Tuesday April 29th

Maybe the Whole World is Developing
After all: China

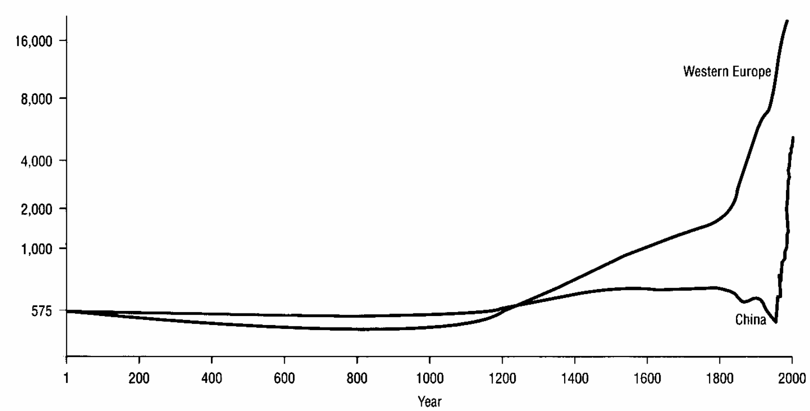
We saw previously how China is taken as the prototypical illustration of divergence and convergence

- The economy was technologically sophisticated: it was at least as advanced in technology and social organization as Europe between 1000 and 1500 AD.
- It then fell behind, and dramatically so, when modern economic growth commenced in the West.

Chart 1

GDP per Capita: China and Western Europe, 1–1998 A.D.

2002 dollars



SOURCES: Maddison, Angus (2001), *The World Economy: A Millennial Perspective*, Organization for Economic Cooperation and Development, p. 42; authors' calculations.

We also saw how there was no shortage of answers to the question of "Why Europe and not China?"

- **Answer 1**: China's very success at managing certain social problems like public health actually meant lower living standards in the Malthusian era, making less surplus available for saving and investment.

- **Answer 2**: Great volatility of income and output, due to climatic conditions, lack of crop diversification etc., leading to safety-first behavior.

- **Answer 3**: Unfavorable endowment of energy resources such as coal.

- **Answer 4**: Europe, not China, was favored with colonies.

- **Answer 5**: Weak institutional support for modern economic growth.

    - And, contra Clark, it was this last explanation that we found worth pursuing.

- The argument, then, was that a thin veneer of public support for economic activity sufficed for a traditional agricultural economy.
- It even supported a small but vibrant manufacturing sector.
- But it did not create a platform for the transition to modern economic growth.
  - European states, in contrast, provided more support for modern economic growth:
    - Courts provided reliable enforcement of contracts and property rights.
    - Public support was provided for the rationalization of landownership and traditional property rights.
    - Arbitrary taxation was limited (recall North & Weingast's argument about the Glorious Revolution).
    - Public revenues were systematically devoted to the national defense and to improving roads & infrastructure, not simply to conspicuous consumption by the Crown.
    - Schools and technical academies were established for training scientists and technicians; prizes were offered for scientific and practical breakthroughs.
  - European states did all this because they had to, given the continent's peculiar geography.

- In China, in contrast, inadequate state support held back market development.
- And, insofar as this reflected China’s equally distinctive geography, it was not obvious that this was something that would change.
- Thus, when China definitively regained its autonomy, expelling the Westerners and the Japanese and consolidating its revolution, it again had a highly centralized, highly authoritarian government, consistent with this long-standing tradition.
  - While this new revolutionary government had different priorities than its predecessors (advancing the socialist revolution rather than maximizing conspicuous consumption), neither was it particularly oriented toward promoting economic growth.

- In the early decades of the new Communist Regime, such pessimism seemed warranted.
  - Growth was anemic.
  - And this anemia was directly attributed (by Western economists) to the policy regime: to continued weak and unpredictable support for market activity, which now meant:
    - Abolition of private property
    - Suppression of market activity
    - Lack of incentives for initiative
    - Arbitrary and unreliable contract enforcement
    - Denigration of technical excellence

We can see this in the phases of Chinese development in the third quarter of the 20th century

- Consolidation (1949-52): private enterprises were placed under government control. Foreign enterprises were nationalized.
- First 5-Year Plan (1953-57): Heavy dependence on low-interest-rate Soviet loans. Construction of modern industrial facilities by Soviet experts, who trained Chinese technicians to run them.
- Great Leap Forward (1958-60): Designed to make use of the country's abundant labor. Mass mobilization. Backyard steel mills. Soviet technicians withdrawn. Low quality output and lack of coordination caused it to fail.

