The Chinese capitalist miracle

Alan Moran asks, how did China transform itself into a modern economic success?

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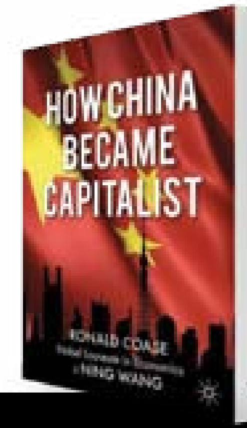

How China Became Capitalist

by Ronald Coase and Ning Wang
Palgrave Macmillan, 2012, 268 pages

The Chinese economic miracle is the latest and most comprehensive success story since the end of World War II. Veteran economists Ronald Coase and Ning Wang explain how in the space of three decades one of the world's poorest countries became the world's leading manufacturer and investor. They attempt to disentangle the twists and turns of Chinese politics and economics in its voyage to success within a framework which rightly judges that no system other than capitalism (which the book calls the market economy), could ever produce such an outcome.

In retrospect the internal contradictions within Communism (absence of appropriate incentives, attenuated property rights, politicisation of business decisions and prices and so on) made its collapse inevitable. But that was not clear in 1970 or even 1980. Yes, communist economies in both the Soviet bloc and China were stagnating. But there were many believing and hoping that the future was about to emerge to demonstrate that socialism actually does work. Intellectuals in particular thought that socialism, which accorded them the status and perks they considered they richly deserved, with a little more reform would demonstrate that the bourgeoisie were unnecessary.

Though the collapse of Communism took place almost simultaneously across the world, a remarkable contrast is evident between Chinese Communism's self-control of its demise and the relatively bloodless overthrow of the system in Europe.

The Europeans delegitimised their Communist Parties and ostensibly opted for a western capitalist system that incorporated democracy and liberty—more so in the former satellites than in the USSR successor states. On the other hand, China's Communist Party continued to maintain its monopoly of political control, vigorously and sometimes brutally suppressing any challenges. Chinese communists adopted capitalism shorn of the democracy and liberty that many considered to be an essential part of its make-up. And in supervising a gradual dismantling of socialism, its *raison d'etre*, China's Communist Party watched over the longest and highest rate of economic growth the world has ever seen. One indicator of this is steel production, traditionally a key indicator of industrialisation. Having increased twentyfold in the past 30 years, China's steel output now accounts for half the world's supply, up from 7 per cent in 1980.

WHILE THE EUROPEAN COMMUNIST SYSTEMS PURSUED CATCH-UP BY HAVING STATE ENTERPRISES ADOPT NEW WESTERN TECHNOLOGIES AND PRACTICES, **CHINA FROM THE MID-1980S WAS LOOKING AT GRAFTING CAPITALISM ITSELF ONTO COMMUNISM**

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How did this happen? How did a ruling political party numbering millions of apparently dedicated Marxists-Leninists retain its power in the decades following 1978 while permitting and facilitating an economic development approach totally alien to its proclaimed ideology? And how did that same Party evolve from a proselytising socialist force to one that welcomed diversity? Coase and Wang offer important insights but leave plenty for others to explain. By the late 1950s, Communist China, like underperforming organised societies of yesteryear, was seeking out ways to catch up with the west. Calls for modernisation started to become increasingly insistent on the part of China's leadership. The first 'four modernisations' program was initiated by Premier Zhou Enlai in 1964 and was aborted by the Cultural Revolution of 1971; other modernisations were subsequently endorsed, including in 1978 (Mao died in 1976) by Deng Xiaoping, shortly before one of his downfalls. The catch-up program sought to emulate the successes without adopting the institutions of capitalism—free enterprise, personal ownership, and the rule of law. Progress was therefore transient.

As well as promising a fairer society, socialism had been the supposed key to a more efficient and richer society. But Coase and Wang note early questionings of socialism. By 1984 when Hu Yaobang, as General Secretary of the Communist Party, had taken this further in asking, 'Since the October revolution (of 1917) more than 60 years have passed. How is it that many socialist countries have not been able to overtake capitalist ones in terms of development? What is it (in socialism) that does not work?'

