Chapter 12

THE CHINESE ECONOMIC SYSTEM

"Americans are just beginning to catch up to the significance of what's been happening in China, and I don't believe they've caught up yet."

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China currently has the most dynamic economic system in the world, recording average annual growth rates of around 10 percent since the government began moving away from communism in 1979. At that rate of growth, **gross domestic product** (GDP) has doubled every seven years, enabling 500 million people to escape poverty in the past thirty years. However, standards of living for most Chinese remain quite low, with **per capita GDP** of about $12,000, just slightly higher than in Egypt or Peru.

In 2010, China surpassed Japan to become the second largest economy in the world and, if current growth rates continue, will surpass the United States in 2029. With one-fifth of the world's population (1.4 billion people), many of whom are living in rural areas and only marginally engaged in the modern economy, China's potential for additional growth is staggering. Yet serious challenges loom over the economy, and China's response will shape the future of the global economy.

PRE-COMMUNIST CHINA 1644–1948

The Chinese Empire was founded in 221 BCE and remained stable and relatively prosperous under seventeen different dynasties for more than 1,500 years. Government was highly centralized, with a competent bureaucracy administering public affairs. By the tenth century, when most of Europe was just emerging from the Dark Ages, China was the most advanced civilization on earth. Its dominance continued until about 1400, as the government used tax revenue to build **infrastructure** such as large-scale irrigation systems and roads. Evidence of China's technological superiority at the time includes the inventions of porcelain, gunpowder, the compass, casting of iron, woodblock printing, machines to spin thread, and paper currency.

In 1644, tribes from the northern province of Manchuria founded the Qing Dynasty. From that point onward, the Chinese economy deteriorated. At the

same time, mercantilism was paving the way for the emergence of capitalism in the West. This simultaneous development in Europe and stagnation in China has been labeled "The Great Divergence."

Weaknesses of the Chinese Empire

What aspects of the Chinese Empire led to its downfall? Some of the usual explanations for the collapse of empires do not apply to China. Imperial overreach was not a factor. After early commercial forays into Southeast Asia, China largely withdrew from contact with other nations. Also, the rulers of the Chinese Empire did not oppress citizens or squander the economy's surplus on royal extravagance. Instead, government affairs were conducted by highly educated civil servants (mandarins) who attained their positions through competitive examinations and were devoted to maintaining peace, prosperity, and stability throughout the country. Although no clear consensus exists among historians on the causes of China's stagnation after the seventeenth century, several factors are relevant.

Chinese Culture

The Chinese Empire sought to supplement state power by creating a sense of national community among citizens. This strategy entailed strict adherence to ethical principles based on the teachings of Confucius (551–479 BCE). By emphasizing social obligations and duty to superiors, Confucianism was invaluable in creating stability and order, but the suppression of self-interest discouraged entrepreneurship, risk-taking, and accumulation of wealth. Merchants in China had low social status because they were perceived as self-interested and unwilling to work cooperatively with others as part of a community.

Political Unity

Unlike Europe in the Middle Ages, where rival states competed for military supremacy, China was a unified empire. With the exception of the Mongol invasion and subsequent rule of Kublai Khan (1215–1294), China faced no external threats. This lack of competition between states meant that Chinese rulers faced no pressure to develop more efficient economic and political institutions. A second problem created by political unity was the absence of an independent aristocracy to challenge and limit the power of the state.

Political Suppression of Commerce

Unlike mercantilist Europe, the Chinese Empire derived its tax revenue from agricultural production. With no wars to fight, the state had little interest in promoting commerce to gain more tax revenue. Market activity was tightly regulated, and the state allocated credit based on personal connections to government. By keeping commercial activity in the hands of loyal supporters, the rulers sought to prevent the accumulation of large fortunes that could potentially threaten the power of the state. The suppression of commerce was aided by the fact that many large-scale investment projects were **public goods** that no private entrepreneur could undertake. For example, Chinese agriculture depended on extensive irrigation systems which were constructed and maintained under the supervision of the government.

Isolationism

The Chinese economy also failed to thrive due to the decision by rulers to turn inward and withdraw from engagement with other countries. This isolationism resulted in both limited access to resources and reduced demand for Chinese goods that might have been exported. While European nations were engaged in exploration and colonization to open markets around the world, China was content to remain economically independent.

Population Growth

Much of China is arid and mountainous. After 1644, rapid population growth combined with a shortage of arable land and a stagnant economy caused living standards to steadily deteriorate. Surplus labor kept wages very low, which reduced the incentive to develop labor-saving technology and suppressed demand for consumer products.

Loss of Human Capital

Government suppression of business activity by the Qing Dynasty caused an outflow of entrepreneurial talent as Chinese business people spread out over Southeast Asia in search of better economic opportunities. The effects of this diaspora are still evident today as ethnic Chinese dominate commerce in many Southeast Asian countries. The suppression of business also impeded the formation of **human capital**. With a stagnant economy, jobs in government civil service offered one of the few pathways to success. Because government jobs required that candidates take competitive examinations testing their knowledge of Confucianism, intelligent and ambitious individuals were more likely to study Confucianism than to pursue a career in science or business. In fact, China largely missed out on the scientific revolution of the seventeenth and eighteenth centuries. Without a systematic method for conducting scientific experiments, the development of technology in China quickly fell behind European advances.

