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Exchange rate risk and economic reform: the case of endogenous institutional change in China

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Exchange rate risk and economic reform: the case of endogenous institutional change in China

Wolfgang Veit

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I Layout of the paper

Over the past 15 years the mutual importance of institutional economics and development economics have grown strongly. This paper attempts to apply institutional analysis to issues of economic development by analysing China's reform process after her accession to the WTO on the background of the hypothesis of vertically dependent institutions. It will be shown that institutions on a lower level (e.g. a fixed exchange rate regime) are dominated by higher level institutions like (e.g. laws governing firms, financial and labour markets). The latter are dominated by institutions on a higher level, for example by regulations governing the economic and political system. Consequently, economic policy options like a change in the exchange rate regime will depend on adjustments in areas ranging from constitutional to company law.

In the second chapter, the concept of hierarchical institutions is introduced. In the third chapter, the general results of China's recent trade liberalisation under WTO rules and the issue of a fixed exchange rate to the US Dollar are recounted. In the fourth chapter, reforms necessitated by China's accession to the WTO, and reflected by the present exchange rate regime, are identified. This is followed by the analysis of institutions that are conducive to successful implementation of those reforms in China.

II Economic Institutions: basic definitions and their relevance for the present study

II.1. Issues in applied institutional economics

Institutions have been regarded as decisive determinants of economic development for some time now. Douglass North's work (North, 1990) was path-breaking in this area and has to a large degree set the framework for institutional analyses of economic development (Todaro/Smith, 2003, 709). However, a recent overview of the literature on the subject shows several common shortcomings: a lack of clear definitions of what institutions are and how they interact with each other and with the economy and the society; a missing analytical framework defining which institutions are exogenous and/or endogenous and showing which other factors are at work; and inaccurate policy recommendations based on the analysis (Jüttner, 2003, 35).

II.2 Typology of institutions

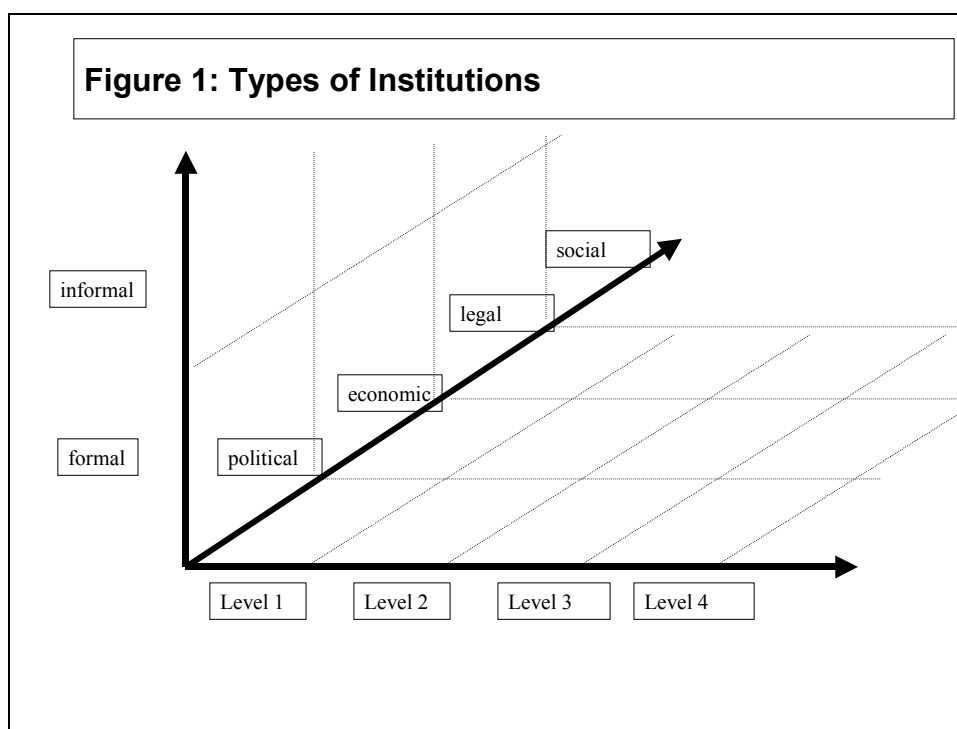
There are three approaches to defining institutions: first, North refers to institutions as "the rules of the game", they are "humanly devised constraints that shape human interaction" (North, 1990, 3). He then distinguishes between formal and informal institutions; examples of the former being written laws and regulations, the constitution, etc. Informal institutions include traditions, taboos, customs etc. (North, 1990, ch5 and ch6). He acknowledges that a delineation of both is often difficult. This may be due to the fact that they overlap or change from one category to the other over time. North distinguishes between institutions (formal or informal rules) and organizations that form on the basis of these institutions, and he clearly sees a repercussion of organizations on the underlying rules. Therefore institutions can be separated into endogenous and exogenous institutions.

