**China: The role of rural-urban migration in economic development under capitalism***

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The transition to a market economy in China began in 1978 shortly after Mao's death in 1976, the imprisonment of the Gang of Four, and the rise of Deng Xiaoping. The Chinese command economy had been even more inefficient than in the Soviet Union, with mass starvation and death brought on by periodic lunacies such as the "Great Leap Forward", aka the Great Leap Backward (1958-61), and the tumultuous Cultural Revolution that began in 1966 and finally ended only with Mao's death.

Deng Xiaoping set about improving China's relations with the West (while remaining cool toward the Soviet Union) and gradually opening China to the outside world. From 1986, the formal adoption of the "open-door policy" greatly accelerated trade and the related inflow of direct foreign investment[1] and technology that Deng knew was essential for the more rapid development of China as an industrial nation. Also, peasants were offered material incentives under de-collectivisation and the Household Responsibility System by allowing them to earn extra income (over and above their share of collective produce) through sale of the produce of their private plots at market prices. The collectives, too, could sell surplus farm products on the open market. This liberalisation spurred a significant acceleration of the rate of growth of agricultural output available in exchange for industrial products. This represented and yielded a symbiotic market-led relationship between an agricultural and an industrial revolution.

Managers of state-owned enterprises (SOEs) were also given greater autonomy and incentives through various performance contracts, some more in tune with value added (rather than output regardless of inputs) than others (see Shirley and Xu, 1997). These performance contracts worked best, however, for SOEs that were more exposed to competition. Many were highly privileged giant monopolies, and their record on productivity has been poor.

Political power remained with the central Communist Party bureaucracy that proclaimed that it was, in Deng's words, "building Socialism with Chinese characteristics", otherwise known as "market socialism". Deng declared that socialism means eliminating poverty, but it seems that it has been the market rather than the socialism that has worked most of

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[1] However, the capital account was not opened up more generally to portfolio flows. This helped insulate China from the worst fallout from the Asian crisis of 1997-99, though growth did suffer a small dip during this period. Due to her huge stock of dollar assets (official reserves currently stand at US$1.3 trillions) China may in some ways be less well placed to weather the financial stresses that currently afflict the United States.

the magic, if by socialism we mean micro-management of the economy with regulation and controls, and non-democratic, poorly accountable state ownership of enterprise.

As is well known, China's overall economic performance since it opened up has been breathtaking, surpassing even that of the four original "miracle" Asian Tigers. The World Bank (1994, tables 1 and 25) estimated 9.0 percent average annual growth of GDP (or 7.6 percent per capita) from 1980-1992, and this rate accelerated slightly, to 10.0 percent per annum (or 9.0 percent per capita) from 1993-2006 (University of Beijing Statistical forum. *www.zujee.com* 2006). This means that in the post-reform era material living standards in China increased on average, albeit from a desperately low level, about 11-fold. It should, however, be emphasised that this is an average. The distribution of the gains has been very uneven.