The Demise of the Chinese Empire

By the nineteenth century, the Chinese Empire was disintegrating for both internal and external reasons. Internally, increasing economic hardship created social unrest as manifested in religious uprisings, revolts against the government, and the formation of secret societies. The Taiping Rebellion, a civil war lasting from 1850 to 1864, resulted in twenty million deaths. Led by Hong Xiuquan (1814–1864), who claimed to be the younger brother of Jesus, the rebels gained control over half the nation and established their own capital city at Nanjing. To combat the rebellion, the Emperor encouraged provincial officials to organize their own

armies, but these armies subsequently formed the power base for regional warlords who challenged the authority of the Qing dynasty.

Externally, China was increasingly the target of Western **imperialism**. British traders wanted Chinese tea and silk, but the Chinese had no interest in exchanging their goods for British textiles because they were capable of manufacturing their own fabrics. Needing a commodity that could be exchanged for tea and silk, the British began shipping opium from India into China. When the Chinese government objected and destroyed a large cache of opium in Canton, the British launched a military attack. In the Opium War of 1840–42, The British seized Hong Kong and forced the Chinese government to pay $27 million for the destroyed opium. In 1858, the British and the French again used military action to force China to accept opium in exchange for Chinese goods. Foreign troops occupied Peking, destroyed the royal palace, and extracted reparation payments to cover the cost of war. By the end of the nineteenth century, 10 percent of the Chinese population was addicted to opium.

China suffered further humiliation in a war with Japan in 1895 that resulted in the loss of the island of Formosa (now Taiwan). Reacting to continuing defeats by foreign imperialists, a group called the Boxers formed to defend Chinese culture from foreign influences. The 1900 Boxer Rebellion resulted in the burning of foreign churches and embassies and the murder of missionaries and diplomats. Troops from the United States, Britain, Germany, France, and Japan entered China to suppress the rebellion and simultaneously laid claim to various Chinese islands and coastal enclaves to serve as entry points into the Chinese market.

The inability of the Chinese Empire to protect itself from foreign incursions led to increasing discontent, particularly among youth. In 1894, a medical student named Sun Yat-sen (1866–1925) founded a secret society with the intent of overthrowing the Qing dynasty. His efforts culminated in a successful revolution in 1911 and the establishment of the Republic of China with its capital in Peking. The new government, however, was unable to secure effective control over the county and became the puppet of regional warlords determined to resist centralized political authority. Sun Yat-sen responded by founding the Nationalist Party (Guomindang), which established a rival government in Canton. A civil war between the two opposing governments engulfed the nation for the next fifteen years.

The Chinese Communist Party (CCP) was founded in 1921, and the Soviet Union brought young leaders, including Mao Zedong (1893–1976), to Moscow for education and training. Mao believed that only communism could free China from domination by warlords and foreign imperialists. Sun Yat-sen also turned to the Soviet Union for support, and he was instructed to cooperate with the Communists in fighting the warlord-dominated government in Peking.

Sun Yat-sen died in 1925, but his successor, Chiang Kai-shek (1887–1975) initially agreed to work together with the Communists. However, by 1927, the Nationalists felt sufficiently confident in their control of government to turn against their allies. The Nationalists rounded up thousands of Communists for mass executions, forcing Mao and 90,000 of his followers to flee the cities. They were pursued by the Nationalists over a two-year period (1934–35) for 6,000 miles from southeast China to remote mountains in the northwest, where the Communists established an impregnable base of operations. This "Long March" was one of the epic events in Chinese history.

Taking advantage of China's internal turmoil, Japan invaded and took possession of the northeastern province of Manchuria in 1931. A long and brutal struggle between the Japanese and the Chinese ensued over the next fourteen years as the Japanese conquered most of northern and eastern China. The Chinese death toll from that war is estimated at more than twenty million people. In 1936, with the nation's independence at risk, Communists and Nationalists set aside their differences and united to fight the Japanese. However, as soon as World War II ended in 1945, the truce was broken, and civil war resumed in China. With their promise to redistribute land to peasants, the Communists rapidly gained support in rural areas. They captured cities by encircling them and cutting off food supplies. In 1949, the Communists won the civil war, and the Nationalists fled to the island of Formosa (now Taiwan), which had been reclaimed from Japan.

CHINESE COMMUNISM 1949–1978

The Communists inherited an economic system devastated by a century of civil wars, foreign invasions, and imperialism. Their initial policies were aimed at stopping inflation, confiscating the land of the warlords, and distributing land to the peasants who cultivated it. By 1952, eleven million acres of land had been distributed to 300 million peasants. The government also confiscated foreign-owned assets, but Chinese citizens were permitted to own businesses.

In 1953, China initiated its first five-year plan for the economy modeled after planning in the Soviet Union. The plan called for raising agricultural productivity and using the agricultural surplus to feed industrial workers and to export in order to gain **financial capital** for industry. The single-family farms established through land redistribution were too small to be efficient, so the government ordered the formation of mutual aid teams consisting of small groups of five to fifteen households sharing land, draft animals, and tools to work collectively.

A year later, the mutual aid teams evolved into agricultural cooperatives consisting of twenty to forty households with collective ownership of all capital. The purpose of forming larger production units was to increase productivity through cooperation, **economies of scale,** and the ability of the CCP to monitor work effort. The collective farms were required to pay taxes and to sell their goods to the government at low prices. The government sold the food at higher prices, using the tax revenue and profit to fund expansion of industry.

