The Rise of China's Economy

By William H. Overholt*

China's economic success, in contrast to that of the Soviet Union, is due to profoundly different economic and political strategies. China has emphasized areas where limited government investments would produce rapid growth and job generation. Farms were given back to the farmers, foreign investment was encouraged, and priority was given to light and medium industry where limited investment resulted in a surge in output. Politically, reform was divided into manageable phases to develop popular support.

MORE THAN ANY other country, China has stood at the pinnacle of world technology and income for the past 2000 years. But for the past two centuries China has experienced weakness abroad and fragmentation at home, and its people have lived in unspeakable poverty. As late as the early 1980s, more than 100 million Chinese had to subsist on an annual income that was less than the cost of a good dinner in New York.

All this is becoming a thing of the past. The Chinese economic takeoff that began with the implementation of Deng Xiaoping's 1979 economic reform plan is eliminating such poverty at a rate previously limited to South Korea, Taiwan, Hong Kong and Singapore. Before China accomplished this feat, virtually any observer would have judged such rapid growth to be impossible for a nation comprising one-fifth of the world's population and an exceedingly diverse economy.

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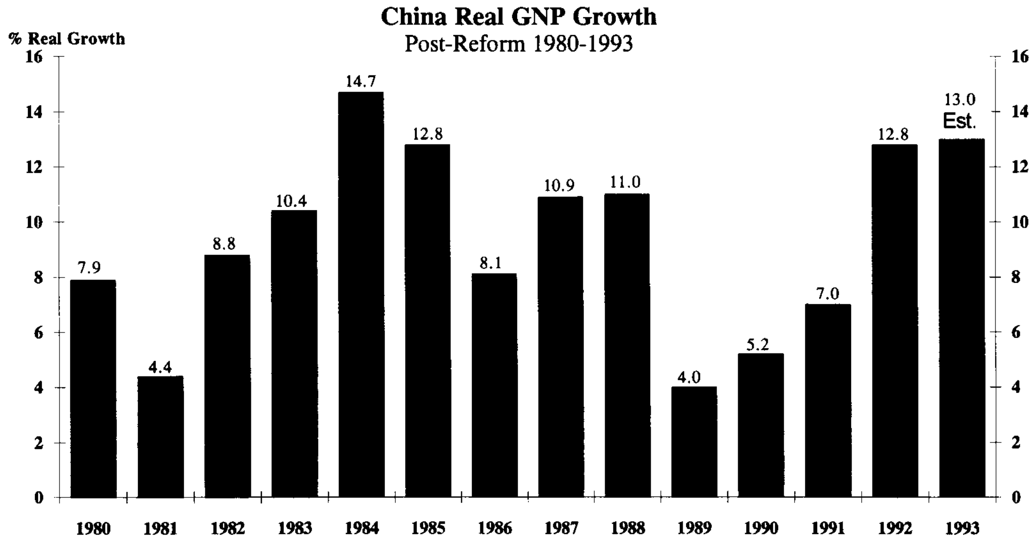
China's economic success has not been confined to raw economic growth. By 1991 foreign trade had risen to $166 billion, signifying that China had moved from autarky to being one of the world's major trading powers. China's exports climbed from a mere $14.8 billion in 1979 to $85 billion in 1992. Not only did exports rise, but they also became more sophisticated; in 1985 manufactured goods comprised only half of China's exports, whereas by 1991 they comprised more than three quarters of all exports.

In 1992 alone foreign investors poured $11.2 billion into China and signed agreements for $57.5 billion of future investments. By 1993 these numbers were approaching $20 billion and $100 billion, respectively. At the end of 1991, it had 37,215 foreign-funded enterprises that were producing $12.05 billion of exports, or just under 17 percent of the nation's total exports. In 1992 alone, the government approved an additional 47,000 foreign investment projects. Inflation, although periodically a serious problem, peaked at only half the levels experienced by South Korea in the late 1970s and one-hundredth of the levels experienced in Poland and the former Soviet Union.