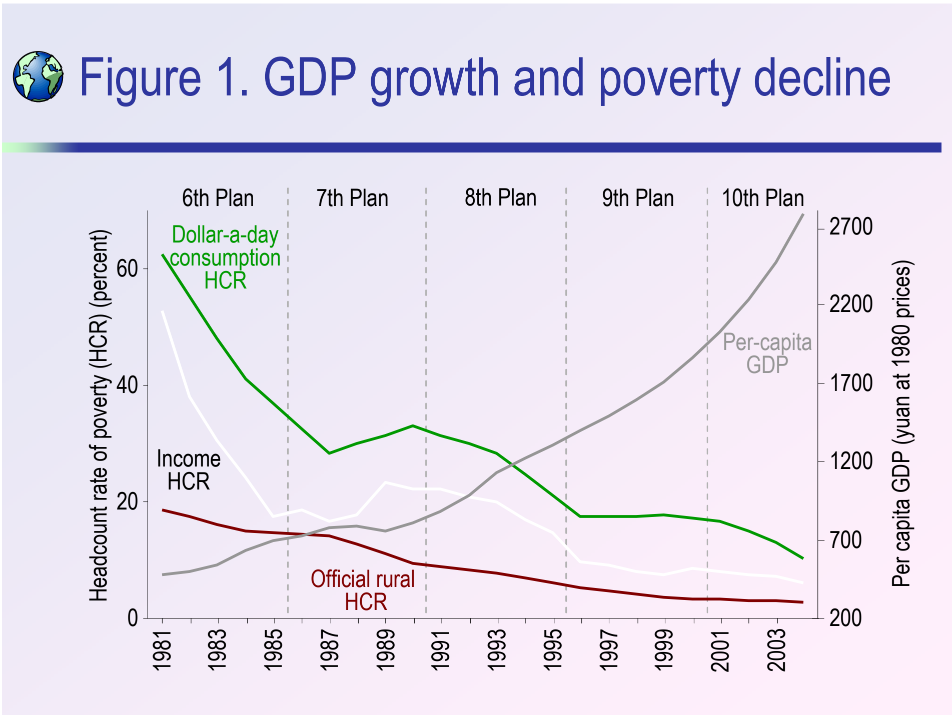
It is a moot point whether a better distribution of income is more important than a more rapid reduction of absolute poverty. Ideally, the maximum rate of sustainable economic growth should be accompanied by a levelling up of low incomes toward the average. But when a country starts from an extremely low average, as China did from 1980,[2] it is almost inevitable that for some time a minority will enjoy significantly greater gains from growth than the rest, and the distribution of income will worsen. The question is by how much and for how long a worsening can continue without engendering intolerable strains and resentments that threaten social stability and a reversal of economic gains.

David Dollar, the World Bank's country director for China, has recently (1997) addressed these concerns. Adopting US$1 a day at purchasing power parity[3] as the conventional World Bank criterion of "absolute poverty", Dollar shows that 25 years of strong growth has fueled a remarkable decline in absolute poverty from 64 percent at the beginning of the reform period to 10 percent in 2004. This means that more than half a billion people climbed out of absolute poverty, with around 640 millions in 1981 and around 130 millions today. This is shown in Figure 1, from Dollar (2007) who updated a study by Ravallion and Chen (2004). The latter study suggested that, though the data could be suspect, as much as half of the decline in absolute poverty may have occurred in the early years of reform when poverty-stricken peasants were allowed to farm their own private plots and sell the produce at market prices. Revallion and Chen also showed that the proportion of households with income less than US$2.15 a day fell from 88.1 percent

[2] However, while China had a reported per capita income in 1980 very similar to that of India – at around US$300 – her "human development" indices on education and health were significantly better than those of India, and later adjustments based on "purchasing power parity" raised China's average per capita income by much more than India's. China's superior human capital (and her superior literacy rates had long historic roots stretching long before the Communist takeover in 1949) helped enable her to exploit more fully the opportunities that market reform opened up. The economic success of Taiwan and Hong Kong, post-1949, was, or should have been, a permanent embarrassment for Mao's regime.

[3] This takes account of the relatively very high internal purchasing power of the renmimbi at the official exchange rate. A dollar will buy 4 pints of beer in Beijing! The hourly wage for ordinary labour in Beijing is about 25 US cents, or 2 RMB. A 60-hour working week is common, and work on many construction sites continues 24-7. (Also notable is that some university classrooms are in use for as much as 14 hours a day, 7 days a week.)

(876 million persons) in 1981 to 46.7 percent (594 million persons) in 2001. Great progress but still a long way to go.