Williamson extends this concept and distinguishes between institutions on four levels, representing both formality and endogeneity (Williamson, 2000). Level 1 institutions are typically informal and exogenous (e.g. general traditional social norms); level 2 institutions include mostly formal rules that determine the institutional infrastructure (e.g. legal and political system) and that can be exogenous or endogenous. Level 3 institutions include

private governance regulations (e.g. contract law) and are endogenous. Level 4 institutions are made up of rules that refer to economic resource allocation (labour laws, social system regulations) and are endogenous.

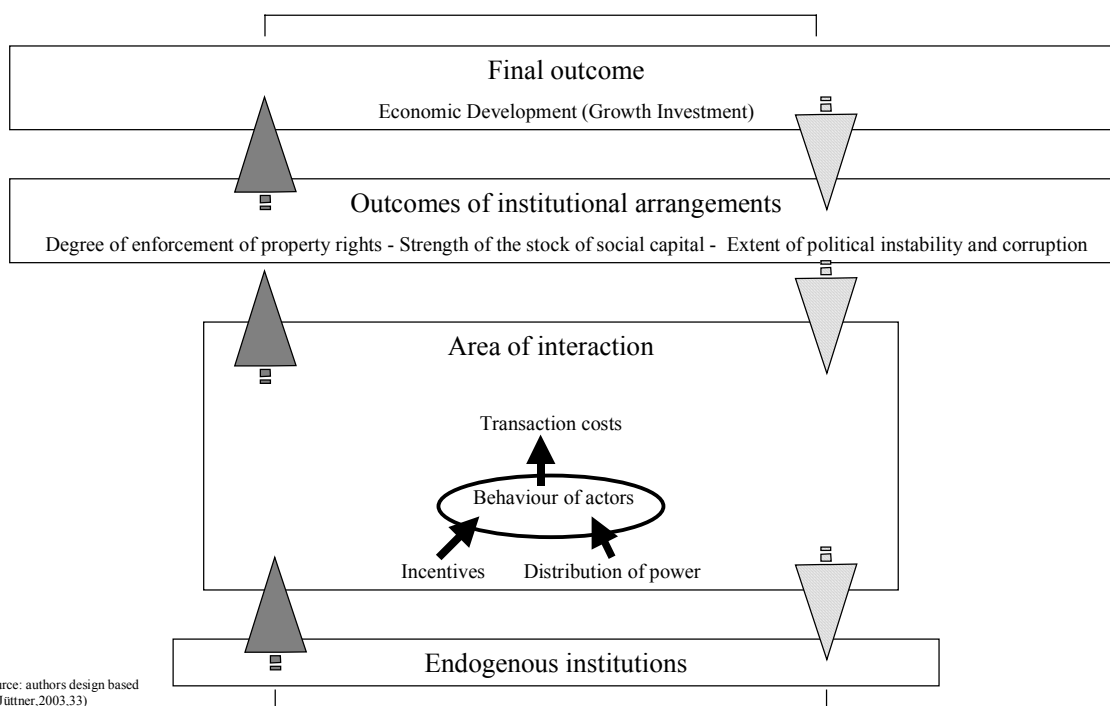
This hierarchical structure implies a hypothesis about causality of institutional changes. As level 1 institutions are exogenous, they are not subject to repercussions from the other institutions. Rather, they dominate the outcome of institutional development on level 2. The design of level 2 institutions itself dominates the results on level 3 and so on. As institutions on level 2,3 and level 4 are endogenous, a direction of causality is not determined. There is room for repercussions within institutions on levels 2,3 and 4. North's division into formal and informal institutions allowed for such inter-linkages, too. He pointed out that "organizations" (in his terminology the results of institutions) "are a major agent of institutional change" (North,1990,5). However, in terms of empirical testing of institutional changes, the concept of hierarchical order of institutions provides better operability.

Finally, institutions can affect different areas of a society. Therefore, they can be distinguished as to being political, economic, legal or social in nature, leading to the following categories of institutions (Figure 1):



The institutional typology laid out above is the basis for an analysis of the economic policy options in China. The hypothesis of hierarchical order of institutions will be compared with the structure of reform requirements after China's WTO accession. In the following chapters, this typology of institutions is the basis of analysis: an exchange rate regime is a typical example for a level 4 institution. The present discussion about the appropriate exchange rate regime for China is used as a point of departure for demonstrating the linkages between economic policy options and the underlying institutional structure over time. As the institutional structure is subject to constant change, the above mentioned hierarchy hypothesis can also be compared with the process of institutional change in China. The dynamic properties of institutions are illustrated in the following figure (figure 2):

Figure 2: Endogenous institutional change and economic performance



III China's Economic policy strategy under WTO

III.1 Implementation of commitments

Since China joined the WTO, implementation of the commitments has been monitored within the transition review mechanism. A large number of suggestions for changes in the way China implements the commitments have been made during the process.¹

However, the implementation by China of the commitments made under the accession agreement are presently neither an outstanding issue of public debate in any of the trading partner countries nor does it lead to international arguments. Also, the statements of officials during the WTO Cancun meeting suggest that China is fulfilling its obligations.