THE BASIS OF SUCCESS: CHINA VERSUS THE SOVIET UNION

The differences between Chinese and Soviet performance derive from profoundly different economic and political strategies. Much of the West has long believed a myth that China is an impoverished version of the Soviet Union and must inexorable follow the latter's failures—because, after all, both were communist countries. On the contrary, China has been following a model of development more similar to South Korea than to its formerly communist bedfellows. Based on analysis of neighboring Asian countries, including most notable South Korea, Taiwan, Hong Kong and Singapore, China's strategy of development has been distinctively Asian. For the Western shopper, there is very straightforward evidence. In major department stores the shoes, shirts, sweaters and



Source: State Statistical Bureau

toys that once carried labels saying "Made in Korea" or "Made in Taiwan" now mostly says "Made in China." Virtually none say "Made in Russia."

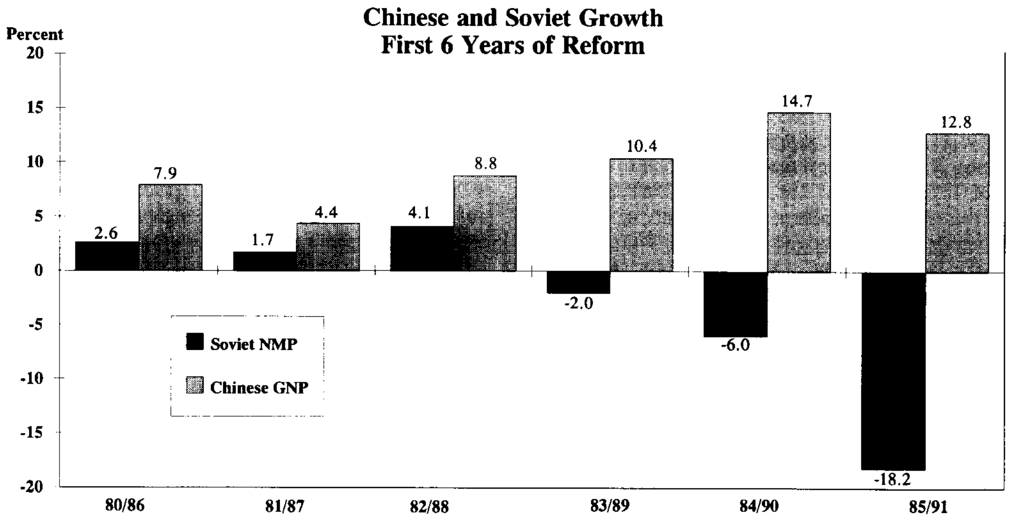
From the lessons of the neighboring small countries, then, Deng Xiaoping and his colleagues derived superior strategies in four areas: economics, politics, administration, and financial markets.

ECONOMICS

Following the examples of the New Industrializing Economies, China gave priority to industries and sectors where limited government investments would produce rapid growth. First, Beijing gave the farms back to the farmers, generating huge increases in productivity, income, and output with negligible state investment; the state's role was largely limited to issuing a legal ruling and using the existing administrative apparatus to enforce its decisions. Second, China was very encouraging to foreign investment. Although the incentives and rules governing foreign investment have required continual refinement, they were sufficiently generous to attract the huge amounts mentioned above. Finally, China gave priority to light and medium industry, where limited initial investment quickly yields a surge of output. Just as Taiwan and Hong Kong had flooded world markets with textiles, garments, shoes, toys, and consumer electronics in the 1960s and 1970s, China quickly became a global force in these same products for the 1980s and 1990s. As in the smaller Asian economic takeoffs, these policies caused an explosion of growth, consumer goods production, personal income, exports, and foreign exchange earnings.

In contrast, the Soviet Union neglected agriculture, was so ambivalent about foreign investment that it attracted very little, and devoted excessive attention to heavy industry. Gorbachev's early programs emphasized massive equipment imports, building more machines, intensified use of machine tools, organization of industry under superministries, improvement of the petroleum industry, and reorganization of the automobile and high technology sectors—all of which were capital-intensive industries. The later debate over privatization also focused excessive attention on industries with huge capital requirements and long leadtimes, rather than the sectors of low costs and quick payoffs. The result of this Soviet strategy, and of some other East European strategies, including most notably Poland's, was a collapse of production simultaneous with unbearable inflation.