The problem is that while great progress has been made in reducing absolute poverty, disparities have grown apace, and to a potentially dangerous degree. The overall Gini coefficient of inequality in household consumption increased from a low 0.31 (an equality of poverty) at the beginning of reform to a high 0.45 in 2004 (Dollar, 2007, p.8). Inequality in important social outcomes such as health status and educational attainment also increased markedly. Why is this and what can be done to improve distribution without slowing the rate at which absolute poverty is eliminated?

The main clue comes from data on the gap between rural and urban incomes. For a country with China's average per capita income, the proportion of the population living and working in rural areas is abnormally high – much higher than countries at comparable levels of development. Sicular et al (2007, p.106) report that in1990 the urban population was only 26.4 percent of the total, and that even by 2002 this had risen to 39.0 percent (and 40 percent by 2005: World Bank, 2007, Table 3.10).[4]

The relatively low degree of urbanisation in China is reflected in one of the largest gaps between rural and urban per capita incomes in the world. Choi (2000) estimated that the

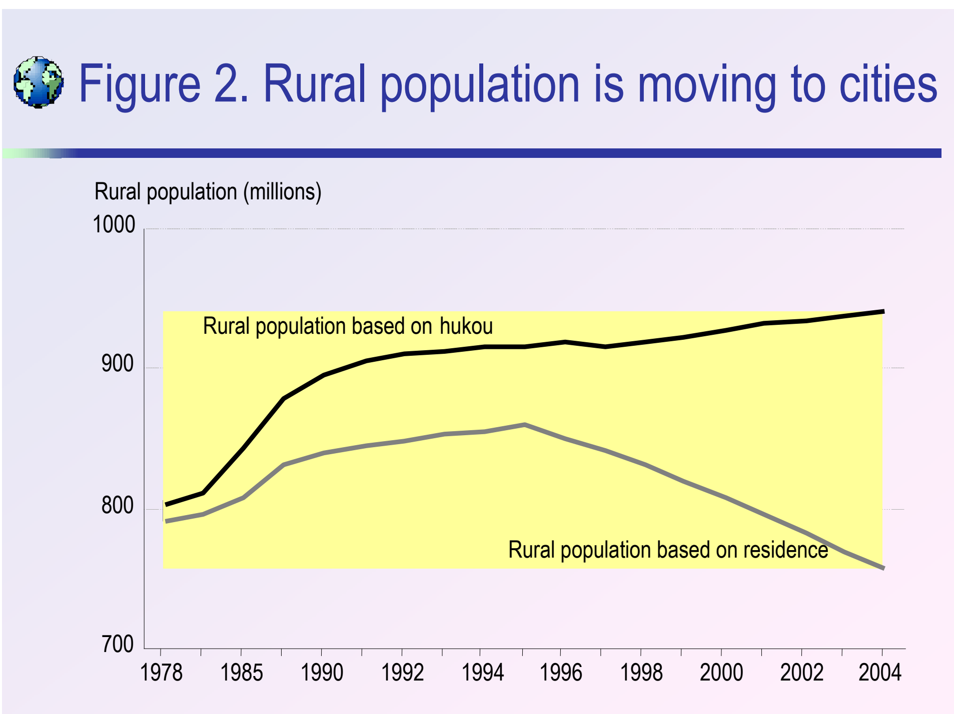
[4] These urban percentages may be compared with the following countries whose average per capita income in PPP terms was significantly lower than China's in 2005: Indonesia (48%), Egypt (43%), Nigeria (48%), Peru (73%) (World Bank, 2007).

gap widened strongly, with few interruptions, from a ratio of 2.1 in 1982 to 2.7 in 1995. According to data collected by Sicular et al (2007, p.113), the ratio was even higher: 3.11 for 1995 rising to 3.18 for 2002. They note that the ratio is somewhat lower if adjustments are made for spatial differences in the cost of living, though this is offset by the fact that adjustments ought also to be made for subsidised public services such as education, health and housing are more available to urban than rural residents.