III.2 Economic policy outside WTO-commitments

Despite the fact that the transition process seems to be well under way, criticism of China by its foreign trading partners, notably the US, has become more outspoken in the past months.

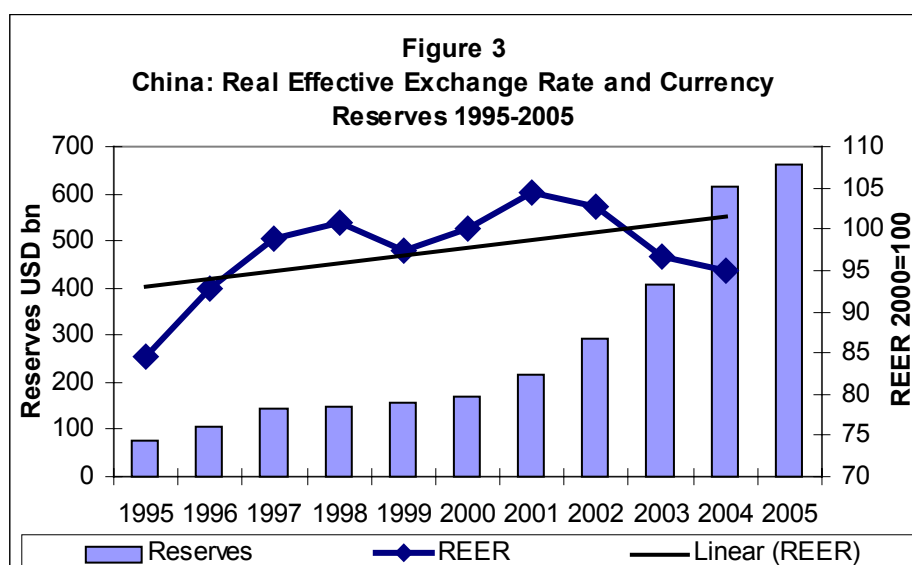
¹ At the time of writing no summary of TRM reports was available. However, the WTO provides information all discussions in separate documents. As an example, see the comment of the EU on Market Access (WTO 2003¹)

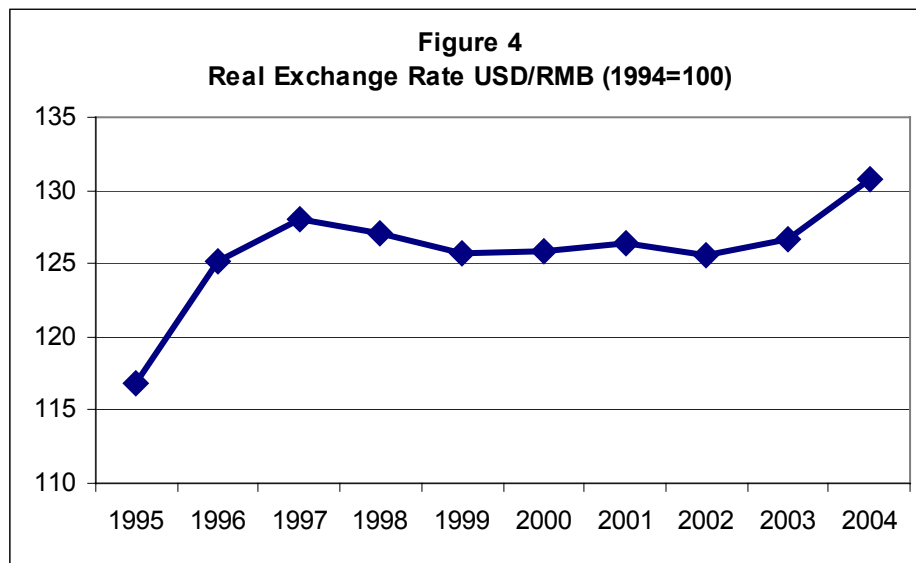
This may be due to the political strains the US administration is feeling, brought about by a stagnating job market and the widening current account deficit.

Nonetheless, economic developments in China may be interpreted as being of a protectionist nature and thus as contradicting the WTO-spirit. Whereas US complaints about China's steel exports have not been accepted by the WTO, complaints about exports of textiles, toys and consumer electronics have not received a ruling yet. Countermeasures against a surge in these imports into industrialized markets are an integral part of China's accession obligations, deviating from general WTO rules. However, besides those specific charges of violating the WTO spirit, there is the general suspicion of dumping on the grounds of the fixed USD/RMB exchange rate.

A fixed exchange rate is not a cause for dumping complaints by itself. However, in the case of China it was accompanied by a strong positive balance of trade with the US that is reflected by an ever increasing stock of foreign (USD-) reserves (see figure 3). Leaving aside the issue of how the US would do without this inflow of capital (which USD-reserves held by foreign countries are), we have to ask whether the unbalanced trade has to be seen as the result of an undervalued exchange rate.