The first five-year plan also entailed the nationalization of most industry and the use of central planning to coordinate economic activity. The Soviet Union offered loans and sent more than 15,000 engineers and technicians to advise the Chinese in constructing and operating factories and power plants.

The Great Leap Forward

The Chinese economy remained sluggish, and by 1958, Mao became disillusioned with the Soviet model of development. Whereas the Soviets had focused on rapid development of heavy industry and large-scale manufacturing, China's major resource was labor. The second five-year plan, called the Great Leap Forward, continued to focus on raising agricultural productivity but dispersed industrial production by establishing small factories scattered throughout the countryside. This strategy sacrificed economies of scale to conserve on scarce capital and rely more heavily on China's plentiful labor.

To improve agricultural productivity, the government abolished privately owned farms, which, along with collective farms, were merged into 25,000 large communes—each with an average of about 5,000 households. The communes provided communal kitchens and free healthcare, senior citizen centers, schools, and nurseries so that working adults could devote full time to production. To decentralize industry and make it more labor-intensive, "backyard factories" were built on the communes to enable local production of steel, chemical fertilizer, cement, hydroelectric power, and tools. The effort to conserve capital was also evident in the construction of infrastructure such as roads, canals, and dams. Hundreds, and sometimes thousands, of people were gathered at the construction site with little more than picks, shovels, and baskets to move massive amounts of earth.

The labor-intensive strategy underlying the Great Leap Forward was based on more than just conserving scarce capital. Mao believed that the Chinese people had the potential to transform the country if they were fully mobilized and engaged in the effort. To this end, he sought to develop an entirely new culture based on selfless dedication to building a new society. Old cultural traditions such as festivals, religious rituals, and elaborate funerals and weddings were banned. Instead, the Chinese people were required to participate in political group discussions designed to instill a strong community spirit and willingness to sacrifice for the good of the nation.

Both subtle and overt coercion were used to "raise the consciousness" of the peasants. Public address systems carried a steady stream of Maoist ideology, glorifying communism and condemning bourgeois self-interest. Communist cadres used physical violence to punish anyone deemed to be counterrevolutionary. Party officials justified this use of force, insisting that only by working together for the common good could China escape its centuries-long poverty and oppression.

By 1960, the Great Leap Forward was clearly failing—mass starvation spread across the country. Natural disasters played a role as a combination of droughts, floods, locust infestations, and rats wreaked havoc on crops. However, Mao's policies were largely responsible for the famine. The relocation of peasants from agriculture to industry caused a drop in farm output. New, untested planting methods proved to be ineffective. In addition, the government established mandatory quotas for agricultural output, and farmers were allowed to keep only whatever surplus remained after they met the quota. The combination of misguided government policies and natural disasters eliminated the surplus, and at least twenty million people died from hunger as agricultural output fell by 30 percent between 1958 and 1960.

Although manufacturing output increased, the results were unsatisfactory. The quality of products coming from the small, communal factories was poor, and, without economies of scale, production methods remained highly inefficient. Also, China lacked sufficient transportation **infrastructure** to move resources and products quickly around the country, so shortages of parts and materials frequently halted production. Representatives from the Soviet Union were so dismayed by Mao's policies that they withdrew their advisors and technicians who, to compound the problem, took the blueprints and operating manuals for many of the power plants and factories with them. The Great Leap Forward was so disastrous that Mao was removed from his position as head of state. After 1961, some private ownership in agriculture was restored, communes became smaller, and farmers were allowed to sell their surplus crops in local markets.

The Great Proletarian Cultural Revolution

Mao was now in a power struggle for control of the country. In 1966, he initiated the Great Proletarian Cultural Revolution to energize the masses by leveling social distinctions and attacking anyone in a privileged social position. These elites included not only his rivals in the Communist Party, but also professors, lawyers, scientists, bureaucrats, writers, artists, and anyone who failed to openly support Mao's policies. Mao accused his opponents of being "capitalist roaders" trying to steer China toward capitalism's reliance on self-interest and markets.

Calling for permanent revolution, Mao ordered the relocation of many urban professionals to rural communes where they performed manual labor alongside the peasants. Factory managers were required to engage in menial tasks such as sweeping the shop floor. The teenage Red Guards harassed and humiliated professionals, intellectuals, and academics suspected of being bourgeois or counterrevolutionary. All high school graduates went directly to a factory or commune where their fellow workers decided who would go on to college based on job performance and "ideological correctness." Once in a university, students were required to combine periods of manual labor with their studies. A collection of Mao's ideas known as "The Little Red Book" became the source of all political wisdom.

Culture

In addition to attempting to eliminate class distinctions, Mao was determined to revolutionize China's culture, which was dominated by ancient rituals and traditions. He sought to erase past culture by ordering the destruction of historical artifacts, books, paintings, and religious sites. Even Confucianism was attacked

for its emphasis on duty to the family rather than the state and its failure to promote economic development. Citizens were required to engage in sessions of "criticism and self-criticism" in which they pointed out the bourgeois tendencies of neighbors and coworkers and then confessed their own shortcomings.

