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CHINA'S REVIVAL

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The Great Depression in the 1930s revealed cracks and limitations in the way capitalism works. In the US these shortcomings were addressed by the New Deal, which included more regulatory checks and balances. The results and consequences of the New Deal were hotly debated for several decades. The evidence from the 60-year period since the end of World War II is clear: democracies with capitalistic market economies have outperformed communist countries relying on publicly owned companies run by state planners. The fall of the Berlin Wall in 1989 signaled the massive failure of communism and state planning.

The magnitude of the current global economic crisis again brings attention to the weaknesses of capitalism. In the US, the bastion of capitalism, voters have just elected one of the more left-leaning Presidents and Congresses in history. The cries for more regulation to curb corporate excesses and unchecked capitalism are loud and clear. At the eye of the storm lies subprime lending in the residential real estate market, and in particular credit default swaps (CDS), which lead to non-transparent ways of buying and selling risks in largely unregulated markets. The consequences have been near collapses of the credit institutions, deflation of asset prices at a speed and scale never seen before, and massive deleveraging.

The invisible hand that Adam Smith posited would cleverly guide economic activities to the effect of an efficient outcome, seems less able to do its job as governments around the globe, very visibly, try to calm financial markets and encourage goods markets with large New Deal-type stimulus packages. The diagnosis and political handling of this global crisis, and how well the global economy fares in the years ahead, will be decisive for how capitalism is practiced for decades to come.

One big country does not fit this dichotomy – democratic and capitalistic versus communist and state-run – at all: China. Since 1978, China has moved away from central planning towards market and from communism towards democracy. Based on Karl Popper’s view that the core of democracy is to have a peaceful and decent transfer of power from one set of leaders to the next, China became sort of one in the fall of 2002 as Hu Jintao took over as President of China. The following spring Hu became Secretary General of China’s Communist Party (CCP). Both positions were previously held by Jiang Zemin.[1] In 2007 Hu’s mandate was confirmed for another five years. In 2012, however, he shall have to leave the reins of power to his chosen successor, Xi Jinping, currently state vice-president.

The purpose of this paper is to reflect on China's unique economic experience over the last three decades. What lessons can be learned from China’s blend of visible central guidance at the macro level and fierce competition at the micro level? [2]

[1] In the fall of 2004 Hu Jintao also replaced Jiang Zemin at the helm of the People’s Liberation Army (PLA), becoming head of the Party’s Central Military Affairs Commission.

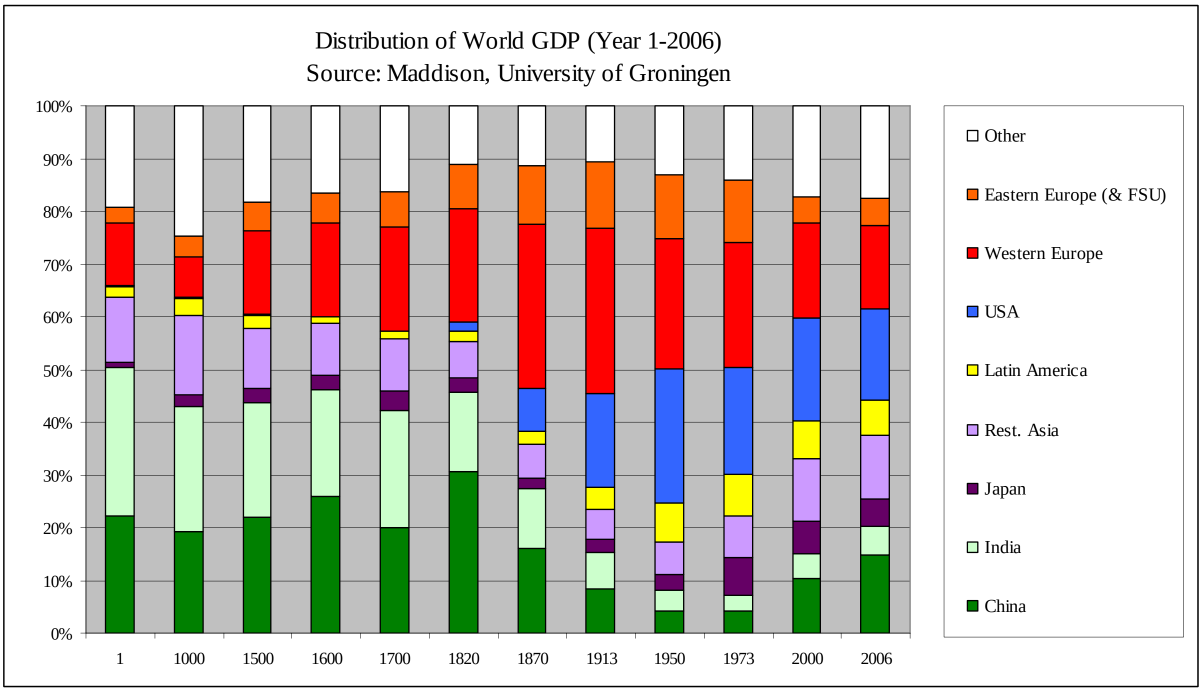
[2] Yao Li at the IFC in China and Harald Havnen at Orkla in Norway have read a previous draft of this paper and given us very useful comments. Nicolai Sand at Stanford University has provided excellent advice in editing the paper. We owe them all our gratitude. Responsibility for remaining errors rests solely with us.

