China. But the effect is temporary and our bilateral relations remain solid. As long as the Philippines can ensure the safety of tourists and do the necessary promotion, it is expected that this unique country with thousands of beautiful islands will be able to attract more Chinese travelers.

We strongly believe that whatever difficulties and hardships lie ahead, as long as we join our hands together and make concerted efforts, we will face the challenges, remove whatever obstacles, embrace various opportunities, achieve mutual development, and enjoy a brighter future.

China: The World's Economic Dragon

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1. Economic Aspects of China's Socialism in Simple Terms

China's socialist period from 1949 to 1978 included the following:

- Massive agrarian reform and collectivization of agricultural land.
- Agricultural surpluses being siphoned to build a strong industrial base (the Great Leap Forward period had been known to cause great famine).
- Main production structure through state-owned enterprises (SOEs) in the industrial sector.
- Use of planned system – quotas with directed destinations for important industrial goods.
- Market sector was still used for petty commodities.
- Centralized planning and distribution for vital sectors (defense, steel, equipment).
- Local planning for other commodities – e.g. agricultural products.
- Social services and housing provided by state enterprises

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and rural collectives to households (free social services – recall barefoot doctors).
- Full employment assured to all workers.

The results of the above policies were mixed. Although equity and access to essential services improved, there was no big increase in growth and productivity in the economy due to the following:
- State dictated to farmers and to SOEs the production output and quota. The economic initiatives did not come from the economic producers.
- State dictated the prices that the outputs will be sold, so this reduced the positive allocative functions of markets.
- State appropriated most of the surplus or profits of the collectives and SOEs.
- There was no competition among the producers of products.
- All the above provided no incentives for farmers and SOEs to be productive, to innovate and come up with quality products.

But the socialist stage, despite many excesses, brought about initial conditions that contributed to the success of the economic reforms undertaken by China since 1978.

These initial conditions were:
- Agrarian reform and collectivization of rural lands resulted in no resistance from a landlord class when government changed agricultural and collectivization policies.
- Local governance capacity – economic management of local areas were developed and used well during the reform period.
- A strong (although outdated) industrial base was created in the planned development of the industrial sector.
- A strong human capital base was brought about by universal primary and secondary education and free health care in the remotest areas.
- The reforms started with an initial condition of equitable

asset and income distribution, which reduced potential tensions and conflicts once economic reforms started to affect distribution adversely.

2. Economic Reforms Phase I: 1978 – early 1990s

From 1978 to the early 1990s, the Household Responsibility System was implemented in the rural and agricultural collectives. These included:
- Collective lands were "parcelized" and allotted to peasant families. These were just rights to use the land, NOT private ownership of land.
- Peasants were given a fixed quota at fixed price to allot food to urban areas.
- But they were allowed to produce surpluses beyond the quota and sell to the market at market prices and retain the profits.
- This led to large production and productivity increases in the rural areas.

In the SOE sector, a dual track system was implemented:
- Similar SOEs were still forced to have a planned quota output (inputs to SOEs or for allocation to different areas) at set prices.
- But again they were allowed to sell their surplus output in the market at higher prices at market rates.
- This gave economic incentives for SOEs to produce more and be more productive.

A private and market economy was slowly being established:
- Incentives for new forms of firms to grow – e.g. the collective township and village enterprises (TVEs) flourished in rural industries.
- Private firms slowly were allowed to grow and compete with SOEs and TVEs.
- Gradual lifting of price controls especially for non-strategic consumer products were effected.
- The state started allowing foreign firms to go into joint

ventures with SOEs in order to tap their technology and foreign markets.
- Simultaneously, there was a slowly opening up to international trade.

The above reforms resulted in a surge of production and productivity increases starting in the 1980s that became the basis of China's becoming the strongest Asian dragon.

China's economic reforms contrasted with that of Russia's reforms. Russia's shock treatment approach engineered by Western multilateral agencies led to a decade of economic collapse in Russia.

On the other hand, China's indigenous gradual reforms were more successful and brought about a surge in economic growth and productivity:
- Russia's shock treatment approach –
  - » liberalizing the markets all at once,
  - » privatizing all SOEs all at once, and
  - » led to economic chaos and economic collapse.
- China used the gradualist approach of sequentially and gradually –
  - » providing economic incentives, first to peasants, and then to SOEs allowing them to have surplus and some profit retention;
  - » slowly opening up markets and competition among producers;
  - » slowly phasing out controlled prices and allowing markets to determine prices; and
  - » slowly allowing private and foreign firms to participate in the economy.

