

ACESA NEWSLETTER

Association for Chinese Economic Studies (Australia) Newsletter No. 9 (May 2006)

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ABOUT ACESA

The Association for Chinese Economic Studies (Australia) (ACESA) was founded in 1987 at the Australian National University and was incorporated in 1998 in Canberra. ACESA is a non-profit and non-partisan organisation aimed at promoting research and exchange activities related to the Chinese economy. It strives to become a leading China research network in the West Pacific region. Its current members come from Australia,

mainland China, Hong Kong, New Zealand, Singapore, Taiwan and the USA.

ACESA runs an annual conference and organises a regular policy conference series in China. The Association is run by the Executive Committee within the general policy guidelines set by the Council of Management. The Secretariat of the Association is located at the Australian National University. ACESA also maintains a website (<http://ajrcnet.anu.edu.au/acesa.htm>) and an emailing list (cesa-oz@anu.edu.au).

LETTER FROM THE PRESIDENT

Ligang Song

Welcome to the latest ACESA Newsletter.

The 17th annual meeting of the Association for Chinese Economic Studies (Australia) (ACESA), "Transition, Growth and Globalization", was organized by the School of Economics and Commerce at UWA on 7-8 July 2005. I should point out that it was the second time that UWA hosted an ACESA annual meeting (the last time was 1997). The conference was attended by over seventy people from Australia, France, Hong Kong, Japan, mainland China, the Netherlands, New Zealand, Singapore, Sweden and the United States. The conference received altogether thirty-five contributed papers which were presented in ten concurrent sessions. To encourage more PhD students to participate in the conference series, this conference was for the first time awarding the best paper and best presenter for PhD students. Prizes for students were won by two UWA students: Duc Vo for the best paper and Bernardo da Veiga for the best presenter. We would express our sincere thanks to Dr Yanrui Wu and Miss Clare Yu for all the efforts they had made in producing such a successful conference.

The 18th Annual Conference of the ACESA will be jointly organised by the Centre for Strategic Economic Studies (CSES) at Victoria University (Melbourne) and the Association for Chinese

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Economic Studies (Australia) (ACESA) on 13-14 July 2006. The conference, under the theme of "Emerging China: Internal Challenges and Global Implications", invites papers addressing a wide range of topics concerning the Chinese economy, including reforms and growth, foreign trade and agriculture, and resource sector and sustainable development. The Conference Convenor is Dr Enjiang Cheng from Victoria University. Please refer to the Association's website at (<http://www.acesa.ecel.uwa.edu.au>) or directly from the conference organiser at <http://www.cfses.com/06confchina/about.htm> for more information about the Conference.

We are happy to see that China-related research activities in Australia have been gaining momentum in recent years. We are pleased that the ACESA has played and will continue to play an important role in enhancing these activities. I would like to take this opportunity to thank everyone once again for your efforts and contributions made for the Association in the past and look forward to your continued support in the future.

Look forward to your participation in this year's conference in Melbourne in July.

ACESA NEWS

17th Annual Conference in Perth

ACESA's 17th annual conference was held in Perth on 7-8 July 2005, hosted by University of Western Australia. The main theme of the conference was "Chinese Economy: Transition, Growth and Globalization". This theme was devised to reflect the trend of globalisation in the world and China's responses. Especially, it captured the characteristics of China economic development: transition. This Conference has 70 participants from 10 countries and regions. And 35 papers were presented in the Conference. Particularly, the award of best paper and best presenter were offered to encourage PhD students' participation. Two students from UWA won the awards.

Membership Update

ACESA members receive the following major benefits:

- discount on ACESA conference/workshop registration fee (usually 20%) and further subsidy towards accommodation and travel expenses for students;
- access to the wide network of expertise for student members through the Student Academic Coordinator;

- free Newsletters and free subscription to the electronic mailing list;
- discount on subscription for the proposed ACESA journal (once launched);
- the input and assistance of other members with your research/thesis/projects/China contacts.