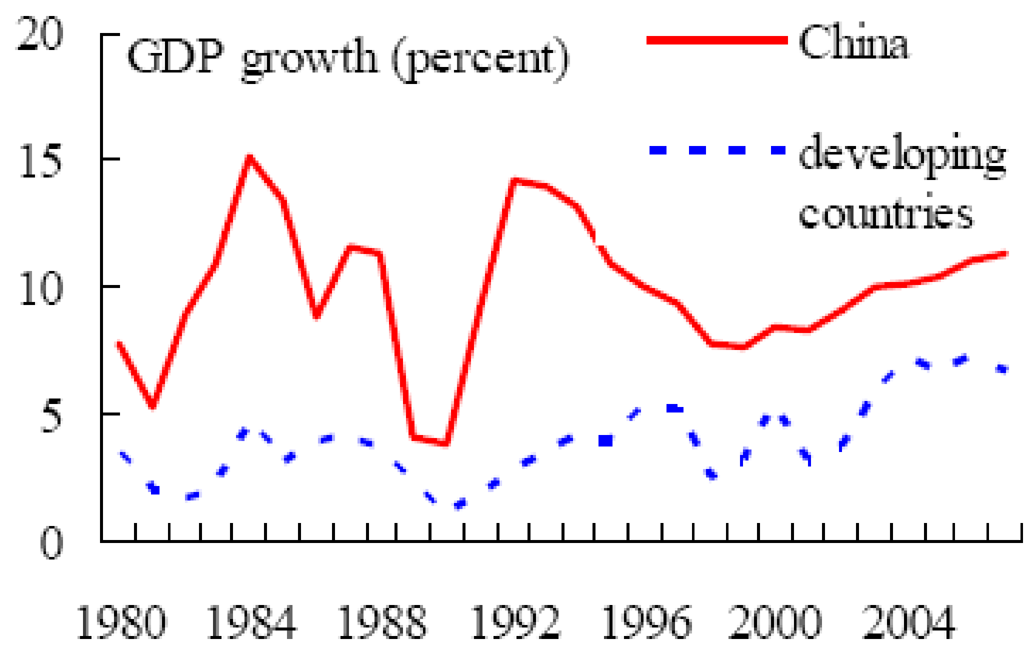
We can see this in the phases of Chinese development in the third quarter of the 20th century

- Cultural Revolution (1966-69): Purge of those with moderate, revisionist views. Denigration of technical excellence. Ideological polarization. Growth rate of -2.5% p.a. and cumulative fall in industrial output of 20%
- Post-Cultural Revolution Period (1970-6): Turn from class struggle to modernization, emphasizing acquisition of foreign technology. Ten-year plan envisaged rapid growth of agriculture and industry. But still little scope for private property, market activity, etc.
  - It is no wonder, in light of all this chaos, that there was little economic growth, and even economic retrogression.

- Of course, we no longer talk about China this way.
- The facts have changed….

Fact (1): growth has been rapid

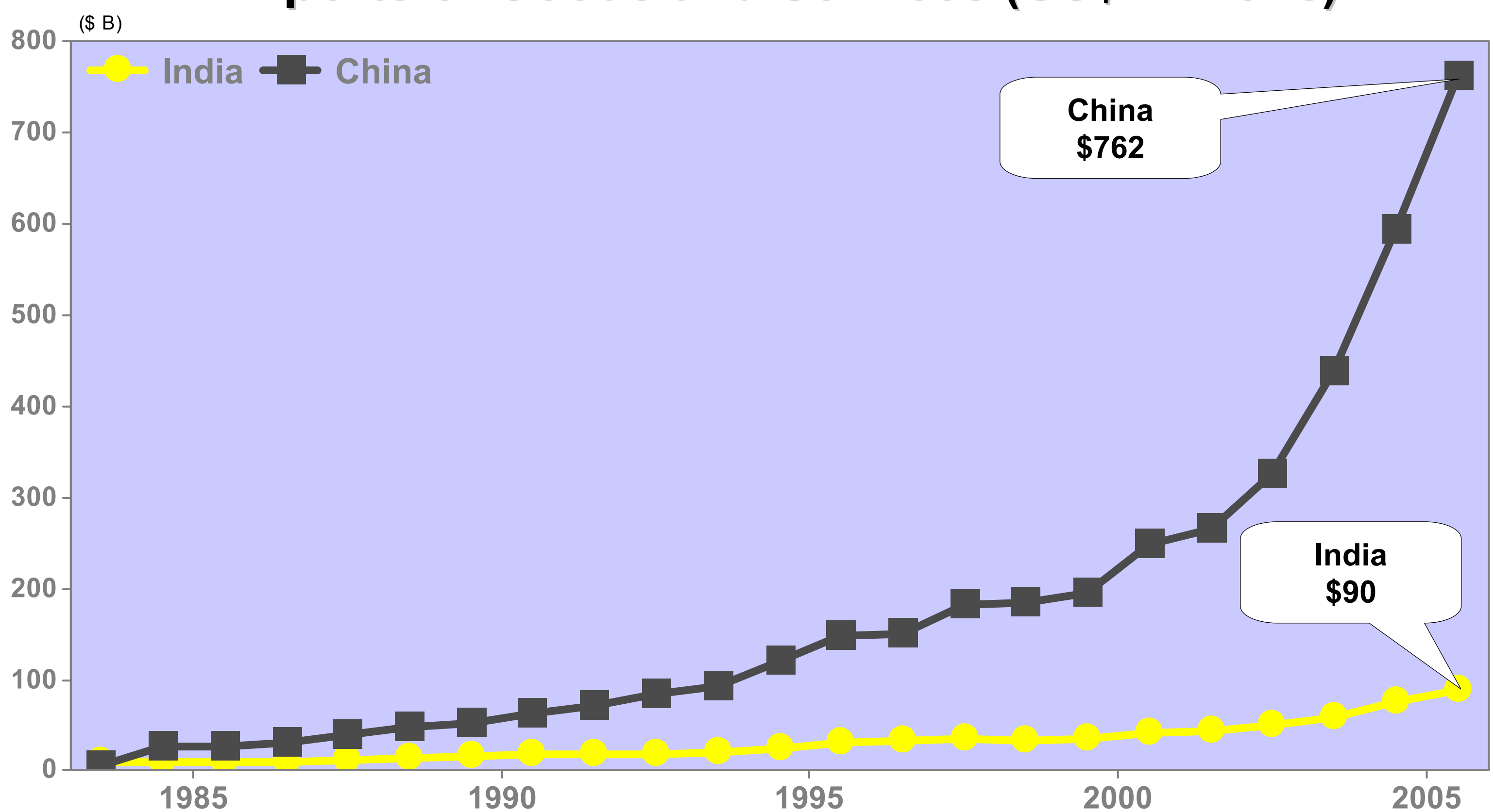
Figure 1. Economic growth has been rapid.