China made sure that the institutional and societal changes were parallel with and not outpaced by rapid unsustainable economic "shock treatment."

China's gradualist and pragmatic approach led to a flourishing of a mixed economy:

- State plans and markets operating at same time.
- State still controlled financial system with state-owned banks and credit much under government control – this is a strong handle for macro stability as it provides flexibility to encourage or to tame the expansion of economy.
- Firms co-existed with different types of ownerships
  - » SOEs – state-owned
  - » township and village enterprises – local government and community owned
  - » private firms
  - » foreign ventures

The surge in growth and productivity increases were accompanied by the following:
- Savings switched from government's hands to the private sector as incomes and profits became more private.
- Households and the private sector became high savers.
- High savings encouraged high investments from both private and state sectors because of a booming economy.
- This spurred the economy into further growth.

Some macro difficulties and political instabilities in the beginning:
- There were initial trade deficits and fiscal deficits in the early 1980s as the economy surged.
- This also led to high inflation in mid-1980s, late 1980s, and mid-1990s.
- Economic difficulties and a clear trend towards economic liberalization without political liberalization led to acts like the June 1989 Tiananmen violent protest which resulted to further political suppression and crackdown.
- This led to a struggle in communist leadership. There was the 'two-step forward, one-step backward' trend to accommodate the conservative old guards.

3. Economic Reforms Phase II: 1993 - ?: Export-led Strategy and High Investments

The reformist group of Deng Xiaoping took the upper hand and continued the economic reforms one step higher.

The government undertook the following:

- Setting up of special economic zones (SEZs) in southern and coastal China (Guangdong, Fujian, Shanghai areas) with good infrastructure and intention to upgrade and expand exports.
- A strong devaluation of the yuan in 1993-1994, contributed to the stimulation of exports which turned trade balance to surplus ever since. This, however, caused initial inflation in 1994, which abated in the second half of the 1990s.
- Allowing multinationals and foreign direct investments (FDIs) to enter the country – joint ventures into tech-related and export sectors.
- China formally joined the World Trade Organization (WTO) accepting all their rules in December 2001

China's phenomenal growth was further spurred by growing exports and continuing high investments financed by ever-growing savings.

The phase, however, brought further policy changes with complicated results:

- Reduction of state plans and quotas towards a more market economy;
- With government losing revenues from SOEs (some losing SOEs are allowed to close down), tax reforms became crucial (VAT, income, and corporate taxes);
- Initially, high fiscal deficits had to be tamed in the 2000s;
- Workers lost their permanent job security and were now allowed to lose their jobs;
- Workers lost much of their free health and social insurance (originally provided by the SOEs or rural collectives; and
- Some social tensions due to the above.

Monetary and financial institutional changes were also effected:

- The People Bank of China (PBC) had been established as the country's Central Bank in 1983 taking over monetary, interest rate, credit and exchange rate policies.
- In the second phase of reforms, it had to tame the state-run commercial banks at the national, sectoral and local levels from overlending in a booming economy.
- In fact, the lax financial supervision throughout the 1980s and most of the 1990s, brought about large non-performing loans (NPLs) in SOEs.
- Subsidized credit to the state sector was substantially reduced so that the SOEs had to secure loans at market interest rates.
- In 1999, four asset management corporations were tasked to take the bad loan assets out of the state banking system and to dispose of them in the private sector.
- The China Bank Regulatory Commission (CBRC) in 2003 took over the bank supervisory functions of the PBC.