We should not be surprised at the difference. The Chinese revolution, for all its flaws, had deep roots in a peasant society, whereas the Soviet revolution was just a Leninist coup brutally imposed from above. Guiding and relying upon energy from below came naturally to legatees of Mao Zedong, even though Mao would have despised the private enterprise and foreign presence that accompanied this particular energizing of the masses. Not that all was rosy. When reliance on the initiative of the masses went wrong, it resulted in the bloody egalitarianism of China's brutal land reforms and the Cultural Revolution. When channeled into a drive for wealth, however, it results in the clothing, sheltering and feeding of tens of millions of the world's poorest people. As a result, China's



Source: IMF; State Statistics Bureau; NMP is the best Soviet approximation of GNP

growth curve after reform resembles an airplane taking off whereas the U.S.S.R.'s resembles a submarine descending.

An important consequence of the Chinese strategy is the generation of millions of jobs for the people who need them most. In this strategy, the growth and income are focused on ordinary farmers and ordinary workers. Large numbers of workers produce, for instance, cheap shirts, and they generate the income to buy some of those shirts for themselves. In contrast, the Soviet or Latin American focus on heavy industry creates a much smaller number of much higher paid jobs, while leaving a huge fraction of the labor force unemployed; moreover, products such as steel have less immediate impact on people's lives. China's strategy has created a vast class of new consumers who wear modern clothing and use modern amenities. Market research commissioned by Proctor and Gamble indicates that there are now many tens of millions of Chinese who can afford five dollars to buy a bottle of Rejoice shampoo. China's Guangdong Province has become second only to the United States as a market for Proctor and Gamble's shampoos. Avon has more than 30,000 Avon ladies successfully selling Western-style cosmetics door-to-door in Guangdong Province. Motorola, which rates China the best place in the world to manufacture electronic equipment, expects China to become its second largest market in the world for second generation cordless phones.

POLITICS

Reform is a domestic political process. Great reformers like Turkey's Kemal Atatürk divide reform into manageable phases and in each phase build a politically overwhelming coalition of groups who see reform as serving their interests. Unsuccessful modernizers like the Shah of Iran antagonize so many groups simultaneously that they become overwhelmed by reaction. Deng Xiaoping was a model reformer in this respect, whereas Mikhail Gorbachev, notwithstanding his admirable record as one of the great international statesmen of the twentieth century, was a caricature of failure. It is noteworthy that virtually all Western writers about China have praised Gorbachev's strategy of doing everything at once, and attacked Deng Xiaoping's strategy of carefully sequencing reforms, whereas historically those reformers—from Joseph II of Austria to Kuang Hsu of China—who have tackled the whole range of reforms at once have mobilized opposition and seen their reforms defeated.

Deng's initial farm reforms doubled the incomes of China's farmers, winning the support of a group that comprises over 800 million people—not a bad start on a coalition. He then facilitated the rise of a class of small-scale entrepreneurs and stimulated the takeoff of light and medium industry, thereby gaining the support of tens of millions more workers and managers. While there were losers as well as winners among these groups, most were winners and—the key political fact—the winners were sufficiently numerous to include almost all of the brightest and most energetic members of these sectors. Deng revolutionized China's financial system and loosened somewhat the restraints on travel and exchanges of ideas by China's intellectuals and students, thereby winning to the side of economic reform these smaller but extremely influential groups. (After the Tiananmen Square incident, Deng decisively lost the support of intellectuals and students for his personal power and for the power structure generally, but these groups remained enthusiastic supporters of economic reform.)

Deng Xiaoping even managed to obtain the support of a majority of the military leadership for economic reform, in spite of the necessity of severely constricting military budgets in order to finance rapid economic advancement. Coincidentally, the year 1979 was both the year when implementation of reform began and the year when China clashed with Vietnam over the latter's involvement in Cambodia. While China achieved its objectives, its army was unacceptably bloodied. Deng successfully convinced much of the leadership that the Army's only salvation lay in access to Western weaponry. This required economic success to finance trade accommodation with Western countries to obtain access to weapons, and drastic cuts in the Army's budget and manpower in order to fund domestic economic progress. The military share of GNP fell from 10.5 percent of GNP to 3.7 percent. In addition to large personnel and budget cuts, soldiers fell far behind the rest of society in income gains, and they have had to go into business to support themselves, but on balance they have been among the strongest supporters of reform.