Source: World Bank WDI and authors' estimates.

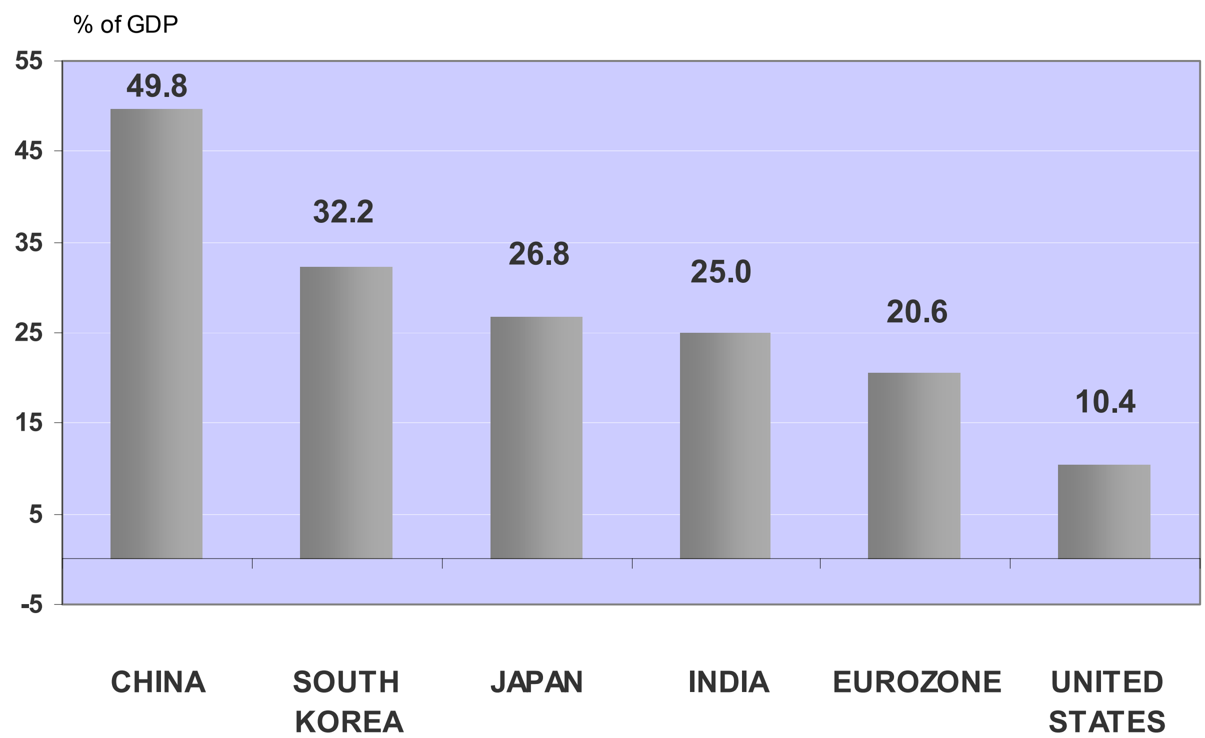
Fact (2): Exports have boomed

Exports of Goods and Services (US$ Billions)