Of all market economies, China is still one of the most regulated

» Regulation of short term external flows: capital account control

» Exchange rate was allowed to float in 2005 but under tight bands

» State sector still controls identified strategic industries: telecommunications, power, coal, oil and petrochemicals, civil aviation, shipping, automobiles, machinery, construction, iron/steel/non-ferrous metals, armaments

» Financial sector largely state-owned with credit flows state-determined

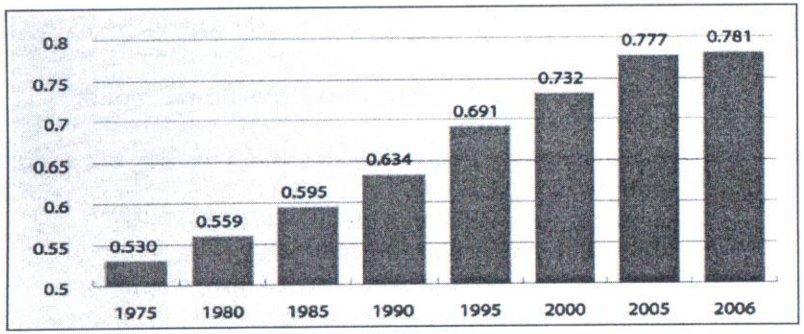
By 2010, China has become a formidable world economic power.

- Foreign exchange reserves of China is the biggest in the world. It was around $2.5 trillion in mid-2010 (June 2010), amounting to almost one-quarter of the entire world's international reserves.
- It overtook Germany in 2009 as the world's biggest exporting country in the world.
- It overtook Japan in 2010 as the world's second largest economy, second only to the United States.

4. Success in Improving Human Development and Poverty Reduction but Increasing Income and Regional Disparities

China improved its human development over the decades as shown below using the UNDP's Human Development Index (HDI).

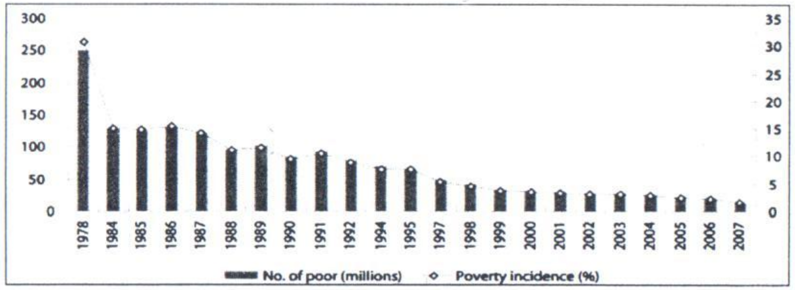
China's Human Development Index: 1975-2006



Source of Date: China's HDI's between 1975 and 2005 are quoted from "Human Development Report 2007/2008" and of 2006 is estimated on the data collected by the project team of this report. (UNDP, 2008. Human Development Report, China 2007-2008.)

It was also able to reduce poverty significantly in China, especially rural poverty as shown in the table below:

China's Incidence of Rural Poverty 1978-2007



Source: China's Statistics Digest 2008: Beijing, 2008; UNDP (2008), Human Development Report, China 2007-2008.

But the high growth in China was very uneven regionally and benefited mostly coastal regions, large urban centers and special economic zones. The western region and hinterlands of China remain depressed and poor.

The income disparities in China are worse than in other Asian countries as shown below:

Income ratio of highest 20 percent to lowest 20 percent

	Early 1980s	*Early or Mid-1990s*	*Late 1990s or Early 2000s*
China	5.6	8.6	10.6
India	5.1	5.4	4.7
Indonesia	5.2	4.7	5.2
Korea	0.0	0.0	6.8
Malaysia	0.0	11.7	7.1
Philippines	10.0	11.0	9.7
Thailand	0.0	9.4	8.3

Source: Asian Development Bank

The reduction of income and regional disparities are among the biggest challenges facing the Chinese.

The table on Human Development Index of China and Its Composition (see next page) shows how western provinces and ethnic minority areas – Tibet, Guizhou, Yunnan, Sichuan, Xinjiang – are far behind in development compared to the progressive areas of, say, Shanghai and Beijing.

6. China and the Global Financial Crisis

China's export sector was hard-hit with millions of workers laid off during the global financial crisis in 2008 and 2009. The Chinese government announced a RMB4 trillion (US$586 billion) stimulus package with the global meltdown.

- The Chinese economy growth rate fell from 11 percent in 2007 and 9 percent in 2008...
  - ...to 6.1 percent in first quarter of 2009.
  - This went up to 7.9 percent in second quarter of 2009.
  - Fiscal stimulus working.
  - Official GDP growth rate for 2009 is around 8.7 percent
  - Official GDP growth rate for 2010 is around 10 percent.
  - But main problem is most of the growth is due to government investment.
  - Consumers still big savers.