Likewise, most of the top leadership of the government and the Communist Party became advocates of reform. After the tragedies of the Great Leap Forward (1958-61) and the Cultural Revolution (1966-76), the radical ideologues were completely discredited and the top Party leaders knew that it had to try something drastically different in order to save both the country and themselves. Chen Yun, the most devoted to central planning of all the octogenarians, actually led the first phase of reform and never advocated reversing the extraordinary successes of his tenure in the early 1980s. Li Peng, a younger devotee of central planning, eventually found himself giving speeches about the virtues of socialist stock markets.

Some top leaders (often described as liberals) have strong convictions that the market is the right direction for the country. Others (often described as conservative, better described as the bureaucratic socialists) have discovered that they can only maintain their constituencies by providing economic benefits and that the only way they can provide economic benefits is by increasing efficiency through reform. Meanwhile, the families of both groups, and the families of senior army officers, were bought for reform by the special advantages of their situation: they could use socialist connections to get special advantages at making money in the marketplace. Thus, through a combination of idealism, expedience and corruption, the nation's power elite was enlisted in reform. Among prospective leaders in younger generations, there are those who would move forward more slowly and those who would move forward more quickly on market-oriented reforms, but none would move backward or stand still.

In contrast, Gorbachev quickly lost the support of virtually all important social groups for economic reform. Farmers remained as neglected and alienated as they had been since Lenin's time. Workers faced stern demands for harder work as their real wages collapsed and their vodka was curtailed. The managerial class found its power and perks curtailed while its real income fell and the overall strategy of industrial revival failed. The Communist Party leadership was told to run for election after three generations of alienating the population. The military, which already had access to high technology, lost much of its budget and access to new technological advance just as all the country's major allies were revolting and aligning with the former enemies to the West. All these groups had reasons to despise the consequences of Gorbachev's reforms and to resist further reform. The principal beneficiaries of Gorbachev's reform were intellectuals and foreigners, the former because freedom of speech was so overwhelmingly important to them, the latter because of Gorbachev's historic statesmanship in ending the cold war peacefully. Other groups were more affected by economic decline and by shame over the collapse of their country.

In politics as well as economics China was the beneficiary of successful Asian models, whereas the U.S.S.R. and Eastern Europe were the victims of inexperience and ideology—this time Western democratic capitalist ideology but ideology nonetheless. The notion that one can have all good things (democracy and all forms of economic liberalization) instantly and simultaneously has proved to be an ideological assumption in the strictest sense, a deeply held belief that has no grounding in practical historical experience.

In this case, we Westerners are in fact caricaturing our own ideology. There is an explicit set of assumptions, such as efficient information flows in capitalist economics, which clearly depend on institutional structures that have not been present in Eastern Europe and take time to build. Likewise, there is a literature on the prerequisites of democracy that dates back to the Greeks, and few of the prerequisites are satisfied by countries in the third world or Eastern Europe. One cannot build a modern glass-and-steel skyscraper just by putting dynamite under an old brick building and exploding it. Trying to create modern market democracies just by blowing up old socialist structures is equally futile.

China has emphasized gradual, carefully sequenced reform, whereas the former Soviet Union and Eastern Europe have been more attracted by spasmodic approaches, most notably Poland's Big Bang: precipitous liberalization of prices and privatization of enterprises. Sudden liberalization risks unacceptable inflation and currency collapse. Overnight privatization creates economic chaos. For instance, the Shatalin Plan, which received widespread Western approbation in the Gorbachev era, envisaged privatization of much of Soviet industry within 500 days. The same professors who applauded that plan would have recognized instantly that a plan to change the ownership and management of all the major firms in New York or London within less than two years could only result in chaos and collapse.

China's approach argues that price liberalization must be measured so as to avoid panic that results in hyperinflation, currency collapse, and political disillusionment with economic reform. Sudden liberation of prices in the context of the severe shortages of supply typical of socialism leads directly to hyperinflation. Poland's sudden liberation of prices produced inflation rates in excess of 2000 percent during the last four months of 1989. The former Soviet Union experienced 91 percent inflation in 1991, rates around 2000 percent in 1992, and an annual rate of around 3000 percent in January 1993. Simultaneously it suffered a potentially catastrophic collapse of its currency. The social consequences of such developments are severe. For example, in June 1992 Soviet farms were collapsing because "new equipment now costs 70 times what it did a year ago, while the price... for milk has gone up only sevenfold... Animal feed on the free market is priced out of reach." Severe inflation frightens away both domestic and foreign investment, thereby destroying the country's potential for economic growth. Inflation itself can be the cause of widespread unnecessary bankruptcies. Such problems throughout Eastern Europe and the former Soviet Union led to widespread political disillusionment (in these cases, with democracy) by early 1992.