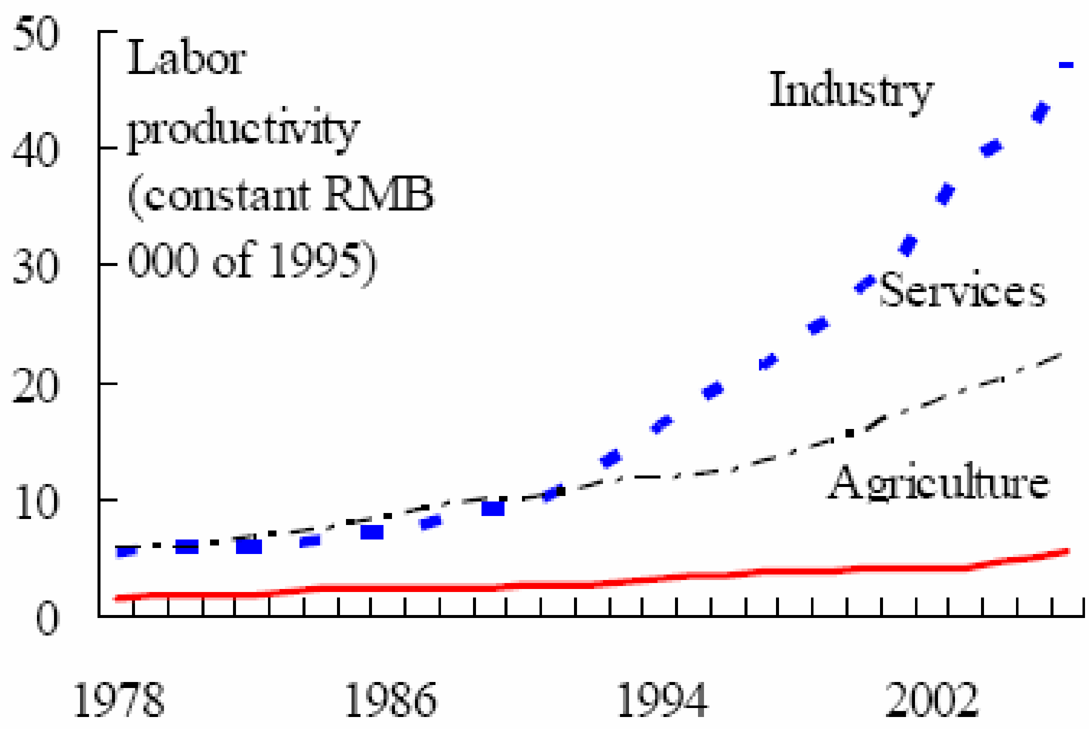
Source: EIU

Fact (3): growth is driven by extraordinarily high investment and savings rates (this is gross domestic savings)



Fact (4): productivity in industry has soared

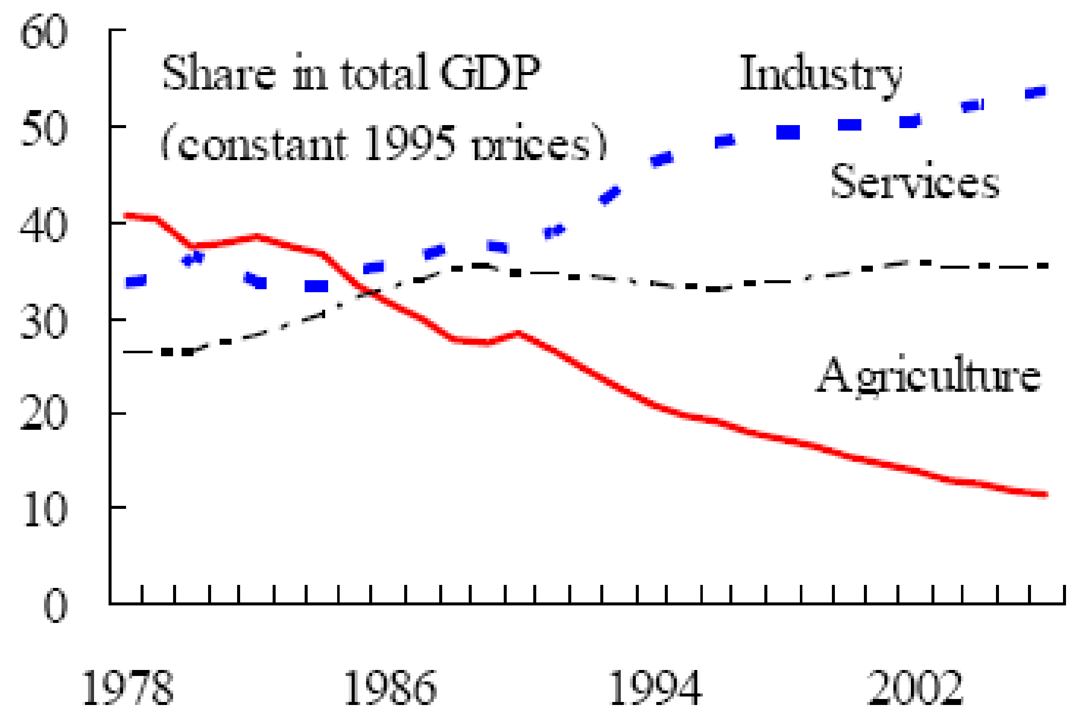
Figure 3. Labor productivity in industry has soared