The membership fee is \$30 a year for regular members, \$10 a year for student members, \$150 for 5-year membership and \$500 for life membership. The application form can be downloaded from the ACESA web page or obtained by contacting the Secretary directly. For membership issues (membership fees and recruiting), please contact Sheng Yu at his address at ANU:

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Mailing List

Currently the ACESA emailing list has over one hundred subscribers. To subscribe it, send an email message to: listproc@anu.edu.au. Do not put anything on the subject line. The body of your message must have the following in the first line:

subscribe cesa-oz <your name>

or *sign cesa-oz <your name>*

To post a message, send it to: cesa-oz@anu.edu.au. If you find it difficult to subscribe it or to post messages, contact Tingsong Jiang at tingsong.jiang@anu.edu.au.

CHINA ECONOMIC RESEARCH NEWS

ANU & Rio Tinto Forge New China Partnership

One of the world's foremost centres of Asia-Pacific research, ANU, and leading resource group, Rio Tinto, form a new partnership to develop a deeper understanding of long-term developments in China.

The Rio Tinto-ANU China Partnership, will increase Australia's knowledge about developments in China and stimulate business and academic study on China in Australia.

" This is an opportunity for ANU and Rio Tinto to show leadership in Australia's understanding of the rapid economic, political and social changes

unfolding in China. These changes will shape the future of both countries," ANU Vice-Chancellor Professor Ian Chubb said.

" ANU has a worldwide reputation for scholarship on the Asia-Pacific, with a greater concentration of researchers than any other university outside the region. We are very pleased that Rio Tinto has recognised the potential to enhance research and education opportunities through this partnership."

Speaking at the launch, Mr Tom Albanese, chief executive, Rio Tinto Copper and head of Exploration said, "We are all conscious that, as business with China grows, the more we will need to understand developments in China. We are fortunate to have in Australia a resource like the Asia Pacific School of Economics and Government, whose China Economy and Business Program has established an international reputation in analysis of the Chinese economy. The Rio Tinto - ANU China Partnership is, quite simply, an investment in deeper understanding."

The Partnership will increase understanding of Chinese social and economic issues, and strengthen research and teaching on the Chinese economy. In particular, it will encourage more Australian students to study the Chinese economy.

Key components of the Partnership include:

- Establishment of the Rio Tinto Chair in Chinese Economy that will be held by an eminent scholar with an outstanding record of distinguished research and publication.
- Rio Tinto Scholarships will be offered at Master and PhD level for students to work in policy areas on the Chinese economy, resource economics and international trade.
- Rio Tinto Internships to provide work experience with the company.
- Tailored Executive Training Programs for Rio Tinto executives through the Asia Pacific School of Economics and Government.
- Research and briefings for Rio Tinto.

The Rio Tinto-ANU China Partnership will be coordinated by the China Economy and Business Program within the Asia Pacific School of Economics and Government.

The China Boom and Its Discontents?

A new book edited by Professor Ross Garnaut and Dr. Ligang Song of the Australian National University, *The China Boom and Its Discontent*, was published in 2005 by the Asia Pacific Press at the Australian National University. Most of the chapters in the book are selected from papers presented at China Update Annual Conference held in 2005, Canberra.

China is shaping the global economy as never before. An insatiable demand for commodities, energy resources and capital, and deepening integration to the world economy has won China acclaim. Yet 25 years of rapid industrial development, far-reaching economic reforms and increasing international competition have also created an array of challenging domestic policy demands.

The China Boom and its Discontents discusses the financial and social challenges that have emerged in the wake of rapid economic growth. Recent research on demographic trends, labour movements, financial development, social security, urbanisation and trade agreements highlight the unfinished progress of reforms in China.

For further details, please visit the Asia Pacific Press's website, www.asiapacificpress.com . On publication is available through http://epress.anu.edu.au/cb_citation.htm.

Joint Fiscal Management Training

In 6-31 March 2006, Asia-Pacific School of Economics and Government of Australian National University organized a short training course in fiscal management for a Chinese official team, which is held jointly with an Indonesian team and is sponsored by AusAID. The training team consists of 10 people, who come from Ministry of Finance and NDRC of China. It is the first time for APSEG to organize such a joint training course.

The training lasts four weeks, and is composed of both the intensive theoretical and policy lecturing and site visit and team discussion. During site visits, the team visited Australia's public service agencies, such as Treasury and Department of Finance and Administration etc.