The Demise of Chinese Communism

The Cultural Revolution was disastrous for the Chinese economy. Output fell 18 percent in 1967, and was no higher in 1969 than it had been in 1966. Mao's power within the Communist Party was again slipping as the failure of the Cultural Revolution emboldened rival factions to question his leadership. When Mao died in 1976, a power struggle ensued over the future course of the country. On one side was the Gang of Four, which included Mao's wife. They wanted to continue the emphasis on leveling class distinctions, suppressing bourgeois tendencies, and isolating China from the rest of the world. An opposing group, derisively called the "capitalist roaders," favored more pragmatic reforms relying on material incentives to reward productivity, greater decentralization of decision-making, and opening China to international trade. The capitalist roaders prevailed, and beginning in 1979 under the leadership of Deng Xiaoping (1904–1997), a series of major policy changes fundamentally reshaped the Chinese economic system and gradually introduced capitalism.

STATE CAPITALISM 1979–PRESENT

Transition from Communism to Capitalism

China and Russia both made the transition from communism to state capitalism, yet China now has the most dynamic economic system in the world while Russia has yet to thrive. Several factors have contributed to these diverging paths.

Pretransition Conditions

Differences in the economic systems of the Russia and China prior to the abandonment of communism may explain their contrasting achievements since the transition.

First, in the Soviet Union, political control was loosened before privatization of property began, so the government felt the need to privatize swiftly before popular discontent led to social disorder or a resurgence of support for communism. In contrast, the CCP maintained tight political control, enabling it to conduct gradual experiments with markets and privatization.

Second, China was less industrialized than the Soviet Union. Because of China's relatively primitive communication and transportation systems, its central planning never matched the Soviet Union in detail or scope. As a result, the transition to local control and decentralized decision-making was easier in China. Despite Mao Zedong's image as a communist hard-liner, his repeated efforts to foster local initiative and autonomy left a legacy of entrepreneurial energy that is contributing to the dynamism of China today.

Third, the Soviet Union's history of oppression by tsars, aristocrats, and then communist elites created widespread cynicism and antipathy toward government. In contrast, the Chinese Empire, whatever its failings in promoting economic development, was benevolent in its intentions, and the large majority of Chinese citizens remained loyal to the government even through the worst phases of communism. Mao remained highly popular until his death because the general populace viewed him as genuinely devoted to lifting China out of poverty and ending domination by foreigners. Public support allowed the government to experiment gradually with reforms designed to move toward capitalism.

Access to Financial Capital

Whereas Russia had virtually no economic ties with noncommunist nations when it began the transition to capitalism, China quickly established links with Western financial markets through the British colony of Hong Kong. Foreign investors preferred China's political stability to the often-chaotic transformation in Russia. Moreover, many of the most prominent business people throughout Southeast Asia were of Chinese descent and therefore eager to transmit technical expertise and investment funds back into China. Between 1982 and 1994, 70 percent of foreign investment in China came from ethnic Chinese outside the country.

Pace of Change

Unlike the shock therapy applied in Russia, the Chinese relied on gradual trial-and-error to guide their path toward a new economic system. The resulting differences are striking. Whereas Russia experienced sharp increases in unemployment and inflation, declining output, and general social distress, China's path to reform yielded annual growth rates of around 10 percent. A gradual transition allowed new economic institutions to develop, evolve, and gain popular support. Mistakes could be recognized before they threatened the stability of the entire system. China's gradual transition away from communism gave citizens a relatively stable economy in which to learn and adapt to the attitudes and skills required for success in the market. By contrast, the shock therapy applied in Russia assumed that citizens would immediately become effective entrepreneurs despite an economic climate of rising unemployment, falling standards of living, failing firms, and widespread crime and corruption.

Goals

Mikhail Gorbachev's failure to steer the Soviet Union toward a viable socialism led reformers in Russia to embrace the vision of a pure free-market system. Government officials consulted with Western free-market economists, who advised the immediate privatization of all property and minimal government intervention. These economists failed to consider the compatibility between free markets and Russia's political and social institutions. The Chinese government, on the other hand, did not fully embrace free markets and remained committed to

fashioning economic institutions that were compatible with Chinese culture. Chinese reformers have been willing to try various forms of ownership and markets without being committed to either capitalism or socialism. In the words of Deng Xiaoping, "Black cat, white cat, what does it matter what color the cat is as long as it catches mice."

Strong State

Russia's focus on dismantling state power allowed organized crime syndicates and ruthless oligarchs to steal much of the newly privatized property and to continue to undermine the Russian economy. In contrast, the CCP has maintained firm political control over the country to ensure a stable and orderly transition away from communism.

Agricultural Reforms

China's transition to state capitalism began with reforms in agriculture. In 1979, a "household responsibility system" reduced the size of communal farms and provided incentives for individual households to increase productivity. Although land remained under state ownership, households leased plots for a period of fifteen years, ensuring that any gains in productivity would accrue to the producers. By the mid-1980s, 93 percent of China's farmland was cultivated by individual households who, in return for use of machinery and equipment, were obligated to sell 40 to 50 percent of their produce to the state at preset prices. Any excess could be sold in the market or to the state at a higher price.

In 1988, the contract period for leasing land was increased to thirty years, and government took on a larger role in providing agricultural infrastructure such as irrigation and transportation systems. With each passing year, the percentage of agricultural output sold at market prices has increased until it now stands at more than 80 percent.

Agricultural land is still owned by the state, but farmers have the right to sell their leases and to use the value of their land as collateral in obtaining bank loans. By allowing the sale of land leases, the government hopes that market forces will lead to farms of the most efficient size.