Source: NBS, authors' calculation.

Fact (5): shifting labor from ag to industry has boosted growth

Figure 2. Industry has driven growth



Source: NBS, author' estimates.

Key growth-sustaining reforms were initiated starting in 1978

- Functions of central government and state enterprise more clearly distinguished, with the intent of giving the latter more autonomy.
- Farmers allowed to keep surplus production.
- Small private enterprises allowed.
- Small state enterprises were transformed into collectives owned by residents of the town or village in which they were located.
- Some prices were allowed to fluctuate.

Why was reform initiated at this point in time?

- One answer is that the cultural revolution had decimated civil service, public administration and the professions, reducing the government's tax revenue. The damage this had done to growth prospects was too obvious to ignore, leading to a change in course.
- Another is that there was growing evidence of the Soviet economy falling behind.
- Meanwhile, other East Asian economies, from Korea to Taiwan, were leaping ahead.
- A final factor is that the Chinese authorities recognized that stimulating growth required purchasing foreign technology. And that required exporting.

  - Den Xiaoping, who came to power in 1978, was aware of these facts and sought to put the ideology of Maoism behind the country, supplementing it if not superseding it with the ideology of growth.

- So these were steps in the direction of private property, rewards for hard work and inventiveness, government accountability, and a functioning market economy (the things that many economists – and our previous discussion – suggest are needed to support modern economic growth).
- But they were only small steps. China was still very far from the “Washington Consensus.”
- Is this a problem for the conventional interpretation?

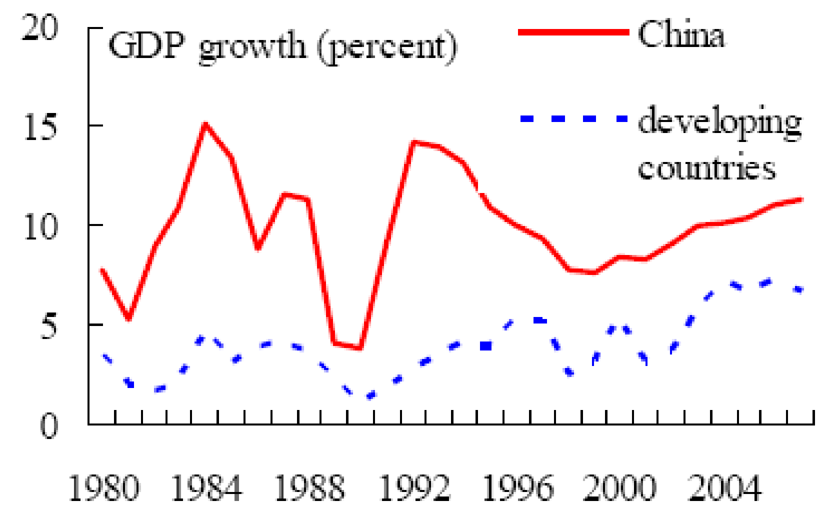
Is this a problem? For even this small steps had strong pro-growth effects

TABLE 11-2 *Performance of the Chinese Economy in the 1980s (%)*

	Real GNP	*Real Gross Industrial Output*	*Retail Prices*
1980	7.9	9.3	6.0
1981	4.4	4.3	2.4
1982	8.8	7.8	1.9
1983	10.4	11.2	1.5
1984	14.7	16.3	2.8
1985	12.8	21.4	8.8
1986	8.1	11.7	6.0
1987	10.9	17.7	7.3
1988	11.3	20.8	18.6
1989	4.4	8.5	17.8

Source: Michael W. Bell, Hoe Ee Khor, and Kalpana Kochhar, *China at the Threshold of a Market Economy*, Occasional Paper 107 (Washington, D.C.: International Monetary Fund, November 1993), 66.

Figure 1. Economic growth has been rapid.



Source: World Bank WDI and authors' estimates.