ANNOUNCEMENTS

2006 Annual Conference in Melbourne

ACESA's 18th annual conference will be held in Melbourne on 13-14 July 2006. Victoria University will host the Conference. The conference will focus on 8 themes: rural china, finance and banking reforms, public finance, development strategy, trade

and investment, energy, climate change and the environment, poverty and equality, science and technology, and other topics related to Chinese economic studies. The calling for paper has been closed, and the deadline for submitting the final paper is 5 June 2006. For more detail, please refer to <http://www.cfes.com/06confchina/about.htm>, or send your comments and suggestions directly to Dr. Enjiang Cheng at Enjiang.Cheng@vu.edu.au.

2006 China Update

China Update 2006 will be held at Parliament House in Canberra on 29 August 2006. China Update is an annual event organized by China Economy and Business Program at the Australian National University.

Call for Comments

ACESA is going to update its website and calls members to give suggestions about the feature and contents of the new website. For the moment, we add the column of "Construction of ACESA", which aims to gather good ideas for further development of ACESA. Please direct your ideas and comments to Yu Sheng at yu.sheng@anu.edu.au or Tingsong Jiang at tingsong.jiang@anu.edu.au.

VIEWPOINTS

Is Growth Built on High Investment Sustainable?

Ross Garnaut and Yiping Huang

High rates of Chinese economic growth in recent years have been associated with exceptionally high and rising rates of investment. This has led to discussion of whether growth that is so dependent on investment is sustainable.

Rising levels of investment have been a feature of the Chinese economy since the 1950s. Leaving aside the large surge of investment in the late 1950s, the ratio of investment to national production had reached and has continued at levels that were high by international standards by the early 1970s.

In the era of central planning, before 1978, investment was applied wastefully, and its positive effects on economic growth offset by low or negative total factor productivity growth. The waste reached its height during the "Great Leap Forward" of the late 1950s, in which the investment share rose suddenly from around 20 per cent to over 30 per cent, and retreated as rapidly, bring national economic performance down with it. This episode is proof of the possibility of growth deriving from high and rapidly increasing investment levels being unsustainable, and is etched in the Chinese public

memory of the dangers of excessive and wrongly directed expansionary policies.

Since the commencement of reform, investment rates have remained high, and from the early 1980s resumed their upward tendency, in recent years reaching levels that are unprecedented in China and rare internationally. On three occasions since December 1978—in the enthusiasm of the beginning of reform in 1979-80, in the febrile reform atmosphere of the late 1980s, and in the aftermath of Deng Xiaoping's exhortation during his famous visit to South China to accelerate reform after the post-Tiananmen uncertainty—investment ratios briefly rose above trend and triggered retrenchment and disruptive deceleration of growth.

The success of the retrenchment policies on each of these occasions meant that none of the investment bubbles of the reform had damaging consequences on anything like the scale of the Great Leap Forward. More generally, the main difference between the investment story in the modern and Maoist periods of Communist Party rule is that in the reform era, capital resources have been allocated in ways that generate reasonably high productivity growth, so that high investment contributes to strong growth in total productivity.

The share of gross fixed capital formation in Chinese GDP has risen strongly through the reform era, from levels that were already relatively high levels by global standards. It moved up from an average of 29 per cent in the 1980s to 33 per cent in the 1990s. By 2004, it had risen to an historic high of 44 per cent.

Investment continues to rise more rapidly than total output, so that the ratio of investment to production will reach new highs in 2005. In the year to the June quarter, fixed asset investment increased 28.8 per cent in nominal terms, compared with the 9.4 per cent increase in real GDP or 14.2 per cent in nominal GDP. Fixed investment has typically contributed around one third of the increase in domestic demand. This rose to over one half in 2003 and 2004.

All categories of business ownership have experienced strong investment growth: state-owned enterprises, collectively owned firms, direct foreign investments, and other private firms. The relative importance of each category has changed over time.

Rates of investment expansion have been high in all sectors, but at the peak of the boom in 2003-04 especially in iron and steel and some other heavy industries, and more generally in construction. Monetary policy was tightened in the first half of 2004 to take some of the heat out of the boom, and especially by restricting credit expansion to state-owned firms in metals, construction and other heavy industry. This adjustment was effective. At the same

time, there has been an acceleration of investment growth in energy and transport.

In what ways might dependence on high rates of investment make rapid economic growth unsustainable? What is the validity of these arguments in favour of the unsustainability of investment-led growth?