China's revival in a global perspective

For more than seventeen hundred years prior to the Industrial Revolution (1750-1900), Asia accounted for more than one half of global GDP and China was the dominant contributor. During the period from 1820 to 1950, Asia's share of the global GDP fell from 56 % to a low of about 15 %. Asia's share of industrial production fell even more, from 55 % of world total to a meager 8 %. However, if current growth rates continue it will take less than two decades before China has surpassed the US as the world's largest economy.

Figure 1 provides a perspective on the relative share of economic activities in different regions of the world for the past two thousand years. China (green portion of the bar) is gaining market share in terms of global economic activities at an accelerating pace.

Figure 1: Distribution of World GDP[3]



If current growth rate differential between the US and China continues it will take less than two decades before China has surpassed the US as the world's largest economy.

China's hierarchical governing structure

At the heart of China's political system is a fairly well understood and well functioning hierarchical structure. The Chinese Communist Party, CCP, "owns" the power and intends to

[3] Historical Statistics of the World Economy: 1-2006 A D, Angus Maddison, GGDC, University of Groningen. See Historical Statistics at http://www.ggdc.net/maddison/

continue to do so. The top echelon of the Party is the nine men Standing Committee of the Politburo. The Central Committee of the Party with about 360 members, including alternates, is the breeding ground for future leaders.

In addition to the party structure there is a legislative structure and a government structure. The National People's Congress (NPC) comprises the legislative body. According to the constitution, power ultimately rests with the NPC, which nominates China's President and approves of the government. In practice, however, the President is picked by the Party, and the NPC acts more like a rubber stamp. That said, the effectiveness and influence of the NPC has increased in the recent years as more and more entrepreneurs and social activists have become members of local and nationwide People's Congresses.

The Party fully controls the government. Wen Jiabao, the prime minister, puts into practice decisions made by the CCP. His tenure expires alongside with Hu Jintao's.

At the next level lie the thirty-one provincial governments. The CCP has branches at all levels of the structure, from provinces to cities and towns, from military facilities to factories and schools. At the provincial level, the Secretary General of the CCP is the No.1 person. He or she will nominate the provincial governor, which in the end is selected by the Party leaders, and is accountable to Beijing. CCP controls and manages the whole of China through this Party system. However, the old saying that the mountain is high and the emperor is far away is still valid, i.e. the governor and party cadres running a province wield considerable power.

The provincial government in turn delegates authorities to prefectures, counties and cities. The townships form the lowest level of state administration. Some 700.000 villages are not part of the formal state structure. Locally elected officers run the villages and deal with administrative matters of the village like tax collections, budgets, public order, and social welfare. [4] As long as peace and calm prevail and economic activities fall in line with general policy and achieve certain thresholds at local levels, Beijing welcomes and accepts decentralized decision making.

The Pew Global Attitude Project (2005) reports that 81 % of the citizens in China say they are satisfied with the conditions in their country. This compares favorably with the results from surveys amongst citizens in the US and Europe where satisfaction ratings range from 20 to 50 %. With the state of anarchy and chaos wrought upon China by the Cultural Revolution (1966-1976), the recent experience of stability and growth makes for content citizens. However, the persecution of dissidents and intellectuals that are promoting democracy, reform and human rights, remains a nasty stain on the Chinese society.

China's growing reliance on the invisible hand ……

In December 1978 all the farmers in a small village in the poor Anhui province met in secret. The peasants agreed to defy the existing system of collective farming and start working the fields on a family basis. Though their actions carried great personal risks, the farmers went ahead with their project. It was a resounding success. The news spread and eventually reached

[4] "Much experimentation is taking place with basic level organizations and institutions, which all makes for a very messy kind of China and one that defies simple categorization". See page 179 in T. Saich (2004), *Governance and politics of China*, New York, Palgrave, a comprehensive and well written analysis of governance and politics in China.