Strikingly, growth proceeded despite problems with these early reforms

- Limited term (15-year) farm leases provided no incentive to improve irrigation, preserve fertility of soil, etc.
- Collective enterprises were tempted maximize wage bill or equivalent rather than maximizing efficiency.
- Managers retained incentives to strip enterprise assets and to overpay themselves. Thus, while it is often said that the lesson of China is that a price mechanism, and not private ownership, is what is essential to success, this is not obviously correct.
  - To be sure, tough state oversight and heavy penalties discouraged asset stripping. (Contrast the situation in Russia after Peristroika.) But will this remain true with political and social liberalization?)
  - Continuing prejudice against private property meant that there was no place to hide stripped assets. (Will this remain true with growth of financial markets?)

One reason growth continued is that the authorities responded to early problems with further reforms

- In 1994 the exchange rate was stabilized and unified. Inflation was brought down.
- Exchange rate then firmly pegged to $ in 1997.
- Exports and inward foreign direct investment encouraged.
- Private enterprises increasingly allowed.
- Starting in 1999 private enterprises did not have go through state trading companies in order to export.
- Finally, in the last few years, the domestic market has been opened up to imports (as China became a member of the WTO).

- Results:
  - Export growth surged ahead at 40% per annum.
  - Growth accelerated again and became less uneven.

But China is still a mixed economy

- We hear about new private enterprises, mainly foreign-investment enterprises, along the coast that act just like companies in market economies, setting their own prices, hiring workers freely etc.
- But central planning remains influential over much of the economy.
  - The prices of utilities, public transport, coal, natural gas, oil, gas and indirectly food (due to state-sponsored ag inventory management programs) are all set by the state. So are interest rates, exchange rates, bank credit lines and bond prices. These are all set by the National Development and Reform Commission, contemporary counterpart to the old planning agency.
  - Similarly, much investment is decided by the National Development and Reform Commission, which directs resources to state-owned enterprises (and by managers of those enterprises, who equate scale with success), and financed by state banks.
- So, increasingly, China has a hybrid system of private ownership and administered pricing. Can this hybrid system continue to allocate resources efficiently?

How then should we interpret China's growth experience?

- There exist two competing interpretations:
  - The *experimental* view
  - The *convergence* view

Experimental Interpretation

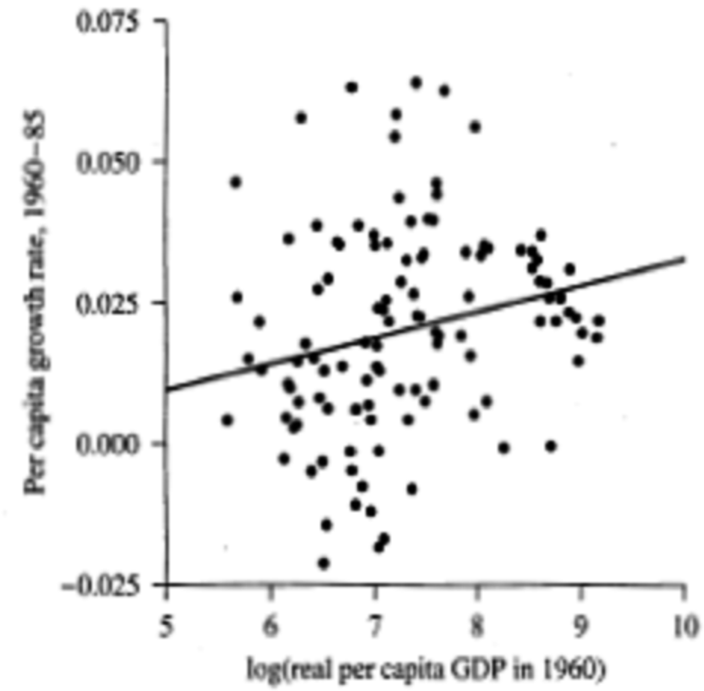
- The authorities are groping toward the creation of a unique kind of Chinese social market economy.
- Reforms have been gradual, incremental.
- Slow reform has minimized social conflict and instability.
- Incremental approach has allowed the authorities to avoid mistaken policies.