Township and Village Enterprises

During the early 1980s, the CCP began decentralizing political authority by giving local officials greater discretion in establishing policy. This local autonomy led to many experiments aimed at improving the productivity of the backyard factories that had been established in rural areas during the Great Leap Forward. Although formal ownership of these small manufacturing enterprises remained in the hands of local governments, private managers were given authority to decide what to produce, what resources and technology to use, and whom to hire and fire. Any profits remained in the local community and were used either for reinvestment or to provide public goods such as schools and health clinics. Other than preferential access to credit, these township and village enterprises (TVEs) received no government subsidies or bailouts, so if they failed to produce goods that consumers wanted, they faced the real prospect of bankruptcy.

By 1985, twelve million TVEs were the major source of new jobs and growth in China. TVEs served as incubators for entrepreneurs who subsequently started their own private businesses. Beginning in 1995, TVEs began to fail at a rapid rate, with 30 percent of them declaring bankruptcy within a two-year period. There were several reasons for this decline. Many managers found better opportunities for profit by starting their own private firms. In addition, by this time, the government was convinced that small businesses were more efficient under private ownership than public ownership and therefore made "credible commitments" to entrepreneurs that that their private property rights would not be violated. Finally, entrepreneurs were motivated to start their own businesses because they could keep all the profits rather than sharing them with the local government. Despite the rapid decline of TVEs, they served as an effective institution for facilitating the transition from collective ownership to private ownership.

Privatization

Private businesses were first permitted in 1978—but only for firms with fewer than eight employees. Deng Xiaoping signaled government approval of private ownership by saying "to get rich is glorious." Since then, the number of private firms has grown steadily, with the private sector surpassing the state sector in the mid-1990s and now accounting for nearly 70 percent of GDP. Most private businesses in China are retail stores and restaurants, but large manufacturing firms as well as joint ventures with foreign companies are also prevalent. They operate very much like private firms in the West, hiring and firing workers based on productivity, paying wages no higher than necessary to attract qualified workers, and seeking to maximize productivity and profit. In 1993, new laws regarding corporate governance and shareholder rights were patterned closely after US laws.

Sweeping generalizations about the relation between government and private businesses are difficult for two reasons. First, decentralization of political authority has led to different reforms in different regions. Local and provincial governments experiment with various forms of regulation, taxation, and provision of infrastructure. In general, however, a high degree of cooperation exists between the public and private sectors because both government and businesses recognize their mutual interest in economic growth. Rapid growth provides businesses with more profit and government with more tax revenue. Second, negotiations between business people and local government officials involve both formal rules and informal procedures. Property rights in China are best described as "fuzzy," and the rule of law is frequently open to exceptions. This reliance on personal negotiations has led to charges of "crony capitalism" as one business might be awarded a government contract or a low-interest loan after conversations with government officials. However, the Chinese have a very different perspective on the role of negotiations. They believe that face-to-face relations and getting to know people contribute to successful business relations by creating opportunities to assess the other person's character and to establish trust.

State-Owned Enterprises

Despite extensive privatization, China continues to maintain about 130 massive businesses owned by the state. These state-owned enterprises (SOEs) are found primarily in industries with extensive economies of scale, which might lead to natural monopolies even in a purely market economy (e.g., transportation, telecommunications, steel, ship-building, aerospace, nuclear energy, mining, oil, natural gas, utilities, banking, and insurance). Beginning with reforms in 1986, the government has attempted to improve SOE productivity by issuing four-year contracts to sell specific quantities of output and to remit a fixed portion of profits to government. Any excess output can be sold in the market, and additional profit can be used for employee benefits or reinvestment. SOEs purchase their resources through the market and charge prices for their products based on supply and demand.

Although output rose dramatically after these reforms, several undesirable effects also materialized. Setting production quotas provided incentives for managers of SOEs to maximize output, but quotas also created an incentive to understate productive capacity in order to persuade central planners to set a low quota. In addition, SOEs tended to exaggerate their need for resources because more resources increased the size of the surplus that could be sold in the market.

In 1992, a new round of reforms led to the privatization or closing of thousands of SOEs. By the mid-1990s, one-third of the surviving SOEs were still operating with negative profit, leading to additional closings and privatization. Some of the SOEs have been converted to employee stock ownership programs (ESOPs) in which workers hold shares of stock in the company and receive dividends proportionate with profitability. In 2007, the remaining SOEs were listed on the stock exchange so that private investors could purchase partial ownership.

Although relatively small in number, the remaining SOEs are so large that they account for 30 percent of all business activity. The government insists that SOEs will remain a fundamental part of the economy, but as the private sector grows, the SOEs will be under increasing pressure to improve productivity. The government is adding to this pressure by increasing the portion of SOE profits remitted to government from the current level of around 12 percent to 30 percent by 2020. This additional burden will result in one of two effects. Either more SOEs will be gradually privatized as they are forced to seek infusions of private capital or they will become more efficient and government will reap much of the additional profit.

Special Economic Zones

During the initial phases of economic reforms, nationwide reforms were considered too risky, so the Chinese government established special economic zones (SEZs) along the southeastern coast. Beginning with four cities in 1978, SEZs expanded to include all of coastal China plus the capital cities of each of the provinces. Within these zones, the government enacted new policies relating to foreign trade, labor markets, stock markets, SOEs, and foreign investment. The SEZs offer extremely low taxation of profits, less regulation, subsidized utility rates, and low rents to attract foreign investment and joint ventures between Chinese and foreign companies. With memories of past imperialism, the Chinese give preferential treatment to ethnic Chinese investors living outside of China, but they are also willing to negotiate with non-Chinese businesses.