The first argument is a matter of arithmetic. Obviously the share of investment in domestic production cannot rise without limit. Therefore if rapid growth comes with investment rising more rapidly than GDP, sooner or later this pattern must give way to one in which other sources of final demand are growing as rapidly as investment. This statement, of course, begs the question: what is the limit to the investment share of GDP? There is no obvious reason why this limit is binding now or soon. However, the current large excess of growth in investment over growth in other sources of demand suggests that early moderation of differential is likely.

The second is that diminishing returns to incremental investment mean that extremely high rates of investment are wasteful, giving poorer and poorer returns for the sacrifice of current consumption that supports them. For this to become the basis for an argument that investment-led growth is unsustainable, the focus must be on the political unsustainability of the policies and governments that support it. The argument would be that sooner or later such a pattern of growth would become unacceptable to the polity, leading to policy change or more fundamental political instability. The former Soviet Union and its satellites in Eastern Europe provide models of unsustainable growth based on excessive rates of investment.

The third way in which it is argued that investment-led growth is unsustainable, is that it leads to excess productive capacity across the economy, which must be followed by deflation, financial instability and retrenchment. This argument is common in discussion of China today.

A fourth possible way in which growth based on high investment might be unsustainable would arise if it were generating such large deficits on the external current accounts that risks were emerging about whether the international markets would continue to finance them without destabilising increases in interest rates, or in the worst case, at any interest rates. This was the situation that triggered financial crisis in several East Asian economies in 1997–98 (Garnaut and McLeod 1998). China responded to financial crisis amongst its neighbours by expanding government expenditure and stimulating investment in a successful attempt to maintain reasonably strong growth. At this time there was some concern that China might also

succumb to the doubts of international suppliers of capital.

A fifth possible way in which high rates of investment-led growth may be unsustainable is suggested by the experience of the East Asian financial crisis, by the Japanese investment boom of the late 1980s, and by the three inflationary Chinese expansions of the reform era. Growth led by high investment will not be sustained over long periods if it contains a high element of speculative activity, with investment commitments justified by expectations of continued increases in asset prices rather than by positive expectations of the present value of cash flows associated with the investment.

A sixth possible cause of unsustainability of rapid, investment-led growth is the difficulty of global economic adjustment to changes caused by the rapid growth of China, and tensions in international relations associated with those difficulties. This is important because China now bulks so large in the international economy, in a way that was not comparable in the newly industrialised economies in their periods of rapid growth, and present to much less degree in the earlier industrialisation of Japan. The more that is invested productively in the Chinese economy, and the greater the associated economic growth, the more that firms and workers in other economies will come under pressure to change their employment and modes of operation. This spurs demands increased protection of goods and services in industries in which China has comparative advantage. It generates increase in global and therefore Chinese import prices for goods and services. It exacerbates political tensions, as established powers react anxiously to the emergence of a competitor.

High levels of investment themselves are consistent with continued rapid economic growth, but that some sources of high investment could contain seeds of instability, and some of the international structural implications of investment-led growth could be destabilising.

(Ross Garnaut is a Professor of Economics at the Research School of Pacific and Asian Studies, and Chairman of the China Economy and Business Program at the Australian National University. Dr. Yiping Huang is the Chief Economist for Greater China at Citigroup. Interested readers may contact Professor Garnaut at ross.garnaut@anu.edu.au)

China's Ownership Transformation: Progress and Prospects*

Ligang Song

China's emergence as a global economic player has been accompanied by a major internal transformation described in a new World Bank/IFC

publication. * Over the past decade, the economy has made the transition from complete reliance on state-owned and collective enterprise to a mixed economy where private enterprise plays a leading role. This is an ongoing process, during which the economy will remain structurally a very diverse one. While some Chinese companies are in the vanguard of globalisation, many are struggling with old legacies of planning. Thus, in these times of optimism and dynamism, increased attention must be given to solving the problems of the state-owned sector.

A key response is *gaizhi*, a Chinese term meaning 'transforming the system', which has become a major phenomenon in most parts of the country; in many cases it has involved full privatisation. Unlike the mass privatisation programs that have occurred in Eastern Europe and the former Soviet Union since the late 1980s, *gaizhi* programs in China have been gradual and low profile. However, the significance of the Chinese reforms should not be underestimated. In many ways they have been as far-reaching as, and generally more economically productive than, those in Eastern Europe and the former Soviet Union.