- The government is trying to increase consumption by
  - "Going West" – developing infrastructure of depressed areas in western provinces
  - giving much social safety nets – health care, social welfare
  - rebates and subsidies for rural families to buy electrical appliances and automobiles
  - institutionalizing social protection as a major mechanism to get consumption permanently up

2006 China's Human Development Index HDI by Province

Ranking		Life expectancy index	Education index	GDP index	HDI
	China	0.792	0.826	0.724	0.781
1	Shanghai	0.886	0.929	0.937	0.917
2	Beijing	0.852	0.924	0.915	0.897
3	Tianjin	0.832	0.929	0.881	0.881
4	Zhejiang	0.828	0.855	0.838	0.84
5	Jiangsu	0.815	0.853	0.821	0.83
6	Guangdong	0.805	0.861	0.819	0.828
7	Liaoning	0.806	0.884	0.775	0.822
8	Shandong	0.815	0.84	0.789	0.815
9	Hebei	0.792	0.867	0.733	0.797
10	Heilongjiang	0.79	0.873	0.725	0.796
11	Jilin	0.802	0.863	0.72	0.795
12	Fujian	0.793	0.821	0.772	0.795
13	Shanxi	0.778	0.866	0.702	0.782
14	Inner Mongolia	0.748	0.829	0.761	0.779
15	Henna	0.776	0.834	0.693	0.768
16	Hubei	0.768	0.84	0.692	0.767
17	Hainan	0.799	0.818	0.684	0.767
18	Chongqing	0.779	0.832	0.681	0.764
19	Hunan	0.761	0.849	0.675	0.762
20	Shaanxi	0.751	0.84	0.677	0.756
21	Guangxi	0.772	0.842	0.65	0.755
22	Xinjiang	0.707	0.836	0.712	0.752
23	Jiangxi	0.733	0.841	0.658	0.744
24	Sichuan	0.77	0.803	0.654	0.742
25	Anhui	0.781	0.783	0.646	0.737
26	Ningxia	0.753	0.785	0.673	0.737
27	Qinghai	0.684	0.751	0.672	0.702
28	Gansu	0.708	0.731	0.623	0.687
29	Yunnan	0.675	0.756	0.627	0.686
30	Guizhou	0.683	0.74	0.554	0.659
31	Tibet	0.656	0.554	0.652	0.621

Note: All the HDIs are estimated by CIRD's project team.

Source: UNDP (2008), Human Development Report: China 2007/08

As China stimulates the economy and returns to high growth, there emerges a danger of a property bubble. Much of private investments in property caused high property prices in major cities. Some problems and responses of China are:

- Problem to potential property bubble is being tackled by
  - » restricting credit to property
  - » local governments should stop selling public land and public properties and rely more on government bonds for revenues
- China is restricting credit growth and increased bank's reserve requirements.
- Another problem is growing local government debt due to the pump priming of the economy – may lead to problems with the state banks.
- Inflation has exceeded the targeted 3 percent in 2010 and is now 4.9 percent. Government is increasing interest rates and reserve requirements.
- China is also very concerned about the strong weakening of the U.S. dollar since it puts a lot of its international reserves in U.S. dollar and treasury notes. U.S. dollar lost 40 percent of its value from 2002 to 2009 and is losing more in 2010.
- China is diversifying to euro and yen. Also pushing for using IMF special drawing rights (SDRs) as substitute international currency as it gives more of its development assistance fund to the IMF.

7. China Continues to be the Fastest Growing Global Economic Power

China's global economic power most likely will grow after this current global recovery since it seems to be leading the global recovery and may make Asia the region leading the recovery.

Furthermore, China is propping up the U.S. deficits and the U.S. dollar by putting much of its foreign exchange reserves in U.S. securities. If it parks the reserves elsewhere,

U.S. dollar and economy – and the global economy – will get to more trouble. This is power beyond doubt.

China has the world's biggest foreign exchange reserves and will be a big funder of the International Monetary Fund and a big donor and lender to developing countries. It is now the biggest donor in official development assistance to Africa.

It is now the top exporter of the world and the second largest economy of the world (and one of the fastest growing one). In a few decades, it will surpass the U.S. as the biggest economy of the world.