The SEZs serve both economic and political purposes. One economic rationale for geographical concentration of business activity is that providing infrastructure such as transportation and communication systems is less expensive if businesses are in close proximity. Also, positive **externalities** are generated as firms benefit from each other's ideas and innovations. Politically, SEZs provide government officials with opportunities to assess the effects of market reforms on the quality of life before opening the entire country to such changes.

The downside of SEZs is the rising social problems that typically accompany rapid urban industrialization. More than 120 million people have migrated from rural areas to the coastal cities seeking work, and as a result, traffic congestion, pollution, unemployment, crime, and homelessness are all on the rise.

Financial Reforms

In the Maoist era, nearly all banking and finance was conducted through the People's Bank of China (PBC). After extensive financial reforms, the PBC now serves simply as the central bank issuing currency, supervising other banks and conducting monetary policy. The PBC relaxed controls on interest rates in 2013 and initiated deposit insurance in 2014. Government controls on the flow of financial capital in and out of the country have also been loosened. Four large state banks oversee the allocation of credit to SOEs, with each bank specializing in loans for construction, agriculture, foreign trade, and industry and commerce. These state banks collectively hold more than 80 percent of all bank assets. In addition, China has commercial banks that lend to private enterprises, state development banks for fast-growing regions, and local credit cooperatives.

The rationale for decentralizing the banking system was to introduce competitive market forces to create greater efficiency in the allocation of credit. However, the dominant state banks continue to base their lending on politically determined priorities rather than the credit worthiness of borrowers. For example, money may be lent to a failing SOE while profitable private firms have difficulty obtaining credit. Stock exchanges opened in 1990 in the cities of Shanghai and Shenzhen. Both Chinese citizens and foreigners may buy and sell stocks in Chinese companies, including state-owned enterprises (SOEs). However, only a portion of SOE shares are available for public sale so that the government maintains controlling interest. Selling shares of stock is simply a way for SOEs to raise additional financial capital.

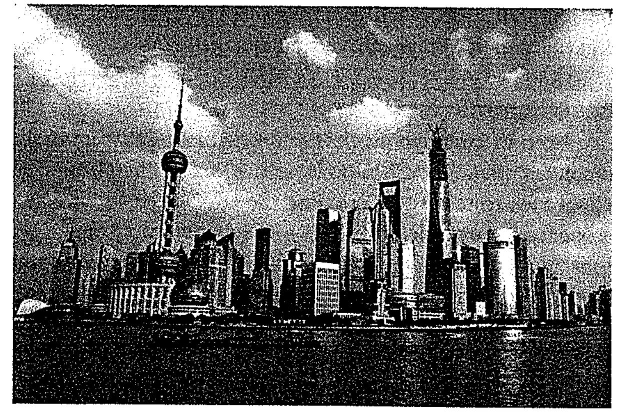

Figure 12.1 The Shanghai skyline provides vivid illustration of modernization and growth in China. (© Shutterstock/smallhorse)

Trade Policy

Like most countries late to industrialize, China has used **tariffs** and **quotas** to protect itself against the perceived threat of imports from more mature industries in other nations. However, because their economy is centered around exports, the Chinese need open access to the markets of developed nations. This desire to export extensively while limiting imports has created considerable animosity in the West, where China is widely viewed as capturing market share with low prices based on cheap labor and lax environmental regulations. Beginning in the early 1990s, China responded to international pressure by reducing trade barriers and encouraging Western corporations to produce in China. By 2001, reductions in trade barriers were sufficient for China to gain admission to the World Trade Organization.

To offset the loss of its protective trade barriers, the Chinese government kept export prices artificially low by intentionally maintaining an undervalued currency. This was accomplished through government purchases of foreign currencies and financial assets. In 1994, China agreed to maintain a constant exchange rate between its currency, the yuan (or renminbi), and the US dollar, but this action simply prevented any further **depreciation**. Yielding to continuing pressure from the West, China announced in 2005 that the yuan would be tied to the value of a combination of different foreign currencies, and minor **appreciation** has occurred since then.

An appreciating yuan places additional pressure on Chinese industry to improve efficiency. Faced with virtually unrestricted foreign imports, Chinese industries such as agriculture, automobile manufacturing, telecommunications, and banking are particularly vulnerable. The Chinese government hopes to soften the impact of freer trade by encouraging foreign firms to enter into joint ventures with Chinese firms. The expectation is that infusions of foreign technology, capital, and marketing skills will revitalize Chinese production methods and create an internationally competitive economy.

The Chinese Communist Party

The CCP has been surprisingly flexible and pragmatic in steering the economy away from communism. The Chinese love adages, and the phrase that captures the CCP's approach to reform is "crossing the river by stepping on stones." The CCP keeps one foot on a stable stone (e.g., SOEs) while searching for the next one. The CCP may not have a clear vision of what lies on the other side of the river, but forward progress will continue as long as the results are positive.

The nature of the CCP is also changing as recruitment of new members is focused on young, highly-educated citizens. The eighty-seven million members include one-third of all private business people. Business leaders and professionals are generally supportive of the CCP, in part because they view membership as opening doors to connections and resources controlled by the Party. Unlike the Communist Party in the Soviet Union, in which promotions depended on ideological purity and agreement with one's superiors, individual advancement in the CCP is based on performance in promoting local economic growth and social stability. As a result, CCP officials have strong incentives to work cooperatively with private businesses. However, the reliance on negotiations and personal ties between government officials and private businesses creates the potential for widespread corruption. Party leaders have initiated efforts to combat corruption, resulting in numerous arrests and convictions.