Figure 3 shows both the development of reserves and of the real effective exchange rate. The latter (left scale) is an indicator of China's international price competitiveness. It is determined by the nominal exchange rate and the price movements in both China and her trading partners. As can be seen clearly, the REER is fluctuating strongly, but shows a positive trend. In other words, China's exchange rate policy has not increased the overall price competitiveness of her exports, but rather reduced the price competitiveness. Based on analysis of competitiveness, there is no support for the assumption that China's exports are unfairly dumped on the world market with the help of exchange rate policy.





Results may change somewhat when the bilateral real exchange rate of the RMB against the USD is considered. However, figure 4 shows that the Chinese RMB has been devaluating against the USD in real terms only since 1998, after having gained (lost competitiveness) in the previous year. On average, China's competitiveness vis-à-vis the United States has not changed, based on Real Exchange Rates. Therefore, the complaint about hidden dumping by means of exchange rate policy is unfounded. China's exchange rate policy is in line with the spirit of the WTO.

Besides competitiveness concerns, the second argument mentioned in favour of a RMB revaluation is the level of international reserves. Again, on the face of it, the strong increase of reserves over the past years may be taken as an indicator of a "wrong" fixing of the exchange rate. However, it must be noted that these reserves have been accumulated during a time when a relatively closed financial account and the steady increase in reserves itself lent credibility to the stability of the Chinese currency. From the experiences of the Asian Financial Crisis China learnt that opening the capital market will undermine this trust in the currency. However, even with formally closed financial accounts, there remain opportunities for capital flows; the more so, if a flexible exchange rate offers speculative opportunities. So, a flexible exchange rate would be no guarantee for a long run appreciation of the RMB.

III.3 RMB Risk

Our latest analysis of the currency risk associated with the RMB, based on the CURRI-model (Veit, 2003¹, 2003²) shows an increase in currency risk since last year. The CURRI-index allows to distinguish between several areas of economic conditions. The macroeconomic situation of China still is positive, but has declined in quality compared to last year. Here, the CURRI-index declined from +10 in 2002 to +4 this year (range -26 to +26). It is, however, the microeconomic area that shows a marked deterioration. Here, the CURRI-index declined from +3 to 0 (range -14 to +14). Within the macroeconomic as well as the microeconomic areas the most pronounced decline was caused by the financial markets, in particular the credit sector. Very strong credit growth and the accompanying worsening of the loan/deposit ratio have led to a negative assessment of the nationwide credit market (aggregate balance sheet and operating account data), from +2 to -3 (range -9 to +9).

It is in this area that international reserves contribute to China's macroeconomic stability. They constitute national savings that are free from the risks of domestic economic

development. The under-capitalized banking system, in particular, can be backed up by the foreign currency reserves in times of crisis as long as financial sector reform has not been completed. The Chinese government makes regular use of reserves for this purpose, the latest example being a recapitalisation of two major state owned banks to the amount of USD 45 bn in December 2003 (Holland/Lague, 2004, 26)

Of course, financial sector reform is closely intertwined with reforms in other sectors of the Chinese economy – so closely, that the Worldbank dubbed them the Gordian Knot (Worldbank, 2003, 4) .

At this point it is sufficient to say that international reserves cannot be used twice. If they are earmarked to shield the country from sudden real and financial crises, they cannot credibly be used to support an appreciation of the RMB. In other words, in risk adjusted terms, there are no or only very limited international reserves that can be used for exchange rate stabilization. If the USD/RMB peg were given up and the RMB appreciated, a considerable amount of the reserves would have to be employed as a backup of the exchange rate. They would not be available for domestic stabilization anymore. This is the second reason for not revaluing the RMB.

This institutional solution of the problem of lacking reforms is clearly sub optimal from a long run transaction cost perspective. However, as long as risk reducing reforms are not in place, it may be efficient in the short run.²