Gaizhi has taken a variety of forms. The more radical forms involve the transfer of state assets to private owners. A properly managed transfer of assets from the state to private owners is a crucial part of the *gaizhi* process, with strong implications for preventing losses of state assets and maintaining social stability. An effective and transparent asset valuation system needs to be built to achieve fair and smooth transfers of state assets.

The restructuring of state-owned enterprises (SOEs) often requires a reduction of redundant workers. A large number of SOE employees have already lost their jobs as result of restructuring programs. To deal with this employment issue, the Chinese government has established a social security system consisting of pensions, medical insurance, unemployment insurance, and a social relief system, which together guarantee a minimum standard of living for urban residents. The government intends to expand the social security system further and to increase the share of the budget spent on social security.

Survey results show that *gaizhi* firms discharged more workers in the year when *gaizhi* was implemented than non-*gaizhi* firms, but they were able to afford to retain more workers in subsequent years. Therefore, it is possible that *gaizhi* and privatisation create a 'win-win' result for both employment and wages growth in the long run.

Market reforms have resulted in a significant degree of insider control, as SOE managers have gradually acquired considerable discretion over the use of state assets. Expanding managerial autonomy was a necessary complement to market reforms, as

managers needed the flexibility to respond to market signals. However, this has exacerbated agency problems by enlarging the discrepancy between managerial control and the ownership structure. The agency costs of this increased autonomy have manifested themselves in various incentives for managers to maintain or acquire private benefits of control through on-the-job consumption and other rents related to investment and business expansion. Survey results show that outside investors in controlling positions are more likely to use, and rely on, the new mechanisms of corporate control to provide effective checks and balances on managerial discretion, and to offer attractive incentives to senior managers.

The merits of *gaizhi* should ultimately be judged on how well the restructured firms perform. While improving enterprise performance was not the only goal of *gaizhi*, the experiment would have failed if efficiency does not improve. Survey results show that privatisation has brought considerable efficiency gains to the enterprise sector. It has a significant positive impact on firm profitability, although a weak or insignificant impact on unit cost and labour productivity. Outside ownership, irrespective of whether private or state, has a strong and significant impact on performance, though this impact tends to be concentrated in the early years of reform.

Although important, the efficiency aspects of the *gaizhi* process most likely will not determine the future of enterprise reform in China. Recently, fairness and distribution issues related to *gaizhi* have been attracting most public attention. The government and the general public are concerned that *gaizhi* has been accompanied by erosion of state assets, corruption, and 'inglorious' enrichment by private individuals. Ongoing public debate in China puts the main issues surrounding the future of privatisation in the country into sharp focus.

What are the implications of this debate for the future course of China's ownership transformation? The main findings from this study do not imply a halt of China's ownership reforms. But they do imply the need for regulations and stronger regulatory capacity. A notable feature of desirable regulations is that they establish stricter standards and a higher level of scrutiny when state assets are transferred to non-state entities. Specifically, regulations need to clarify the methods that can be used to reform SOEs, such as reorganisation, mergers, leasing contract operations, joint ventures, transfer of state assets, and the joint-stock and joint-stock cooperatives systems.

Regulations also need to specify the procedures to be followed, including preparation of restructuring plans, appointment of auditors and appraisers, the determining of the price valuation of state assets,

method of payment, and the need to protect the interests of creditors and employees. They must also require that the state property rights of non-listed enterprises be transferred on the property rights exchange without regard to the region, industry, investment, or affiliation of the enterprise. In addition, transfers must be made publicly and competitively by auctioning, public bidding, agreed transfer, or other means that are stipulated in state laws and regulations.

The new regulations should devote special attention to management buy-outs (MBOs). They should address conflict of interest issues by prohibiting the managers who are buying the state-owned assets of their own firms from participating in key decisions on any property transfer, such as financial auditing, the terminating audit, asset and capital verification, assets evaluation, and the setting of the base price of property.