Whereas Western nations tend to place high priority on the protection of individual rights, the CCP accepts individual rights only to the extent that they promote prosperity and stability. The rights of religious groups are respected as long as they do not attempt to proselytize or subvert the authority of the state. Freedom of speech and freedom of the press may be restricted if the government judges them to be destabilizing to social order. In 1978, citizens were permitted to express their ideas on posters hung on public walls in Beijing, but that freedom ended a year later when Deng Xiaoping was criticized by name. An expansion of civil liberties in the 1980s culminated in 1989 when approximately one million people gathered for six weeks in Tiananmen Square, the central public space in Beijing, to protest against government corruption and lack of full democracy. The event ended with 200,000 soldiers dispersing the demonstrators with tanks, tear gas, and gunfire, resulting in hundreds of deaths. Soon after, the government reversed its liberalization policies, claiming that strong political authority was needed to preserve social order. More recently, the government blocks material on the Internet deemed to be disruptive of Chinese society.

Social Policy

The effort to control population growth led China to impose certain restrictions on reproduction. Beginning in 1977, families were strongly discouraged from having more than two children, and in 1980, that limit was reduced to one. Couples who pledge to have only one child may receive bonuses from their employer, longer maternity leaves from work, more generous pensions, and access to higher-quality medical care and housing. Penalties for having more than one child include higher taxes, less desirable housing, and fines. Exceptions to the one-child rule are made for ethnic minority groups that might otherwise experience declining numbers.

In 1994, a new law banned marriages unless the man is at least 22 years of age and the woman at least 20. Cohabitation prior to marriage is not permitted. The government has the legal authority to enforce mandatory sterilization for persons carrying diseases or possessing genetic defects that could be passed on to children.

Efforts to control population growth have been so successful that unintended consequences have appeared. Because Chinese culture prizes male children over female children, parents whose first child would be female have sometimes opted for abortion or infanticide, hoping that they will have a male child next time. As a result, 17 percent more boys than girls are born, and millions of men are unable to find marriage partners. Another concern is the relative lack of young people to support an aging population. In recognition of these problems, the government loosened its one-child policy in 2013 so that any family in which at least one parent is an only child is permitted to have two children.

China's social programs are minimal because the SOEs traditionally provided their employees with housing, child care, healthcare, education for children, libraries, dining halls, and theaters. With the number of SOEs in sharp decline, the state has not yet filled the void in social services. A nationwide pension fund was only recently established.

A growing gap exists between those who are prospering in the new economy and those left behind. Poverty and homelessness exist, particularly in large cities where the poor are sometimes evicted from their homes and land to make way for new development. Until recently, migrants who moved to cities lost any entitlement to social services in order to discourage people from leaving rural areas unless they possessed employable job skills. However, China is growing so rapidly that labor shortages are developing. As a result, in 2013 the government extended social services to migrants in all except the largest cities.

Environmental sustainability is becoming increasingly problematic in China. With a strong central government, China has the administrative capacity to enact and enforce laws protecting the environment. However, CCP leaders have apparently chosen to give economic growth priority over environmental protection. The extent of pollution in China is evidenced by the fact that five of its cities rank in the top ten most polluted cities in the world. Air quality is often so bad that urban residents resort to wearing masks to cover their mouth and nose. Half the rivers are unfit for human use. The second largest lake in the country has been rendered unusable by algae bloom due to pollution.

Despite the obvious deterioration of the environment, political support for sustainability remains weak. Concern for the environment tends to increase after basic human needs have been met, but nearly a billion Chinese people remain in poverty. Local governments are reluctant to enforce the few existing environmental laws because they are in competition to attract new businesses by minimizing production costs. The national government is reluctant to impose any regulations that would increase production costs and therefore make Chinese goods less competitive in global markets. The CCP appears to assume that the Chinese people are willing to tolerate environmental degradation as the sacrifice required to achieve higher levels of consumption.

Culture

Over the centuries, ethnic Chinese who emigrated from China often prospered in their new locations, particularly in Southeast Asia. This raises an interesting question—does Chinese culture contribute to economic success? Clearly, Mao Zedong did not believe so; his Cultural Revolution attempted to erase the past and build a new society. However, there are several plausible links between Chinese culture and recent economic performance.

Confucianism, with its emphasis on selfless dedication to family and community, seems antithetical to entrepreneurship. However, Confucianism, along with Taoism and Buddhism, provides many Chinese citizens with a highly ethical philosophy of life. As a result, many of the **collective action problems** that arise when individuals focus exclusively on self-interest are more easily resolved in China. Individuals, businesses, and local governments are more inclined to cooperate in promoting the common good.

The Chinese word *guanxi* translates as relationships or connections between people. Due to guanxi, the Chinese are more likely to consider the needs of others when choosing a course of action. Guanxi creates trust, as manifested in the networks and communities formed between private businesses and between businesses and government officials. Networking allows small firms to gain economies of scale as they share market information and innovations in technology and product quality. Business owners trust that government officials are committed to helping them succeed and therefore cooperate with taxation and regulation. Government also trusts that businesses will act in a socially responsible manner. Of course, these trusts are sometimes violated, but the penalty can be a loss of guanxi and a resulting loss of access to information and favors.