IV Economic policy and trade liberalisation under WTO rules

IV.1 Exchange rate policy as an indicator of reforms

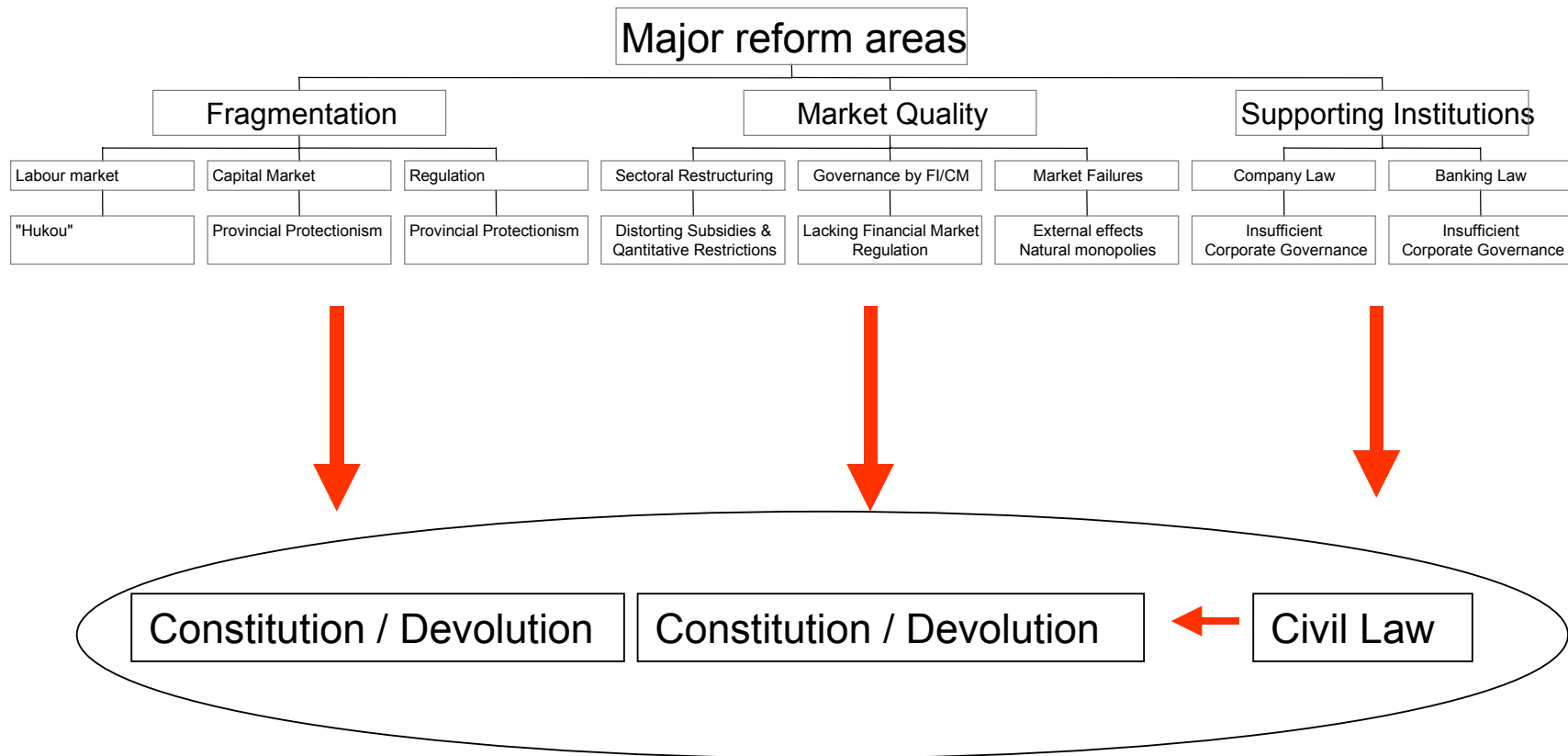
In the previous section it was pointed out that the exchange rate policy reflects not only the external balance but that it also has to consider overall risks of an economy. A fixed rate policy that leads to a strong build up of reserves – at least in the case of China – points to considerable nationwide economic risks. These risks remain as long the country remains fragile because reforms are unfinished or have not even begun.

IV.2 Areas of economic reform

Figure 5 shows different areas of reform in China. The most urgent areas have been identified in many analyses over the past years (see for a comprehensive account: OECD, 2002). As a matter of fact, the required reforms are incorporated into the 10th Five Year Plan 2001 to 2005. However, implementation is lagging. The need for reform is due to three principal structural weaknesses in the Chinese economy: fragmentation of the internal market, lack of market quality, and insufficient supporting institutions.

² The issue of flawed institutional settings has been raised early in the institutional economics literature (e.g. by Williamson, 1985, 408).

Figure 5: Reform Agenda in China



IV.2.1 Fragmentation

Fragmentation is of both macroeconomic and microeconomic nature.

On the macroeconomic level, a lot has already been achieved. Macroeconomic instruments within fiscal and monetary policy have been improved over the past years and their effectiveness is increasing. Tax reform remains a challenge, but this problem is deeply rooted and cannot be solved without reforms in the micro sphere (corporate accounting in particular and corporate governance in general). Less progress has been made in the area of internal market access, both in factor and goods markets. In particular, regional barriers to inter-provincial trade and investment lead to nationwide sub-optimal resource allocation and efficiency losses. Lack of labour mobility – basically a microeconomic phenomenon, adds to these macroeconomic deficiencies.

Most of the reform challenges are of a microeconomic nature. National economic fragmentation, basically a macroeconomic issue, has microeconomic aspects as far as labour mobility is concerned. The Hukou system which restricts the movement of labour within China has been circumvented by many workers. However, in the wake of illegal worker flows, mostly from rural to urban areas, a number of new structural problems arise. Most prominent is the exclusion of urban illegal residents from social, legal and educational services. Therefore, the Hukou system establishes incentives for the creation of a third class of citizen: besides rural and urban citizens, an increasing number of unregistered urban “non-citizens” is to be expected. Indeed, the rising statistical discrepancy in urban employment points in that direction (OECD,2002,541). Besides solving or avoiding, respectively, this social problem, a reform of labour market laws would also strengthen the efficiency of resource allocation on a national level.³

Generally, Chinese economic fragmentation is a matter of relationships between provincial and central government. The process of devolution has been going on for some time now, bringing autonomy to the regions at the cost of reduced efficiency. In order to avoid the drawbacks of decentralisation, a master-plan for establishing sustainable relationships between the provincial and national levels is needed. In most countries this is laid down in a basic law or constitution, as it is presently discussed in the EU. Therefore, a constitutional reform is urgently needed.