***Hukou* restrictions on rural-urban migration**

Comparisons are also complicated because most estimates of the income gap are based on data that exclude unregistered migrants resident in urban areas. The Maoist pre-reform regime had a so-called *hukou* system that greatly restricted people's geographic (hence occupational) mobility (see, for example, Wang and Zuo, 1999). Each person has a registration (*hukou*) in either a rural or an urban area, and this cannot be changed without the permission of the receiving jurisdiction. Dollar (2007, p.10) explains:

> In practice cities usually give registration to skilled people who have offers of employment, but have generally been unwilling to provide registration to migrants from the countryside, Nevertheless, the migrants are needed for economic development, and large numbers have in fact migrated. Many of these fall into the category of "floating population". There are nearly 200 million rural residents who spend at least six months of the year working in urban areas (Figure 2).




From this we can see that about 940 million persons, or 72 percent of the total population of China (about 1,300 millions in 2004), were registered in rural areas, but only about 760 millions (58 percent) were mainly resident there. Figure 2 (from Dollar 2007) indicates the growing relaxation of the *hukou* system, but it remains a significant constraint on migration. Urban workers without the urban *hukou* are still denied access to schools for their children, and to subsidised housing and healthcare.

If we include the unregistered migrants resident in urban areas (some 160 millions in 2004) this would somewhat narrow the urban-rural income gap. Sicular et al (2007, p. 123) note, however, that if we allow for this there would only be a modest influence on the overall level of inequality in China because the lower between-group inequality is offset by higher within-group inequality. Migration increases inequality within urban areas by restraining the growth of the unskilled urban wage while established urban workers, with greater education, experience and skills – and an artificial degree of scarcity – enjoy more rapidly rising wages. Ronald McKinnon (2006) has a chart (Figure 3 below) that shows the nominal growth of wages in Chinese manufacturing, 1994-2004. Deflated by the rate of inflation (68 percent over this period), we may deduce that the real wage rate rose by 78 percent during the same period as real GDP grew by 214 percent (or by about 190 percent in per capita terms. Thus it is clear that while Chinese wages grew rapidly, they did not grow as fast as output, which means that they were not growing by enough to help the distribution of urban income.

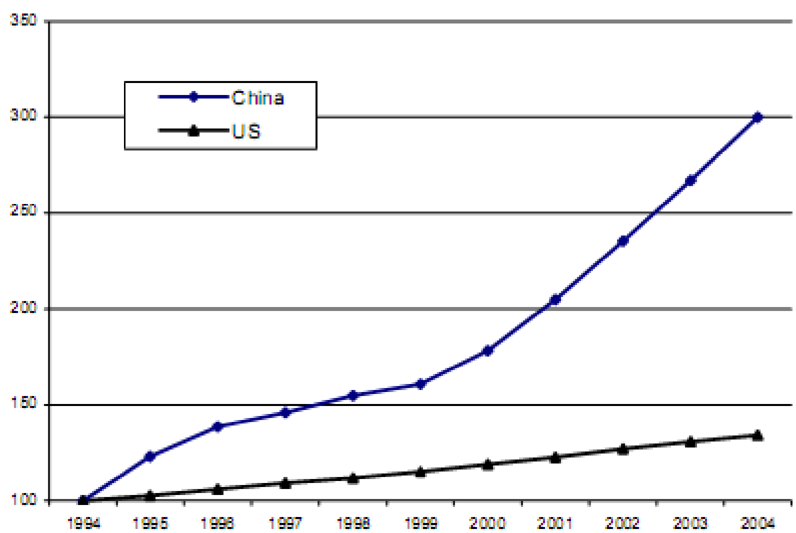



**Figure 3: Nominal Manufacturing Wage Growth for US and China 1994-200. Source: McKinnon (2006)**

Dollar (2007, p. 11) argues, in defence of the *hukou* system, that "it should be noted that China's urbanization so far has been a relatively orderly process. One does not see in China the kinds of slums and extreme poverty that exist throughout Asia, Latin America and Africa." This is true; but to the extent that it limits the opportunities of the relatively poor rural population to move to better-paid employment, it contributes to the persistence of as many as 130 millions – hidden from urban eyes – still living in extreme poverty in rural areas. (Rural incomes, incidentally, are enhanced significantly by remittances from migrant family members.)