Convergence Interpretation

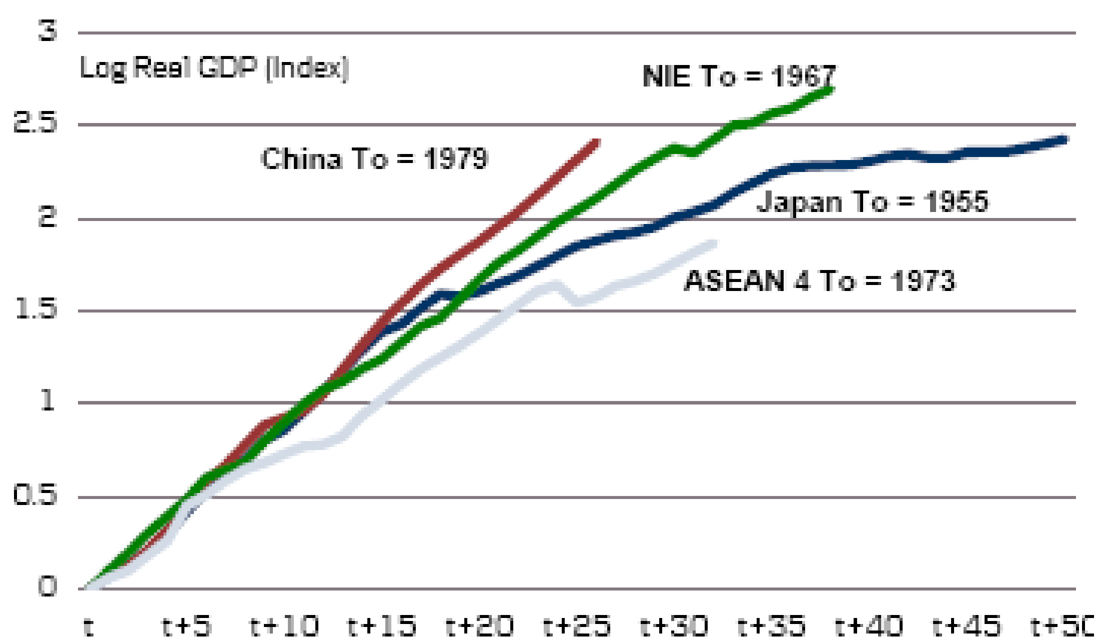
- China is reluctantly converging to standard model of market capitalism
- Its growth was fast despite the slow pace of reform, not because of it
- The slow pace of change and repeated reversals reflect conflict within the country over direction of reform, not a theory of experimentalism
- Special circumstances (unusually large share of agriculture combined with high population density on the land, small size of SOEs) made possible rapid growth despite slow reform.
- Implication is that the model would not have worked in other transition economies

Cross-Country Evidence

- Can we use international comparisons to shed light on this controversy?
- A cross-country growth model can entirely explain Chinese growth from 1979 through 1995 by invoking:
  - initial per capita income,
  - favorable physical access to sea lanes
  - export orientation,
  - proportion of labor force in low-wage agriculture
  - stable monetary and fiscal policies
- Implication: distinctive Chinese institutions and policy strategies added (and subtracted) nothing. They were neither the source of the country's rapid growth nor a barrier to it.



This is also more or less what this figure would have told us



- This is the kind of evidence cited by members of the convergence school when they argue “the convergence school is right and the experimentalist school is wrong.”
- But jumping to this conclusion leaves out something important. For exactly how the Chinese implemented their reform and liberalization was, in fact, distinctive
  - They started with reform of the rural sector, and followed only considerably later with reform of the industrial sector.
  - They took some unusual approaches to rural reform, initially encouraging collective ownership rather than private ownership.
  - And the main way the industrial sector was reformed was by growing new industrial enterprises (using the capital and labor resources provided by a now-more-efficient agricultural sector) rather than by closing down existing, inefficient state enterprises.

Reform of State Owned Enterprises (SOEs) was very gradual

- 1979-: managers could make decisions regarding bonuses, how and what to produce, market and how to price. Prices of outputs liberalized.
- 1983: Managers would sign contracts about taxes and profits to be turned over, but losses were forgiven.
- 1985-: prices of inputs liberalized. Small SOEs collectivized.
- 1990s: Privatization of small SOEs. 175 property rights exchanges were established to transfer ownership.
- Control of most SOEs transferred to local and regional governments. They see no particular advantage to having SOEs as opposed to a thriving local economy. They have been privatizing them at an accelerating pace.
- Turning large SOEs into joint stock companies to strengthen market discipline on managers. But shareholders have few rights. Can corporate governance be effective in this setting?

- Throughout, however, the productivity and profitability of the SOEs has been disappointing.
- The reason this has not held back Chinese economic performance is that the industrial sector, dominated by SOEs, was small at the outset of the transition.
- What differed between China and other transition economies, in other words, was not a superior policy strategy toward this problem but different initial conditions.

So why not go faster on SOE reform?

- SOEs continue to be important employers (although SOE employment has fallen by 50 m.).
- In a country where only 1 in 7 workers has some form of social insurance, more rapid downsizing of SOEs could fan political unrest.
- SOEs provide housing, health care, schooling, other social services.
- Absent a social safety net, SOE reform threatens essential protections for many families.
- And until the private sector ramps up further and the government enhances its revenue raising capacity, there are few alternative ways of providing these services.