Deng Xiaoping, China's paramount leader at the time. After some hesitation, he decided that the Household Responsibility System for working the land should be adopted by the whole of China. Each peasant, after having submitted the required quotas of rice and grain etc. to the state, would be free to dispose of the remaining as he saw fit. A market for agricultural products soon developed and production soared as China re-introduced individual incentive into farming.

Since then, China has slowly and steadily opened its economy more generally to market-based principles. Through suitable incentives the egoistic trait of man is put to good use in the sense of utilizing the productive resources in society more effectively. Today most sectors of the Chinese economy rely on market-based competition. Note that there is room for state owned enterprises and state owned banks in a market economy. The important thing is competition, i.e., that there are alternative suppliers of goods and services; that all companies, state or privately owned, have a good measure of autonomy; and finally that underperforming companies exit the business.[5]

China has applied a "bottom-up" approach to reintroducing market forces, starting at the farming and retail level and moving up to include industrial sectors, financial services, energy and resource-based firms. The scaling down of state owned enterprises (SOEs) doing away with 40 million jobs, took place under quite unfortunate circumstances – in the late 1990s as the consequences of the Asian crisis hit China. However, Zhu Rongji, prime minister at the time, stayed the course, focusing on the development of a vibrant and dynamic private sector. China's admission to the World Trade Organization in December 2001 was an important element in Zhu's strategy. The WTO acts as a kind of referee, making China stick to the rules of the game, evolving into a more market oriented economy. The results have been stunning – economic growth in the double digit level, which came to an end last year.

However, an economic strategy based on investment and exports now is in need of change. The development of a "harmonious society" that the present Chinese leaders put so much emphasis on, implies that consumption, both private and public, will play a larger role in the future. The resource intensity in production, including energy consumption per unit of output, must come down. And the allocation of credit through the banking system needs to be more balanced, i.e. to a greater extent benefit small and medium sized private companies.

In China government expenditures, including transfers, now account for a good 21 % of GDP.[6] In 1978 this figure stood at 31 %.[7] In the US government expenditures have increased from 20 % of GDP in 1947 to 33 % today. For European countries the comparable figures are significantly higher. With about 60 % of GDP being channeled through the public coffers, Sweden finds herself on the top of the list. Over the past three decades, China's private sector has grown at an accelerating pace while in the western world the private sector has declined relative to the public sector.

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5 Many of the large, independent power producers – most of which use coal to generate thermal power in China – are publicly listed companies, though often with government ownership control. The main concern of these companies is not profit, but growing their electricity generating capacity. Recently, this sector has been loss making, mainly due to high coal prices. The government will compensate them for their losses in the long run by raising electricity tariffs paid by consumers. A "soft budget constraint" still applies. Exiting the business is not an option.

6 See Quarterly Update on China from the World Bank, December 2008.Here is the link: http://siteresources.worldbank.org/INTCHINA/Resources/Quarterly_December_2008.pdf

7 See IMF's Occasional Paper 23 from 2004, "China's growth and Integration into the World Economy", edited by Eswar Prasad.

China’s shift to a market economy has paralleled the country’s deliberate decentralization of authority and power to its thirty-one regional provinces, their cities and counties, and ultimately to towns and villages. How China fits into the traditional concept of a one party state needs some rethinking.

…. while at the same time maintaining a visible one

A quarter of a century ago China was a more egalitarian society in terms of income distribution than Norway, which prides itself of having a welfare state. With its more rude form of capitalism, China is now a less egalitarian society than the US which focuses on equality of opportunity rather than equality of outcomes.

The stated goal of the Party is to have a full fledged social security system by 2020. Education, health and pensions will consume a steadily larger share of government expenditures in the years ahead.

As was the case in the 1978 Anhui province village, practice may precede policy and drive changes in regulations. Another example of this has been the development of a market for land-use rights. All the land in China is publicly owned, giving individuals commercial ownership of the land for limited periods in the form of land-use rights. Farmers have increasingly traded these tilling rights to the point that in many provinces such land-use-rights have been traded beyond the framework set by the authorities. In the fall of 2008, Beijing reacted and announced new policies allowing farmers and villages to buy and sell land-use-rights for periods as long as 70 years. However, the Party has declined private ownership of the land in the full sense of the term. Ultimate ownership of land still rests with the community. The potential for more efficient farming through economics of scale still weighs less with policymakers than the risk of social instability that may follow an increase in landless and unemployed people.