The debates also imply the need for a competitive environment in which ownership structures evolve so that different interests provide checks and balances on each other and prevent concentration of economic and political power. A critical aspect of such a competitive environment is the ability of outside investors to inject capital and energy into enterprises. Given the limited role that private outside investors have played in the ownership reform process so far, the conclusion is that China needs more — not less — outside private ownership at this stage.

However, impediments exist on both the demand and supply side of the process. Investors have difficulty finding independent and reliable financial information about companies. Publicly available records on many aspects of a company's business are often either unavailable or unreliable. Corporate accounting is also frequently lax, especially by foreign standards. The existence of different classes of shares presents a major obstacle to the development of China's equity market as it creates conflicts between different shareholders, particularly between the holders of legal person shares and the holders of tradable shares. This complicates the corporate governance of Chinese listed companies.

While private enterprises are becoming more active in acquiring and restructuring SOEs, they still account for a small share of all *gaizhi* cases. Government policy is to expand the role of the private sector, both domestic and foreign, in the process of ownership transformation. This will require sustained efforts from both the government and the private sector to improve the business environment for private economic activities and to move China's private enterprise towards global best practice. China is making substantial progress in improving official attitudes towards the private

sector, which will significantly facilitate the process of its ownership transformation.

(Ligang Song is Senior Fellow and Director of China Economy and Business Program in Asia Pacific School of Economics and Government at The Australian National University. Interested readers may contact Dr. Song at ligang.song@anu.edu.au)

* This article appeared in APEC Newsletter, Vol. 10, No. 1, Australian National University, January 2006

* *China's Ownership Transformation: Process, Outcomes, Prospects*, co-authored by Ross Garnaut, Ligang Song, Stoyan Tenev, and Yang Yao, The International Finance Corporation and the World Bank, Washington, DC, June 2005.

Recent Developments in the Social Security System

Tim Murton

Many of the far-reaching economic and social reforms since 1978 have resulted in structural changes to the economy, particularly in the transition from a centrally-planned to a socialist-market economy.

A significant focus of China's economic reform agenda has been the reform of state-owned enterprises (SOEs). In a bid to improve efficiency, SOEs are now no longer required to provide the same level of services once expected. The change for social security provisions has been direct and significant. SOEs are no longer required to provide cradle-to-grave welfare in pensions, childcare and other social services. Consequently, since the mid to late 1990s, the Chinese government has been exploring alternative sources of social security provision.

Coupled with a rapidly ageing population that is beginning to affect the demand for social security, the government has recognised the need to strengthen the social security system. It considers social security reform to be a key component of the overall reform process. The Chinese government also believes that social security reform underpins economic growth and is necessary to social stability in the process of rapid, market-oriented growth.

Social security in China commonly refers to social insurance and social relief. Most attention in social insurance reform is paid to pensions, which is the most active area of social security reform. The major pension reforms include the introduction of the occupational pension scheme, and developments regarding the National Social Security Fund, the sale of state-owned shares and the Liaoning social security pilot program. Social relief emphasises the urban minimum livelihood guarantee scheme. Although not regarded as a core component of the

social security system, the issue of social welfare is addressed, specifically the increasingly important role of communities in providing basic social services to the local population.

Each of these reforms demonstrates the government is responding actively and realistically in the social security field and that it has already made great strides in this area. The introduction of occupational pension schemes and the Northeast Social Security Pilot Project are two key examples. These reforms have taught the government a number of critical lessons that provide guidelines to be followed throughout the country. However, significant challenges such as the funding shortfall and the sale of state-owned shares remain and continue to put pressure on the sustainability of the social security system.

Social security reform will remain one of the top domestic concerns for the Chinese government. It has recognised the importance of a holistic approach to such reform and has already begun to adopt such an approach. The social security system is likely to develop as a comprehensive system with each component interacting as one cog in a larger machine. In particular, the Urban Minimum Livelihood Guarantee scheme and social welfare are likely to play increasingly important role in the social security system, especially as means of staving off social unrest and ensuring a basic standard of living for populations residing in urban areas. Of most significance, each of the reforms has a key role to play in deepening economic reform in China.

(Tim Murton is Acting Assistant Section Manager, Capacity Building, Department of Family and Community Services.)

Editor's note: This issue of the ACESA Newsletter was edited by Mr. Sizhong Sun, the Australian National University. The editor wishes to acknowledge the support of the members of the Association in the compilation of this issue of the newsletter.