The fact is that only about 15 percent of China's GDP originates from agriculture (see table 1),[5] whereas about 60 percent of the population live in rural areas. Both of these percentages are bound to fall in the future toward the levels in developed countries (such as the USA, shown in the table with only 1.4% of its GDP from agriculture, and where only 2 percent of its workers are engaged in this sector), as the Green Revolution, still in its relative infancy in China, spreads throughout the land.

**Origins of GDP (%)**

Surce: Pocket World in Figures, 2005 ed. The Economist

| | USA | China | Hong Kong | Singapore |
|---|---|---|---|---|
| Agriculture | 1.4 | 15.4 | 0.1 | 0.1 |
| Industry of which | 20.3 | 51.1 | 12.8 | 35.7 |
| Manufacturing | 14.1 | 35.4 | 4.7 | 28.1 |
| Services | 78.3 | 33.5 | 87.1 | 64.2 |
| GDP per head | US$35,990 | US$980 | US$23,080 | US$20,710 |

**Table 1**

Fortunately, there is a substantial amount of income that rural residents can and do earn from non-farm activities, and China is well known for its "factories in the fields". In general, however, these rural enterprises do not enjoy the pervasive agglomeration economies that urban enterprises enjoy, and they do relatively little to bridge the glaring disparity between the percentage of GDP that is generated in rural areas and the percentage of the labour force employed (or unemployed, or underemployed) there. This disparity is, of course, the flip side of the urban-rural income gap. An efficient free market system is not only one where goods and services move freely from producer to consumer under competitive conditions. Fluid factor mobility is just as important, both for efficiency and for greater equality.

## Land and labour in country and city

The factors of production are land, labour and capital. Land cannot move, though it can be put to ever-changing use, including from rural to urban use. Perhaps the greatest source of social unrest in China relates to the ways that peasants have been prevented

[5] The data in Table 2 below suggest that the share of agriculture in China's GDP fell below 15 percent around 2000, and that by 2006 its share had fallen to less than 12 percent.

from selling their private plots (held on long-term leases from the state), or have been dispossessed by large corporations and developers acting in league with corrupt local officials. As China's cities expand, farmland once almost worthless is now in high demand for power plants, factories, or luxury housing.

BBC correspondent Dan Griffiths reported (2 August 2005):

> Some estimates suggest that more than three million people were involved in demonstrations last year, and the government in Beijing is getting increasingly concerned… The Communist Party's complete control over land allocation has led to corruption on an enormous scale. Power rests in the hands of party cadres, and corrupt officials can often act with impunity. They sometimes take over land to sell directly to developers, pocketing the profits. They also take bribes or cream off much of the compensation paid to those who are moved out of their homes. This abuse of authority in the pursuit of wealth is one of the dark sides of China's economic miracle.[6]

As the population of China's cities grows apace, space does not. As demand for urban land increases, with supply fixed, the price trends strongly upwards. This implies large transfers of wealth from tenants to owners.[7] This also encourages speculative land acquisition, which fuels unsustainable booms. Both real estate and stock markets have been booming in 2007, and it remains to be seen whether China will suffer the same fate as Japan in 1990-91, when both of these markets crashed violently, putting an end for more than a decade to Japan's capitalist economic "miracle". The storm clouds currently looming over the world economy, with origins in the US sub-prime mortgage market, may pose a particular threat to China, given her ever-closer economic ties to the US.