Investments over 100 million USD typically need central government approval, while smaller investments are handled at the provincial level. The level of cooperation between provincial and central governments is good. Provincial governments will not pass along requests to the central government unless they feel fairly confident that the plans will meet with approval.

The central government collects more than 20 % of GDP through taxes and other fees. The government spends this in growth-promoting ways. Comprehensive industry policies, partly based on large State Owned Enterprises (SOEs), play a central role. According to the Fortune Magazine, about 25 Chinese SOEs are listed among Fortune Top 500 global companies. However, the Chinese government intends to continue the deliberate and steady privatization of most of its SOEs, while retaining majority ownership of companies in selected strategic sectors such as utilities, natural resources, transportation, telecommunication, and banking. This reflects the CCP’s goal of maintaining a firm grip on the backbone of the Chinese economy.

China’s privatization of its SOEs does not occur by selling off whole companies and/or by auctioning large blocks of the companies. Typically, the government accepts dilution over time by allowing entities in the private sector to contribute capital and know-how, a process intended to improve the performance of the individual SOEs. This is often combined with a listing of the shares on one of the two mainland Chinese stock exchanges (Shanghai and

Shenzhen). Over time the government ownership stakes are further diluted through subsequent capital injections from private investors. However, a look at the market value of the Chinese governments "A-shares" on the local stock exchanges reveals that the government has not only attracted risk capital and management know-how, but also has captured a large share of the capital gains generated in the process.

Note that the Chinese privatization of SOEs stands in stark contrast to the privatization process in Russia and part of Eastern Europe after the fall of the Berlin Wall, where SOEs – through non-transparent voucher schemes – ended up in the hands of a few oligarchs practically "overnight". It is closer aligned with the gradual and partial privatization of large utility companies in Europe or the partial privatization of the Norway's Statoil. Partial privatization where foreign companies join forces as strategic partners with Chinese SOEs, not only risk capital is secured, but also know-how. The experience of large State Owned Banks comes to mind.

Governments at various levels are big promoters of investments

There is strong competition between the provinces to attract new investments. Higher level government officials, who are concerned with providing a better life for their many citizens, focus intensively on ways to promote economic growth. Rural China faces a massive rural "under-employment" problem, resulting in an annual migration of about 1% of the population (13 million people) from poor rural farming areas to the modern industrial and manufacturing urban sector areas. To absorb the net increase in the urban labor force China needs an annual economic growth rate of 8 % to 10 %.

Local and provincial governments are working closely and in concert with the private sector to attract and promote investments. The authors' own experience from the provinces of Jiangxi, Guangxi, Guangdong, Shandong, Hunan and Hebei, as well as from Shanghai and Beijing supports the assertion that local governments are an integral part of the promotion apparatus for investments and economic activities more generally.[8]

Let us give one example. As part of a feasibility review for a large integrated pulp and paper project in the Jiangxi province, one of the authors had a meeting with government officials for the province and the city of Nanchang. The most surprising aspect of the meeting was not the general niceties one would expect from a semi-official meeting, but the sales pitch made by the bureaucrats: They gave in-depth project details and outlined the specific levels of support the project required in the near and long term. The industrial park in question would have all the infrastructures completed by such and such date, power would be guaranteed at a price of so much, the river would be dredged for the required draft, the port would have such and such capacity, tax benefits would include this and that, qualified was available, resettlement of people from the park was compensated for by the government, etc., etc. It was a business pitch one would not expect from a politician. About 18 months later, the mill opened – on time and on budget – and the government held its part of the deal. It was more than a pitch.

[8] Some local government officials, it should be added, have a more sinister motivation for promoting economic growth – receiving a bribe.

What works is what counts

The Chinese have a rare talent – they are quite apt at learning from the experiences of others. What counts is what works. Ideology takes the back seat.

China's policy on exchange rate determination and capital mobility illustrates this point. In the mid-1990s China unified the exchange rate and allowed the yuan to be convertible for transactions on the current account, i.e. for trade in goods and services. Also, China fixed the price of the American dollar at 8,28 yuan. The yuan, however, was not convertible for transaction on the capital account. Foreigners could not buy financial assets in China. And likewise, the Chinese were not allowed to buy financial assets abroad.

In 1998 the Asian economic crisis hit China. However, allowing only inflow of direct investments from abroad and not of financial capital, the run on the yuan to devalue was manageable. Other countries in the region, having followed the advice of the IMF and liberalized the capital account, saw their currencies tumble out of control. Economically they fared worse than China. Staying the course, i.e. maintaining the peg to the dollar, China contributed to stabilizing the region economically.