China has, on the other hand, liberalized prices gradually, and, like other Asian countries such as Indonesia, has been careful to ensure that the price of rice is not allowed to become so volatile as to endanger the lives of subsistence-level rural people. During liberalization, China has built the institutions that will enable it to control inflation, namely credit controls and bond markets. The result has been rapid growth with a manageable inflation cycle. China's national inflation never exceeded 20 percent (less in the countryside where most of the people live, and about double that level in major cities).

China has been particularly cautious about privatization. If one privatizes before price reforms have taken full effect, then many firms are bankrupted not because they were inefficient but because their product prices were set below market. For instance, it is not unusual in some socialist countries for prices of a commodity like coal to be set at only 5-10 percent of market levels; having to sell so far below market prices will quickly bankrupt the coal company if it suddenly loses subsidies and has to pay market prices for inputs. Moreover, this problem is not really solved by Big Bang price liberalization, because an effectively liberalized price system does not mean just instant freeing of prices but also a network of institutions that can receive price signals, analyze trends, and take appropriate action; such a network of institutions takes years to develop. If one privatizes rapidly at a time when inflation is high and growth low, as is typical in the early phases of spasmodic liberalization, then one creates mass unemployment at just the time when the economy is least able to absorb extra workers.

Just as important, premature privatization can starve the nation's retirees, because in many of these systems pensions are paid by the enterprises. It can expropriate the rights of long-serving employees, who had a right to company housing, pensions, medical care, and education under socialism and would have earned a private home under capitalism, but may find themselves suddenly homeless and bereft as a result of premature privatization. Such privatization can cause collapse of a banking system that has been forced for generations to carry loss-making state enterprises by making ever-larger "loans" to them.

Finally, an efficient national privatization program requires stock markets, analysts to assess the value of companies, and brokerages to communicate the analysis and to manage stock transactions. Without such a system for assessing the efficiency of companies, analyzing economic trends, communicating the findings widely, and trading efficiently, capitalism cannot function and may produce worse than socialism. Hence China has a policy of delaying privatization until it has successfully liberalized prices, created a national pension system, provided alternative medical and education programs, undertaken major banking reforms, and created working stock markets. It is characteristic of China's reform that it has moved its currency to near-market levels and opened its stock markets to foreigners in a much earlier phase of reform than South Korea and Taiwan, but has been much more determined than East Europeans to create the institutions necessary to make markets work properly before undertaking widespread changes of ownership.

No policy has been more criticized in the West than

China's caution regarding privatization. No policy, however, has been more central to China's success than its gradual but steady emplacement of the foundation stones for successful privatization. Spasmodic privatization of major industries—as recommended by Jeffrey Sachs and others—followed by collapse of production in turn deters foreign and private investors. In contrast, China has focused on stimulating an explosion of investment and production by foreign and private investors and using the new production to alleviate its people's poverty and to fund the solution of the problem of the state sector.

Recently, advocates of shock therapy have argued that China's most successful phase of reform, namely agricultural reform, occurred very quickly and in effect was a form of shock therapy. While reform did occur very quickly, this analysis is erroneous. Return of the farms to the farmers began spontaneously in Guangdong without government approval. It led to such immediate economic and political benefits that the government endorsed it and facilitated its spread rather than suppressing it. The difference from shock therapy is that there was no shock. Avoidance of shock has been the essence of Chinese policy.

The other central difference between China's approach and the East European approach has been construction versus destruction. Jeffrey Sachs and his colleagues have focused on the destruction of socialist institutions, namely central planning and state enterprises. China has concentrated on construction of market institutions, namely private enterprises, investment systems, stock and bond markets, workable price mechanisms, and most recently modern banks. If one defines the goal as decreasing the share of socialist production in GNP, then one can say that Poland has focused on decreasing the numerator while China has focused on increasing the denominator. The denominator is more malleable, and increasing it expands popular welfare.