

Can the quality of the environment be improved?

Increased urbanisation and economic activity has taken place in the context of an environment that is subject to a high level of pollution. Government policies have been successful in containing the level of pollution but, even so, five of the ten most polluted cities in the world are in China. Investments under the 9th and 10th five year plans have improved pollution control. Indeed, the quantity of sulphur emissions rose only 5% between 1993 and 2003, despite GDP more than doubling in the same period. The upswing in emissions in the recent business cycle suggests that it will be a significant challenge to ensure that environmental measures and energy policies are sufficiently forceful to lower pollution levels markedly. New legislation, introduced in 2003, has strengthened the use of economic instruments by markedly increasing penalties paid for the emission of air and water pollutants. As yet, though, few old power stations are fitted with anti-pollution equipment and the level of pollution, both for air and water, remains high. The key to ensuring further improvements in air quality, which currently imposes a welfare cost estimated to lie between 3% and 8% of GDP, will be the effective enforcement of laws by local environmental bureaux and ensuring that pollution emissions from major sites are carefully monitored. ■

Can development be sustained?

A marked evolution in economic polices over the past two decades has led to a long period of sustained economic expansion. National income has been doubling every 8 years and this has been reflected in the reduction of the poverty rate to much lower levels. Indeed, by some accounts, over half of the reduction in absolute poverty in the world between 1980 and 2000 occurred in China. At the other end of the scale, average incomes in major coastal areas are on a similar development path to that seen in other East Asian countries one generation ago. Considerable challenges face the economy, not the least of which is a rapid increase in the age of the population, but continued evolution of economic policies, especially in the areas of the allocation of capital, labour mobility, urbanisation and the creation of a improved framework for the development of the private sector of the economy, should ensure that this development momentum is sustained. ■

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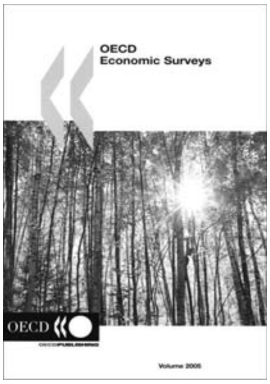

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