With improved competitiveness and rapidly increasing surpluses on its current account China started a process of gradual appreciation of the yuan, from 8,28 yuan to the dollar in the summer of 2005 to about 6,80 yuan to the dollar three and a half years later. By restricting capital mobility, China is able to have a managed exchange rate as well as an autonomous interest rate policy. This suits China well. With ample domestic savings (at a rate of about 50% of disposable income at the household level) import of capital beyond direct investments by foreign firms, China does not need.

In the field of exchange rate policy, China has opted for what suits her needs – not what economists in the IMF or at far away prestigious academic institutions have recommended. Observing what works and what does not work in other countries is an important input in decision making in China.

The restructuring of the banking system

By the turn of the last century, many believed that the SOEs large and growing losses were creating an imminent banking crisis. Nonperforming loans in the state owned banks in China exceeded 40 % of GDP. Economic growth in China seemed hard to sustain.

Surprisingly, the expected financial crisis never materialized. The private sector has grown rapidly since then, while banks in parallel have been recapitalized. By having foreign banks as strategic partners, providing both equity capital and know-how on credit allocation according to market principles, the structural problem of inexperienced Chinese bankers also seems to have been solved. Today non performing loans in Chinese banks amount to less than four per cent of GDP.

Low returns on investment

A few years ago, Deutsche Bank released a research report showing the low return on investments in China compared with those in India. This is consistent with the widely held view that China does simple manufacturing work for other countries, subsidizing consumers world-wide with low cost products, whereas India is running a tighter ship, seeing to it that capital is receiving a reasonable remuneration.

Using traditional measures of return on investment such as the project-level internal rate of return (IRR), the authors' experiences are consistent with observation of Deutsche Bank. The Chinese private sector appears willing to make investments even though the IRR is below what one normally would consider a minimum in a market economy. With an abundance of savings being put aside by households that do not have recourse to international financial markets, however, it seems rational for the Chinese to accept lower returns on investments. The return on physical investments in China closely aligns with the interests paid on banks' savings accounts.

Another plausible explanation for the lower IRR is a variation of the "infant industry argument," which says a country (in this case the private sector) might temporarily accept lower returns to accumulate know-how and gain market shares with the intention of making a higher return in the long run. Part of the explanation for the Japanese economic miracle some thirty and forty years ago was that Japanese companies took a longer term perspective than publicly traded companies in the US and Europe where management spend too much time focusing on quarterly earnings.

It should be noted that the rapidly growing economy creates ample opportunities for strong return on investments in a variety of retail, service and niche industrial sectors. The "excess supply issue" is more prevalent in large industrial sectors.

Finally, viewed from the country's perspective, the private financial rate of return would need to be adjusted to take into account the benefits to China as a whole. With massive surplus labor in the countryside, the shadow price of labor is way below its market price. From society's point of view, it is the shadow price – or the scarcity price – of labor which is relevant. If one were to plug the shadow price of labor into IRR calculations on investment projects, the estimated return is bound to be significantly higher. From this vantage point the supporting role played by Chinese governments at various levels to encourage real investments and employment makes good sense.

Intellectual property rights

Some suggest that the Chinese will face problems staying competitive once they are forced to accept intellectual property rights to a greater extent. No doubt there have been and still are lots of infringements of intellectual property rights in China. However, if we look at new patent filings in the US as a benchmark, we find China and India are gaining ground rapidly. The US Patent Office reports that Chinese applications for patents grew by a compounded rate of 42 % for the 10-year period 1997-2007, significantly faster than for any other country.[9] With 33 % India recorded the second fastest growth rate over the same period. The overall growth rate of all patent filings was 8% for the last decade**.**

Patents usually provide protection for a period of 17 years. We would expect China within soon to be receptive to stronger enforcement of international intellectual property rights. For instance, the pharma industry in China has gone through years of strict reform, especially with regards to drug patents. The industry is slowly transforming itself from a fragmented one to an industry where R&D, non-generic drugs etc are promoted by government by means of tax breaks and incentive programs. The rational for the Chinese themselves to adhere to international rules for patent protection in this line of business is obvious.

Concluding observations

China has done exceedingly well in terms of economic growth over the last three decades. Daunting challenges remain to be addressed. A decaying environment and huge differences in living standards stand out as the two most pressing issues. The pragmatism that has characterized China's revival, the ability to cooperate across different levels of governments, and the ability to learn from the experiences of other countries will serve the Middle Kingdom well also in the decades to come. Other countries may benefit from studying the way in which the public and private sectors interact in the Chinese economy.

[9] Number of Utility Patent Applications filed in the United States, by Country of Origin, Calendar Years 1965 to Present, US PTO Home page.

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