Housing finance is central to China's rapid structural transformation toward an urban-industrial nation. To understand why the growth of cities, hence buoyant urban housing finance, is essential for the continuance of rapid overall economic growth, one has to examine the different income elasticities of demand for urban versus rural goods and services. With no particular change in the terms of trade (relative prices) between sectors, one can see, from Table 2, that between 1993-2006 the growth of supply and demand for mainly urban-based manufactured goods and services greatly outpaced the growth of supply and demand for agricultural produce.

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[6] Similar examples of corruption came to light recently in Shanxi province where owners of brick kilns had been kidnapping children and holding them as slave labourers, with the connivance of bribable local government officials. The other dark side of China's development is official complacency over environmental degradation and pollution, with the coal-rich Shanxi province again one of the worst offenders, responsible for 90 percent of China's sulphur dioxide emissions. The issue has been highlighted by Elizabeth Economy in *The River Runs Black* (2004). Meanwhile, in traffic-congested cities the number of cars is doubling every six or seven years (Beijing now has more than 3 million). Levels of airborne particulates are now six times higher in Beijing than in New York.

[7] All land in China is owned by the state, but transferable urban land-use rights are sold to individuals for periods between 40 and 70 years. As for rural land, this is "collectively" owned, but farmers are given 30-year leases, often, however, without supporting documents. (See *The Economist*, March 10, 2007 for a discussion of the controversial new "Real Rights Law" on private property.)

| Year | GDP in billions of RMB | | | | Percentage Growth (real) yr-on-yr | | | |
|---|---|---|---|---|---|---|---|---|
| | GDP | Agriculture | Manufact | Service | GDP | Agricultur | Manufact | Service |
| 1993 | 3533 | 688.7 | 1645.5 | 1199.2 | 14 | 4.7 | 19.9 | 12.1 |
| 1994 | 4820 | 947.1 | 2244.6 | 1628.1 | 13.1 | 4 | 18.4 | 11 |
| 1995 | 6079 | 1202 | 2868 | 2009.4 | 10.9 | 5 | 13.9 | 9.8 |
| 1996 | 7118 | 1388.6 | 3383.5 | 2345.6 | 10 | 5.1 | 12.1 | 9.4 |
| 1997 | 7897 | 1426.5 | 3754.3 | 2716.5 | 9.3 | 3.5 | 10.5 | 10.7 |
| 1998 | 8440 | 1461.8 | 3900.4 | 3078 | 7.8 | 3.5 | 8.9 | 8.3 |
| 1999 | 8968 | 1454.8 | 4103.4 | 3409.5 | 7.6 | 2.8 | 8.1 | 9.3 |
| 2000 | 9922 | 1471.6 | 4555.6 | 3894.3 | 8.4 | 2.4 | 9.4 | 9.7 |
| 2001 | 10966 | 1551.6 | 4951.2 | 4462.7 | 8.3 | 2.8 | 8.4 | 10.2 |
| 2002 | 12033 | 1623.9 | 5389.7 | 5019.7 | 9.1 | 2.9 | 9.8 | 10.4 |
| 2003 | 13582 | 1706.9 | 6243.6 | 5631.8 | 10 | 2.5 | 12.7 | 9.5 |
| 2004 | 15988 | 2095.6 | 7390.4 | 6501.8 | 10.1 | 6.3 | 11.1 | 10 |
| 2005 | 18309 | 2307 | 8704.7 | 7296.8 | 10.2 | 5.2 | 11.7 | 10 |
| 2006 | 21087 | 2477.4 | 11429 | 8177.7 | 11.1 | 5 | 13 | 11 |

Table 2: *Source:* University of Beijing Statistical forum: *www.zujee.com*, 2006. (Thanks to Ran Zhang (2007) for compiling this table.)

From this table we can calculate that during 1993-2006 real GDP grew by an average of 9.99 percent per year, agriculture by only 4.0 percent, manufacturing by 11.2 percent, and services by 7.4 percent. These differential trends in demand and supply are bound to continue. Thus rural workers will experience ever more powerful push (displacement by modern methods in agriculture) and pull (higher urban incomes) influences on them to migrate to escape rural poverty. An essential role in boosting this mobility of labour must be played by the housing finance system.