IV.2.2 Market quality

Market quality refers to the factors that allow market processes to work in an efficient manner. This is basically a microeconomic issue.

An important area for functioning markets is sectoral restructuring. Markets can play an important role in reallocating resources when external conditions change, as they presently do in China. It is well known that subsidies and quantitative controls of production work against those market forces if they are set in the wrong way.

Restructuring of the rural economy is probably decisive for China’s future, as it determines such areas as regional development, resource utilisation, efficient participation in world trade under WTO rules, equitable social progress, and balanced industrialisation, to name but a few. Presently, the policy governing agricultural production, with quantitative requirements and subsidies playing the most prominent role, is not conducive to restructuring. It supports

³ Labour market regulation is subject to change; implementation, however, will come gradually with so-called pilot areas (like the North Eastern provinces in the case of social security reform) as testing grounds. (GOV 2004¹), (GOV 2004²)

agricultural production and hinders industrial production such as processing of agricultural production. Reduction of government intervention will correct financial incentives; if combined with less fragmentation, restructuring will be facilitated even more.

However, implementation of these reforms will require the cooperation of political decision-makers on several levels. Political tensions between regions and the centre can most probably not be avoided, as a certain informal sovereignty of provincial policy-making has been established in the past. This refers to the powers of provincial governments vis-à-vis the central government as much as to the relationship of party bodies on a regional and a central level: the property rights to political decision-making are blurred, they have to be defined more clearly within both governmental and party areas, and between government and party. Again, the success of reform will crucially depend on clear guidelines to be set by a constitutional framework (level 2/3 institutions).

Another factor contributing to low market quality is the lack of governance of enterprises by capital markets (level 4 institutions). Financial market regulation is overdue, and it will contribute to many other areas of economic reform. Rural restructuring, i.e. rural industrialisation in particular will benefit from nationwide financial flows that allocate resources efficiently. The creation of a nationwide financial market, however, restricts the power of local party/government bodies and will be successful only if it is supported by a constitutional adjustment.

Finally, “market failures” such as external effects and natural monopolies need a regulation that simulates market conditions. As long as such regulation does not exist, it will offer opportunities for extra-normal profits that attract funds which could have been used otherwise with higher efficiency. Again, the legal situation must be changed in a way that establishes clear rules for property rights on national assets/liabilities, i.e. on the exploitation of monopoly situations and environmental resources.

IV.2.3 Supporting Institutions

Company law and banking law are of major importance here. Re-allocation of resources (financial funds and labour) is generally regarded as a major part of economic reform. The channels for funds are defined by regulation governing these factor markets. Regulation of financial markets and of labour market has already been discussed above. However, within financial markets it is necessary to distinguish between several actors. On the one hand, there is regulation of capital suppliers, be they banks or stock markets. On the other hand, the conditions of capital supply depend on the risk that is attached to investment projects, i.e. on the conditions that govern the users of capital. Conditions will be the better the less risk is involved in the capital markets. Economists refer to asymmetric information that reduces market quality and hinders optimum flows of resources. In order to mitigate the effects of asymmetric information, company law and banking law have to be designed in parallel steps. Then they will complement each other and close loopholes for those who happen to have an information advantage. However, this again is politically sensitive. A company and banking law that supports reform will have to deal with SOEs and other areas of economic government activity, and it will restrict the scope for intervention. In order to achieve that, again, civil law has to be founded on a clear constitutional basis.

IV.2.4 Conclusion

A common feature of the requirements for reform is the need for legal and constitutional changes. Property rights must be well defined, and in the Chinese context that means a restriction of party/government powers. It is unclear in how far the Chinese society is willing

and able to do just that. It should dominate the discussion that is preceding the implementation of detailed economic reforms.

IV.3 Sequencing of reform

Requiring the completion of legal and constitutional groundwork for the implementation of economic reforms raises the issue of sequencing of reforms. The literature on sequencing is abundant, therefore the focus will be on the general steps of reform and institutional change in particular.

Since the country's external opening and domestic liberalization in 1978 China has made astonishing progress in changing its ways in general. This leads to the question where China stands at the moment, and whether it can draw any conclusions from the experiences of other countries.⁴

Figure 6⁵ shows that generally reforms can be associated with two stages (Worldbank,1997,152). In the first stage, a government directly and centrally implements the changes in the economic landscape such as price reform, deregulation, and macroeconomic stabilization. The initial economic benefits of reform are large enough to compensate the relatively few losers of reform (Worldbank,1997,145).

