

Do you know China?

了解中国

# Crossing the river by feeling the stones

## China's economic reform program

In 1980 China had a completely communist economy—100% of economic activity and property was controlled by the government. While such things are hard to measure, it is now estimated that roughly 30-40% of its economy is state-dominated, with the rest being free market oriented. This is a result of China's highly successful economic reform program which began in 1980 when Deng Xiaoping assumed leadership of the country.



## Economic Shock Therapy in Russia

In the early 1990', a group of economists, mostly from Harvard, were advising Russia to engineer a relatively quick transition from a centrally planned economy to free market oriented one. The concept was given the moniker "Economic Shock Therapy." Some say it worked in Poland. It sure didn't work in Russia. State assets ended up in the hands of a relatively small number of "oligarchs." Russia went through a financial crisis and a prolonged contraction. Private enterprise never really took root. The result has been extremely low growth since the formal end of the Soviet Union.



## Crossing the river in China

China opted for a gradual transition to the free market, applying step-by-step reforms over many decades designed to let the free market portion of the economy gradually grow bigger than the state-dominated portion. The architect of the program and China's leader at the time, Deng Xiaoping, had been a senior official in the Communist Party since its inception. He didn't have a Phd from Harvard, but perhaps he better knew what would work in a country that never really had a free market economy. The gradual approach led to China averaging 8+% growth over four decades, ascending to the second largest economy in the world, and becoming "factory to the world."

## Key Aspects of Reform

Below are a few examples of the gradual approach to change that China took.

**Price and market reform:** Under communism, markets and producers had quotas and fixed prices. China began to let producers sell more than their quota, at whatever price they wanted, if there was demand. Gradually the free-market portion each market outgrew the quota portion until quotas were completely eliminated several years later.

**Agriculture Reform:** Start by letting peasant farmers keep more of what they farm, then giving them more control of the land assigned to them, allowing them to lease/sell it and make other changes.

**Special Economic Zones:** Private enterprise, foreign investment, and foreign trade were jump started by the creation of "special economic zones" which permit foreign investment and private companies. Two SEZ's were created in 1980. Fourteen more in 1984. More than 35 by 1995.

**Foreign direct investment (FDI):** FDI began only in SEZ's then gradually spread to other parts of the country. Initially on joint ventures were allowed. In the mid-1990s it became easier for a foreign company to have a wholly owned subsidiary. In the 2000's more industries were opened to foreign investment.

**Trade:** China's simplified tariff rate decreased from 50% in 1980 to 12% in 2002 (joined WTO in 2001) to 9.8% now.

## Why did gradual reform outperform a shock therapy?

Of course there is no exact answer to this question. A few factors to consider would be as follows:

### Weakness in the Rule of Law

All less developed countries have weakness in the rule of law as evidenced by the fact that virtually all low income countries are assessed as being high in corruption via Transparency International's Corruption Perception Index. Commercial transactions in general, and distributing state assets in particular, are very difficult when the rule of law is weak. Russia lost control of its most important assets. China let businesses grow around those assets while avoiding the free-for-all that a premature state asset auction would create.

China still has corruption and rule of law problems. It didn't acquire the rule of law faster than Russia (that will come later), but it figured out a better way around the rule of law challenges.

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### Slow change makes it easier to adapt

Reform changes how people earn a living, buy what they need, make decisions, relate to each other (as boss, colleague, etc.), live their lives. When it comes to such big changes, slower changes cause less disruption and make it easier to adapt. This in turn allows support for reform to grow while minimizing reasons for opposition.

## The Future of Economic Reform: From Slow Reform to No Reform

Virtually all China observers would agree that the pace of reform has slowed dramatically in China. Some would say it began to slow in the mid-2000's, others might say the slowdown began after the financial crisis. There have been some promising initiatives, like the Free Trade Zone established in Shanghai. But most haven't spread very far. The internationalization of the RMB, China's currency, is a good example of an important reform plan that simply hasn't been pushed very far and as such international holdings of the RMB remain very limited.

China's current leader, Xi Jinping, has said that he wants "the market to be decisive" in the economy, a strong statement in support of more liberalization. He has also said he wants a strong and active state sector, which runs contrary to more liberalization. So far, it seems the state is getting the benefit of the doubt.

Meanwhile, less reform has been accompanied by both slower growth rates and the rapid accumulation of debt in China (debt to GDP increased from 120% in 2008 to roughly 300% currently).

Some would say the most effective way to combat slower growth and overwhelming debt levels would be more reform. Time will tell if China moves decisively in that direction again, or whether the general stall in reform remains.

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