Hu Yaobang would not have been the first to voice such concerns even though they questioned the party's core beliefs. Even so, not many people would have had sufficient information to raise such doubts partly because censorship severely limited information—even to senior party members—about the extent of China's backwardness and how western economies operate. Overseas trips provided rude awakenings as when in 1978, Vice Premier Wang Zhen visited England and found his salary was only one sixth that of a London garbage collector.

While the European Communist systems pursued catch-up by having state enterprises adopt new western technologies and practices, China from the mid-1980s was looking at grafting capitalism itself onto Communism. The proximity of China to the Asian Tigers of Hong Kong, Taiwan, Singapore and South Korea provided an object lesson for success, especially since the entrepreneurial leaders of the first three were the children of uneducated emigrants from China itself. Not only therefore did the Chinese have the failures of socialism as an example but they also could see the astonishing successes of these newly enriched capitalist countries.

Deng Xiaoping was a key player throughout the Chinese transformation process, even eventually managing to persuade the Communist Party that Marxism was a pragmatic ideology willing to try new systems of ownership and trade. Notwithstanding this breathtaking apostasy, the conversion of China to a fully-fledged capitalist economy involved several paths which were only loosely connected.

In the late 1970s, foreign trade and foreign direct investment became the first areas where liberalisation was introduced. Vastly important in this was the Shenzhen (Guangdong) free trade zone adjacent to Hong Kong. As a catalyst for the introduction of free enterprise Shenzhen had its genesis, not as a means of introducing free enterprise, but as a means to halting the flow of economic refugees to Hong Kong. The Communist authorities were involved in considerable expenditures in trying to stop this illegal exodus of the tens of thousands of people each year, an exodus which also involved many hundreds drowning. To their utter astonishment, in examining the cases of refugees who made it to Hong Kong, they learned that they earned one hundred fold as much as those who remained behind.

The establishment of Special Economic Zones (SEZ) operated on capitalist lines in Shenzhen and elsewhere to attract foreign investment which blossomed. Eventually Shenzhen's SEZ transformed a village of 30,000 people into a vast metropolis which now has 14 million residents.

Agriculture led the way to domestic private enterprise. In 1978,

Shenzhen factory
Source: *Shutterstock*

private farming was a criminal activity, but 1976 saw its first secret reintroduction by peasants at a Sichuan village called Nine Dragon Hill. The success of that village and a few others in increasing production was compelling. From 1980 the party instituted a progressive lifting of the ban on private farming. Fairly soon virtually all land had been divided into individual plots, though remaining under state ownership. Productivity soared.

The de-collectivisation also extended to previously moribund village industries. The output of these industries was growing at 20 per cent a year by the end of the 1980s and accounted for 26 per cent of GDP 15 years later. Four-fifths of these enterprises were privately owned, and all of them were subject to the dictates of the market and not any level of government. In 1980, a rural producer and hawker of confectionary, based on watermelon seeds, became one of the first millionaires.

This liberalisation in rural villages took place at the same time as changes in major cities, where unemployment was previously solved by sending youth to rural areas. But the youths started returning in vast numbers from the late 1970s. With little for them to do, the party allowed small businesses to be formed. Elements of the rule of law and contracts were introduced from 1978 initiating the path to the full panoply of property rights law, a process which was not, however, completed until 1988.

An essential attribute of a market-based economy is decontrolled prices for goods and services. Tentative steps were taken towards this in the early 1980s, were reversed in 1983, but soon recommenced and in 1984 most manufactured goods were no longer subject to controls. Nonetheless, even by 1995, 78 per cent of producer goods were transacted at controlled prices (though by then many of these had become much better aligned to market prices).