In the second stage the number of losers of reform increases, not least because deregulation in the first stage now needs to be turned into re-regulation of markets. The growing number of losers and the increasing need for compensation makes the implementation of reform politically more difficult. It has to be accompanied by reform of the framework for political decision-making. As the population now has higher and opposing stakes in the results of economic policy, the government needs instruments that balance these contradicting forces.

Figure 6: Sequencing of reforms and China's position

	<i>First Generation</i>	<i>Second Generation</i>
Goals:	<ul style="list-style-type: none"> •Inflation control ✓✓✓ •Growth ✓✓✓ 	<ul style="list-style-type: none"> Improving •Social conditions •Competitiveness •Macro stability ✓
Instruments :	<ul style="list-style-type: none"> •Price reform ✓ •Deregulation ✓ 	<ul style="list-style-type: none"> •Civil service reform • Judicial reform • Modernisation of legislature
Actors:	<ul style="list-style-type: none"> •Government&Economic Institutions ✓ 	<ul style="list-style-type: none"> •Government&Economic Institutions ✓ •Judiciary •Parties •Media
Challenge:	<ul style="list-style-type: none"> •Macro-management by insulated technocratic elite ✓ 	<ul style="list-style-type: none"> •Institutional Development dependent on middle management in the public sector

Source: World Bank¹ 1997, p.152

⁴ The EBRD transition indicators show an average transition performance of 2.1 on a scale ranging from 1(lowest) to 4 (highest). IMF,2000,180) based on (EBRD, 1999)

⁵ Ticked areas indicate reforms that have been achieved in China

Rodrik (1999) formalizes this problem by an equation. It contains changes in economic growth EC (endogenous) and institutions of conflict management CM, latent social conflict SC and external shocks ES (exogenous variables) ⁶:

$$EC = - ES*(SC/CM)$$

If the government tries to keep that role of balancing, it will by its actions be causing the social conflicts and at the same time trying to reduce them in its capacity as institution for conflict management in Rodrik's terms. This will create conflicting targets and a credibility problem, increasing further the political strains emanating from the society's interest groups. This constitutes a lose-lose situation for the government. A devolution of powers therefore is in the interest of the central government.

V Institutional requirements for successful reform

V.1 Political implementation of economic reforms

As already mentioned, the success and sustainability of reform depends on the wish of the population for change and on the results of a political cost benefit analysis: gains have to exceed losses, and compensation of losers by winners – indirectly via the government – has to be accomplished. This compensation process has to be designed well, because in most cases the gains will not appear parallel to the losses. The government has to finance these transfers, or it has to convince losing citizens that holding on to reforms is worth the effort in the long run. Both cases require the government to enjoy a sufficient degree of credibility (Hemmer,2002,386).

Credibility depends on previous experiences the population made with the government. These include (Worldbank,1997,pp147),(Hemmer,2002,pp386)

1. Sudden changes in laws and political decision-making
2. Low stability of the Government
3. Uncertain and unclear property rights
4. Unreliable legal system
5. Corruption
6. Robustness of the institutional design

Stability (2) of the government has never been an (open) issue in China since 1949. It ranged as a top priority among officials and the population alike (Stiglitz,2002,183pp)

Since opening up, China has made progress in all the remaining fields, probably with the exception of corruption (5) which seems to be a typical and probably passing phenomenon of transition countries (see also: Riedel/Pollak, 1986,21). The changes of laws (1) were preceded by long internal discussions and may not have come as a surprise to a part of the population. However, measured by the standards of property rights (3) and reliability of the legal system (4), China clearly still has some way to go. In these areas, credibility of the government will be challenged most and a high priority should therefore be attached to improvements.

⁶ The description is based on (OECD,2001)

V.2 The role of institutional design and China's institutional settings

Empirical research has shown that the following indicators describe the robustness of the institutional design (6):

1. Electoral/party system
2. Checks and balances
3. Political regime

A majority electoral system rather than a proportional representation system seems to be conducive to reform as it establishes a broad and stable majority for the ruling party. In the case of China, the majority of the communist party in the legislative bodies is undisputed, thus producing the effects of a majority electoral system. However, internal power-broking is opaque and thus a constant source of speculation. This reduces the robustness and credibility of the government. Internal reform of the party creating more transparency and rule-based decision-making would reduce this disadvantage.

Checks and balances can have a very stabilizing effect on government policy, as they prevent arbitrary and sudden policy changes. However, they create so-called veto points which allow interest groups to slow down those reforms they regard as harmful. Even if this is not the case, veto points can slow down the reform process considerably. Clearly, there has to be a careful weighing of the advantages and drawbacks of checks and balances. In China, an independent judiciary may be seen as a substitute for other institutional checks and balances. At present, checks and balances are effective mostly on the intra-regional level, showing all the disadvantages and few of the beneficial effects. In this case, wide-ranging legal and constitutional reform would gain even more importance.