**Labour mobility and housing finance**

The system must be both dynamic and sustainable, avoiding the mistakes of Japan in the late 1980s and in the USA and elsewhere today. In China about 68 percent of all mortgages are provided by the four large state-owned banks, a further 19 percent by other banks. The rest (about 13 percent) is mainly provided by housing provident funds (HPFs), mostly available only for employees of state-owned enterprises.[8] From a low base of about 3.4 percent of GDP in 2000, the value of the stock of outstanding mortgage loans in China nearly tripled to 10 percent in 2005. This is a remarkable pace of expansion but the level is still below other developing countries such as Malaysia (24%), Chile and

[8] Information on housing finance is from Loïc Chiquier (2006) who relied partly on a provisional September 2006 document drawn up by the Financial and Private Sector Development Department, East Asia and Pacific Region, the World Bank that David Dollar kindly made available to me, and that I have also drawn upon here.

Thailand (16%), and much below developed countries such as the US (65%) and the EU (45%). It is also still a relatively small proportion of overall bank balance sheets (about 9 percent in 2005). In Singapore, where 90 percent of households became owner-occupiers within 25 years of her becoming an independent Republic in 1965, much greater reliance was had on their Central Providend Fund (CPF) to finance mortgages. There the compulsory CPF pension contributions peaked at 50 percent of all gross wages and salaries by the mid-1980s, and the government permits most of these to be withdrawn for use as down-payments and monthly servicing charges. As a result residential construction became a dynamic 'leading sector', along with exports, in the Republic's phenomenal, sustained economic growth over four decades.[9]

Thus in China there is still plenty of scope for continuing rapid expansion of lending for residential construction by banks and HPFs.[10] Prudent regulation is essential, however. In 2006, alarmed at the rise in the ratio of house prices to average incomes, along with rising loan-to-value (LTV) ratios, the government reduced the maximum LTV from 80% to 70% as a way to preserve the quality of the increasing portfolio and hence the soundness of the banking system. Mortgage terms are mainly for 10-15 years, and only for new housing. This limits the potential demand, and these limits or restrictions could easily be relaxed as and when the availability of non-inflationary savings for the system is increased. Liquid bank deposits have not carried a very attractive real rate of interest for savers, and very recently the government has reduced the rate of tax on interest income to try to encourage saving while at the same time trying to restrain the inflationary growth of the money supply. To supplement retail deposits and, it is believed, as a way to spread risk, the government has also been experimenting with two pilot mortgage securitisation schemes. Again, the world is learning that close monitoring of such innovations is essential if securitisation is to reduce rather add to the risks associated with borrowing short to lend long – an essential feature of housing finance.

**The foreign sector**

Though fancy financial derivatives are relatively rare inside China, the Chinese government is itself heavily involved in foreign money markets, with more than US$1.3 trillion in official foreign reserves.[11] This reflects another dangerous interventionist practice on the part of the Chinese government, namely the maintenance, over a long period, of a highly undervalued exchange rate for the renmimbi against the US dollar. This has artificially cheapened Chinese exports in foreign markets so that despite heavy inward direct foreign investment (which normally generates a balance of trade deficit as

[9] Singapore's Housing Development Board and Urban Development Authority have played a significant role in recent years as advisers on urbanization in China, notably with respect to the development of the new city of Suzhou, near Shanghai. On the role of the CPF in Singapore's massive housing programmes, see Sandilands (1992).

[10] China's HPFs are partly modeled on the Singaporean system, but the coverage is far less, and there are more than 300 different HPFs throughout the country, operated by large SOEs or local authorities. Their portfolios are therefore highly concentrated locally, hence subject to greater risk of local economic downturns. This risk would be reduced if they were to be consolidated into a few larger regional funds.