Finally, Chinese culture may breed a complex combination of personality traits conducive to economic success. Because China was once the most advanced civilization on earth, citizens have a strong sense of national pride and even superiority. Unlike people in other developing nations, many Chinese view their current success as simply a restoration of their rightful place in the global economy. At the same time, the history of domination and exploitation by foreign powers left the Chinese with a sense of shame and inadequacy. This combined sense of superiority and inadequacy generates a powerful drive to excel.

Capitalism or Socialism?

We have labeled the Chinese economic system as "state capitalism," but it could just as easily be called "**market socialism.**" Indeed, the CCP calls China a "socialist

market economy." Yet with each passing year, privatization and market reforms push the nation further toward capitalism. Is a complete transition inevitable or will China remain a hybrid economic system and, more importantly, will this hybrid continue to generate the astounding growth rates of the past three decades?

CCP leaders are clearly committed to further expansion of the private sector and greater reliance on markets instead of planning. They recognize the importance of unleashing the powerful motive of self-interest, the role of competition in improving efficiency, and the importance of prosperity in maintaining social order and stability. Yet the CCP, using the metaphor of a "bird in a cage," also maintains a firm grip on the economy and on society. The market and individual rights have gained considerable latitude, but ultimately political considerations define the acceptable boundaries of individual freedom.

All capitalist economies constrain the market with politically determined rules and regulations, but the extent of state control is still greater in China than in Western nations. For example, to prevent a speculative bubble in housing prices, some cities restrict home ownership to no more than one per family. When the global financial crisis of 2008 threatened the stability of the Chinese economy, the government responded with a $586 billion stimulus package, which represented a significantly larger percentage of GDP than a similar program in the United States. Similarly, in response to a 27 percent drop in the Chinese stock market in June of 2015, the government ordered SOEs and government pension funds to buy stocks, reduced brokerage fees, and prohibited large shareholders from selling.

Despite more than three decades of robust economic growth, potential problems loom on the horizon as evidenced by a decline in the growth rate to less than 7 percent in 2015. Investment spending currently accounts for nearly half of China's GDP, potentially raising the problem of **excess capacity**. Unless exports or domestic consumption rise to provide additional demand for goods and services, new investment opportunities will dwindle, and the Chinese economy will become vulnerable to a financial collapse. Pressure from other countries to force an appreciation of the yuan will dampen the growth of exports, so China needs to transition from investment spending to domestic consumption spending as the major source of demand in the economy. Citizens can increase their consumption only to the extent that their incomes rise; therefore, higher wages are essential to China's continued growth. In 2013, the government acknowledged the need to stimulate consumer spending by raising the minimum wage by 20 percent to $270 per month, still less than one-fourth of the US minimum wage.

A second problem, known as the "middle income trap," could arise if wages increase too rapidly. Other developing nations have experienced robust growth until labor shortages led to rising wages, which reduced the country's **comparative advantage** in labor-intensive industries. At that point, exports weakened and growth slowed. So, China faces the challenge of finding the right balance between higher wages to fuel consumer spending and low wages to promote exports. Chinese manufacturing wages have risen by 12 percent annually since

2001, but they remain low by Western standards. Rising wages need not reduce a nation's ability to export if productivity is rising at the same time so that per-unit labor costs remain roughly constant. Labor productivity in China is increasing at 11 percent per year due primarily to the introduction of more automated production processes.

A third potential impediment to continued growth in China is the amount of debt accumulated by local governments and private businesses. One of the reasons that investment spending accounts for half of GDP is that credit is readily available. Interest rates are low due to the fact that the Chinese save 40 percent of their income. The past single-child policy and lack of pensions or social security meant that families needed to save to support themselves after retirement. Low interest rates, in turn, have encouraged Chinese firms and local governments to borrow extensively based on the expectation that rapid growth in demand will generate enough revenue to service their debts. Any significant slowing of growth could result in widespread defaults on debt payments and an ensuing financial crisis.

Rising inequality poses another potential problem for China. Beginning in 1979, the CCP pursued a conscious policy of uneven development by dividing the country into "three belts." The coastal provinces would specialize in export industries, finance, and trade; the central provinces would concentrate in agriculture and energy production; and the western provinces would emphasize mining and animal husbandry. This strategy was based on the theory of comparative advantage, which suggests that specialization and trade lead to increased efficiency. However, the result has been growing prosperity in the eastern regions, whereas the central and western parts of the country lag behind in development. This growing inequality potentially jeopardizes both economic and political stability. Economically, the lack of purchasing power in the interior provinces restrains consumer spending and economic growth. Politically, inequality is leading to rising social tensions as manifested in protest demonstrations against the government, acts of terrorism, and growing resentment and cynicism. In response, the CCP has recently changed its development priorities to channel more investment into the interior provinces. Even private businesses are expanding into the interior to take advantage of cheaper labor.

Critics of China have been predicting its imminent demise for several decades, and yet the economy continues to achieve phenomenal rates of growth each year. Growth will undoubtedly slow, as it has for all countries after the initial phases of industrialization. The challenge facing China's leaders is to adjust to slower growth while avoiding a financial collapse caused by overinvestment in productive capacity, excess debt, and speculation in the real estate and stock markets. Despite these potential pitfalls, the country's overall prospects remain bright. If China manages a "smooth landing" by stabilizing at a more sustainable rate of growth, its success will provide a model for other nations to study.

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