The choice of an optimum political regime is probably the most difficult issue, as it relates to more issues than just to economic reform (Todaro, 2003, 710). In particular, the institution of democracy serves the goals of personal freedom and human conditions of life – goals which are hard to put into perspective (Durth et.al., 2002, 214). However, if judged by the effect on economic reform alone, democracy is not necessarily the superior regime (North, 1990, 109). This is particularly true if the democratic regime is furnished with a large number of veto points. Then reform may be slowed down or stalled. However, Braga de Macedo assigns democracy a positive role for the same reasons: he interprets institutions comparable to veto points as tools for higher accountability which strengthen governance (Braga de Macedo, 2003). An assessment of the pros and cons of an increase in the degree of democracy is presented by the OECD (OECD, 2001, 62) drawing on the work of Rodrik (2000) and Clague (1997).

V.3 Policy recommendations

The decisive question remains: is China well equipped with the tools to implement the required economic reforms? The above analysis shows that with respect to (party-)electoral system, checks and balances, and political regime, the necessary structure for implementation of reforms exists. The political costs, however, could be reduced by

- increasing party-internal transparency
- establishing party-internal rule based electoral systems
- establishing a truly independent judicial system

The principle of the “Three Represents” (formulated by the previous Chinese administration under Jiang Zemin) may be understood as a first step in this direction. It clarifies the functions of the party and it may lead to a kind of controlled transition to an internal democratic system. If successful, it creates the political buffers that are necessary for absorbing the political shocks that are associated with reform, thus stabilizing the government and increasing its credibility.

VI Summary and conclusions

The hypothesis of endogenous institutional change does not seem to be rejected by empirical observations in China during and after the phase of WTO accession.

China is on an orderly way of implementing the commitments made during accession negotiations in that all disputes are discussed within the framework provided by WTO. However, some doubt is cast on the sincerity of its adherence to the “WTO spirit” by critics of the present RMB/USD-peg. These critics contend that the RMB is fixed at an unnecessarily low rate, thus creating a dumping effect for Chinese exports on the US market. However, a closer look at the data does not support this hypothesis. The RMB exchange rate has not led to an increase in competitiveness. Even more, the visible deficiencies of the Chinese economy and its institutions require external savings which could probably not be increased without the USD peg. Therefore, the peg should be seen not as an unfair support of exports, but as a necessary safeguard against the perils of domestic economic development. That makes economic reform the more urgent. Areas of reform can be grouped into three major concerns: fragmentation of the economy, quality of the market, and quality of supporting institutions. Analysing ways for improvement of those issues shows that the legal basis of the Chinese economy and society is often too ambiguous. A clear-cut definition of economic and political property rights would be conducive to economic reform. This finding is in line with the present stage of reform in China: typically, after basic stabilization and growth has been achieved, the need for institutional upgrading becomes more and more urgent in developing countries.

Reform will have uneven distributional effects. At this stage, credibility of the government is crucial for the success of reforms. Credibility itself is connected with the solution of a number of problems: some of them are not an issue in China, others still have to be tackled. Among the latter, robustness of the institutional design is of particular relevance. It is determined by the type of electoral system, the number of checks and balances, and the political regime. On all three accounts, China features quite positively: the communist party system’s effects on reform are comparable to those of a majority voting system; the number of checks and balances is limited, but can be supported by legal reform; and the political regime is – as far as economic reform is concerned – not a barrier.

In order to reduce the political cost of reforms, three basic institutional reforms should enjoy priority: transparency within the party system, rule based decision-making within the party, and establishment of a truly independent legal system.

In other words: China’s institutional change has to set in at the level 2 institutions, if not level 1 institutions depending on the role of cultural factors in the formulation of constitutions. Adjustments on these levels will then determine the institutional outcome on levels 3 and 4, which are often – but, according to this analysis incorrectly - considered to be the crucial reform areas.

Suggestions for further research:

An analysis of political institutions and their reform in China is close to speculation if performed by an economist. This is particularly true for the issue of transition from party rule to democratic rule, as touched upon above. Nonetheless, institutional economics provides the tools for such an analysis. North's distinction between informal and formal institutions can be applied to the Chinese setting: party decision-making is considered to be opaque, following unknown rules. These rules can be interpreted as being informal: subject to party customs as much as to Chinese leadership traditions. In the process of economic development, formal rules (here: a constitution) gain importance compared to informal institutions. During this shift in predominance of institutions formal and informal institutions should complement each other from an efficiency perspective (Jüttner, 2003, 12). On the other hand, path dependency typically is a result of imperfect markets. North explicitly refers to the set up cost of a constitution in that context (North, 1990, 95). In the Chinese context this may imply that the transition from informal party rule to formal democratic rules via democratisation of the party is in fact an efficient detour as compared with a hypothetical direct switch (North, 1992, 26) to democracy. A number of methods have been developed recently to measure the quality of institutional settings in countries (EBRD, 1999), (DeMelo et al, 1996), (Weder, 2000). A comparative assessment of the approaches is provided by the IMF (IMF, 2000). These methods might be useful in designing efficient paths of institutional change in China. However, these are only sketchy remarks on a subject that deserves more attention.

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