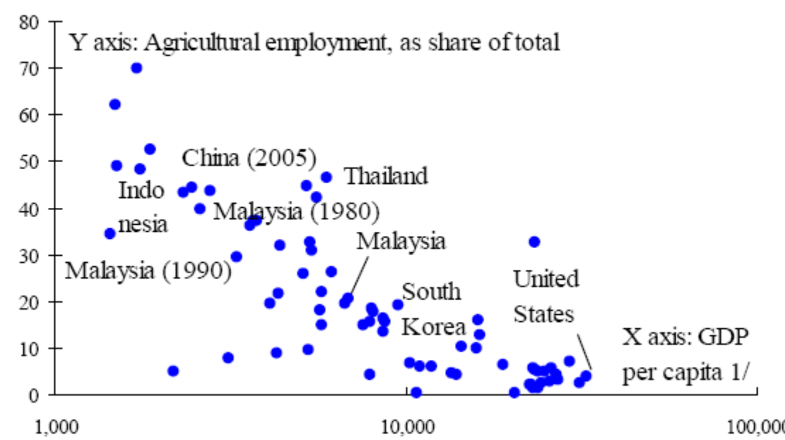
So for how long is China's present growth model sustainable?

- In pursuing a model of export led growth sustained by a stable, undervalued currency and high rates of capital formation, China is following the same model as Japan, Korea, Taiwan, Hong Kong, and Singapore.
- TFP calculations suggest that this strategy is very similar to its predecessors, and similarly based on extensive growth.
- At some point, China will have to move to more intensive growth. It is already beginning to move up the product ladder.

The model probably still has some time yet to run

- China still has 200 m. underemployed workers in ag. If the overall economy grows at 10% a year, it can absorb 10 m. of them annually. So China can maintain its present model of extensive growth, which is supported by abundant supplies of cheap labor, for at least another two decades, assuming that 10% is an upper bound on growth..
- Another way of putting the point is that the distribution of employment between ag, ind and services is the same as in the US 100 years ago.

Figure 6. China still has a large share of employment in agriculture



Source: WDI, NBS, authors' calculation. 1/ 2001, unless otherwise indicated.

Conclusions:

- China’s economic success puts paid to some simple-minded explanations for modern economic growth.
- In particular, the view that you need to put in place private property, strong investor rights, reliable contract enforcement, and an unfettered market economy all at once is hard to reconcile with China’s incremental approach – and the fact that it paid immediate dividends.
- Yes, growth requires governmental support, as we emphasized earlier. Chinese policies were considerably more supportive of economic activity and growth after 1979 than before.
- But it would appear from Chinese experience that this support can be provided in a variety of different ways. The “Washington Consensus recipe” (privatize, liberalize and stabilize, all as quickly as possible) is not the only way.

Conclusions

- For those who think that China's experience can be generalized, it is also important to observe that the country's circumstances were special (it had some special advantages):
  - A small industrial sector (compared to the former Soviet Union and Eastern Europe) meant that the problem of state-owned enterprises was not as severe.
  - The fact that the economy had been so screwed up before 1978 meant that there was considerable scope for making up lost ground if only a few basics could be put right.
  - The one child policy limited dependency ratios, and favorable demographics meant high labor-force participation and high savings rates. (Soon, of course, the tables will turn).
  - A large network of overseas Chinese meant access to technology and finance.

Conclusions

- This experience is, clearly, open to multiple interpretations.
- One way of understanding China's success is that it demonstrates the importance, when there is a centralized, authoritarian policy regime, of that regime strongly supporting growth, and doing so with sensible policies.
- In this view, China has benefited from a growth-oriented government that has followed a sensible, gradualist approach to liberalization and opening.
- But, in this view, the regime could equally, at any time, turn back in the other direction, re-nationalizing property and suppressing private enterprise as under Mao, shutting out foreign trade and investment as under the Mings and Qings. Centralized authority without checks and balances provides no protection or automatic self-corrective mechanism to guard against such decisions.

- Another view would be that maybe, as a result of market opening, there now exists a significant degree of government centralization and healthy competition.
- Maybe as a result of market opening, the constituencies for a form of market economy are too significant for the central authorities to turn back.
  - Maybe there exists a balance of power between Beijing and regional governments.
  - Regional governments now have to compete with one another to attract *foreign investment enterprises* (and enterprises generally). Maybe this competition makes for reasonably good, growth-oriented government.
  - Maybe the authorities in Beijing were constrained by fears of first rural and urban unrest – in other words, they had to pursue growth-promoting policies to stay in power.

- But even after Chinese experience had made this evident, in the 1980s, there were other developing countries that lagged behind.
- In substantial parts of the developing world – Africa, Latin America, even India – the decade of the 1980s was one of disappointing or no growth.
- Why was this?
  - Did some of these countries lack China's advantages (China has a long coastline; many African countries are landlocked. Who is better situated to grow by exporting?)
  - Did some of these countries have an even less favorable institutional inheritance (the slave trade, colonialization, and ethnic fractionalization leading to weak government)?
  - Good questions. Maybe next time we can suggest some answers…