[11] *The Financial Times*, August 24, 2007, reported that the state-owned Bank of China had revealed it held nearly US$10 billion in securities backed by US sub-prime mortgages.

foreign firms first import raw materials and components parts before exporting the value added) there has been a prolonged period with large balance of trade surpluses. The allocation of resources has therefore been heavily and artificially skewed toward exports. China has become very heavily dependent on international trade to keep its economy on the move. With a smaller economy than that of the US, its export-to-GDP ratio stands at 36.8%[12], compared with only about 12% for the US (and a mere 4% for China at the beginning of the reform period in the early 1980s). Exports to the US account for 8.6% of GDP, with a similar amount going to the EU, so China is critically dependent on the continuance of buoyant growth in those economies, which cannot be relied upon. This is how Jim Walker (once a student of mine, now chief economist at CLSA) summarised the dangers earlier this month:

- Its domestic supply is desperately out of sync with domestic demand because China has built an industrial structure that is crucially dependent on global demand growing above trend. The current account surplus is now a whopping 12.1% (forecast) and 12.4% for next year. Real retail sales are trending down which is why the external surplus is trending up.
- Exports grew by 28% in first 7 months of 2007, with a surge of 37% to Europe (whose share of Chinese exports is now 20%, slightly above the share going to the US). Unlikely to be sustainable as US and European growth falters. Japan's share has dropped to 8.5%. Credit squeezes in US and Europe will be bad news for the 40% of Chinese exports going there.

In November 2001 China finally was allowed to join the World Trade organisation after agreeing to reduce its own trade barriers. Her average tariff was reduced from about 40% to 10%. But she has had a current account surplus in all but 7 years since 1980, and the chronic undervaluation of her currency has more than offset the liberalisation of trade during this period. A strong case could be made for invoking the Bretton Woods "scarce currency clause" against China in these circumstances, though the US can also be blamed for running persistent and large fiscal deficits that she has allowed to be financed to a substantial degree by selling Treasury bills to the Chinese. The US threat to discriminate against Chinese imports constantly runs against the fear that China might retaliate by selling her huge stock of Treasuries, though at the same time the Chinese must fear that such a move would so depreciate the dollar as to devalue their foreign reserves. Nonetheless, an accelerated appreciation of the renmimbi would reduce import costs for Chinese consumers and so boost their wealth, permitting a desirable increase in domestic purchasing power – including toward housing – that would reorient production in those directions.

**A concluding personal note**

I was invited as a Visiting Professor to Renmin (the People's) University in Beijing this summer to lecture to their students on the classical theory of economic growth as pioneered by Adam Smith, Allyn Young (1856-1929), and Xiaokai Yang (1949-2004). These three were great advocates of the essential role of natural liberty in the growth process, with stress on competition, mobility, and free domestic and international trade.

[12] Credit Lyonnais Securities (Asia) (CLSA), Triple-A bulletin, September 5, 2007.

Their key common aphorism was that “specialisation or the division of labour is limited by the size of the market”. Thus competition and openness were the key policy implications. Xiaokai Yang was arrested during the Cultural Revolution, at the age of 18, for daring to write a pamphlet criticising Maoism and spent 10 years in gaol. He used his time there wisely and on his release in 1977 was able to sail through a degree in economics that earned him a scholarship to Princeton. He subsequently developed the implications of Allyn Young’s famous presidential address to the British Association on “Increasing returns and economic progress” (Young, 1928) in many books and journal articles (e.g., Yang, 2004). These prompted Nobel Laureate James Buchanan to nominate Yang for a Nobel prize. Yang’s untimely death in 2004 prevented him from receiving the recognition he deserved. But it is pleasingly ironic and encouraging that Yang’s passionate pleas for greater economic and political freedom led his students to set up a centre to promote his ideas at Renmin (“The People’s”) University that proudly proclaims that it was the first university established by the Communists (in 1947).

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