Structural reform lies in the heart of the debate on China’s economic future. The Middle Kingdom’s rapid economic growth since economic reform started in 1978 has created admiration, fears and envy about its development. Many people even think that a rising Chinese economic power might eclipse the US within a decade or so, if its current growth rate persists. Whether one takes a benign or cynical view on China, the most crucial factor that decides its future growth is economic reform. Here, mixed signals have confused many observers. Some see a total lack of reform incentive, and argue for an eventual collapse of the Chinese system under the increasing weight of economic imbalances. Others, while sanguine, are puzzled by China’s snail-pace reform despite a strong push from the central authorities.

There are indeed significant changes taking place in the system. But many of these changes have often been overlooked because they are subtle changes at the margin of the system and hence are not yet obvious in mainstream thinking. One of the problems in analysing China is to judge its reform by quantity. It is more crucial to assess the progress of reform, or the lack of it, by the momentum that it generates. Evidence suggests that its forward momentum is strong. Beijing is experimenting with dismantling the classical communist policy icons, such as public asset ownership, population control and financial repression.

The need for reform

Economic reform serves to raise output efficiency so that the available resources can be better and fully utilized to sustain and raise long-term growth potential. This can be seen in a simple Production Possibility Curve (PPC) framework (Figure 1.1). The PPC shows the tradeoffs an
economy faces when it chooses its output combination of any two goods. We use consumption and capital goods in our generalized example here. In other words, each point on the PPC represents some maximum output combination of any two goods, given all the resources available.

The PPC is concave in shape due to rising opportunity costs. In our framework, as more and more output is shifted towards the capital good, the production shift cuts deeper into the stock of resources used for the consumption good. In all likelihood there will not be resources to move that are as good at making the capital good and as poor at making the consumption good as the previous output shift. Hence, to get the same increase in the output of the capital good, more units of the consumption good must be forgone. This result is symmetric. Shifts going the other way towards more consumption good raise the opportunity cost of capital good with each shift.

Economic inefficiency suggests that China’s economy is operating inside the PPC, for example point U in Figure 1.1, with massive unemployed and/or underemployed resources. Implemented properly, economic reform can purge the structural flaws in the economy and move employment towards the PPC by better allocating resources and raising output efficiency. For example, any output bundle within triangle UBC in Figure 1.1 is superior to bundle U. In the longer term, economic reform enables technological progress, thus expanding resources supplies and rejuvenating productivity growth. This will, in turn, push the PPC outwards, allowing the economy to enjoy larger output bundles.

Indeed, structural changes have shown their impact on the Chinese economy by reducing the amount of economic inefficiencies. Various studies have found that China’s total factor productivity (TFP) grew by

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**Figure 1.1** Production possibility curve