660 million people

Have been lifted out of poverty due to China's free market economic reforms beginning in the 1980s

Source: *The Economist*

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Share markets are important to facilitate capital accumulation and to allow investments to be traded, but the first stock exchange was opened only in 1986. It was not until 1990 that major stock markets could operate in Shanghai and Shenzhen. Soon after, there commenced a gradual sale to employees of state enterprises, especially those (over half of the total) which were technically insolvent. This was accompanied by reforms that allowed surplus workers to be sacked (an unemployment insurance scheme was introduced at the same time).

Coase and Wang claim that socialism was endorsed by Mao only in the mid-1950s but, if so, this would seem to contradict the basis of the Communist Party. Nor are they systematic in describing the astonishing growth of internal savings (which were 53 per cent of national income in 2010) that propelled industrialisation, and how this was underpinned by property rights laws.

Other intriguing questions with incomplete answers are: how were lumbering and inefficient government-owned firms transformed into the privately owned nimble and highly productive businesses that have led China to dominate world manufacturing? And how was it that the State Owned Enterprises (SOEs) that are still the backbone of heavy industry and infrastructure have, once corporatised, been run at a tolerable level of efficiency without which the private sector propelled growth could not have created the success observed?

Indeed, of the 31 Chinese firms in the Fortune Top 300 in 2011, only one (which is Hong Kong based) did not have majority government ownership. Two of the three biggest were fully government owned.

Though all these firms operate under western type corporate law, according to Coase and Wang, the state firms in monopoly sectors employ 8 per cent of the non-farm workforce but account for 55 per cent of total wages. The inferred high wages in monopoly firms suggests they are less cost-conscious than those facing competition, which, if true, makes the performance of the rest of the economy that much more impressive.

Coase and Wang examine but ultimately dismiss fears of some prominent Chinese about a dearth of entrepreneurs which could stifle growth in the future. They are surely right in this. Similar concerns were voiced by South Koreans when that country's growth was founded on firms doing the more menial tasks that mature businesses outsourced to them—40 years ago the Samsungs, LGs and Hyundais barely existed. Coase and Wang also note that China is now the largest producer of PhDs in the world, having risen from one of the poorest nations to the second biggest economy.

Chinese Communists, while retaining the name have emasculated and even forgotten the theory on which it rode to power. From Marxist works being virtually the only political books being available in the 1960s, Coase and Wang cite evidence that by 2008 students, even those applying to join the Communist Party, were barely aware of Karl Marx's *Communist Manifesto*. The party had become one of many different career paths and was completely shorn of ideology.

In this respect Coase and Wang refer to an interview that China's Premier Wen Jiabao had with western media where he quoted not only Adam Smith's *Wealth of Nations* but the lesser known *Theory of Moral Sentiments*. Even though the quotation was recruiting Adam Smith in support of measures to combat income inequality in China (a dubious interpretation of Smith's own view) it is unlikely that any other world statesman would have been adequately versed in Adam Smith in these two guises.

The roots and durability of China's success remain contentious. Many see the prominence of the SOEs as indicative of strong state guidance or manipulation of the economy.

This is difficult to square with the evidence of economic failures and successes around the world. Government ownership *ipso facto* has meant poor outcomes for the businesses themselves and eventually, in the case of Eastern Europe, for the economies in which they were housed. Even strong guidance by governments has been associated with failures as was previously the case in the 'mixed' pre-1990s Indian economy when government economic manipulation was considerable. Similar guidance and 'winner picking' in the West also failed. Where claims have been made of successes from government guidance, as in the case of Japan and Singapore, they have—under closer scrutiny—been found wanting.

Efficiency in China was unleashed by the opening up of the economy to entrepreneurship, the better incentives for productive work and the high rate of savings that followed from a recognition that these are secure from government seizure or wasteful usage. State industry manipulation and even, beyond a point, favouritism by state agencies, would undermine the phenomenal growth that continues to be witnessed.

Since Mao, China has risen from one of the world's poorest nations to become the second largest economy. It is difficult to see what will stop a continued rise in incomes to levels that may reach or exceed—as some have forecast—as much as 40 per cent of world GDP twenty years from now. R