

Introduction: The Transformation of China's Economy

This book is about the transformation of China's economy into a market economy with its special characteristics. It deals with the process of transformation and the special features of the Chinese economy. It contains much of what I have discovered about China's economy and the economics of institutional transformation from research, teaching, traveling, working with Chinese educators and government officials, and observing the Chinese society simply by talking to Chinese friends and citizens since 1980. As an introduction I would like to make three sets of observations. The first is about the economics of institutional changes. The second is about China's government, and third about China's historical and cultural traditions. In the remainder of this book the reader will find these observations elaborated upon in more detail.

In the study of economic transformation, the role of the government needs to be stressed. Thomas Jefferson has aptly remarked that the government is the best which governs the least. However, in the process of an economic transformation promoted by government, the government has to play an important role, even if Jefferson's statement is valid when a set of economic institutions is well established. The economics of transformation is related to the economics of transition, since both deal with changes in economic institutions. A possible difference is that the latter conveys a notion that the economy is in a temporary state of transition to some ideal state, such as a special form of market economy. The former does not carry a notion of a known final stage of transformation. It studies the process of economic transformation without a definite statement regarding the final state.

Secondly, besides understanding the important role of the government it is important to understand the role of the remaining sectors which may support or reject the reform measures introduced by the government. These sectors may also play an important role in initiating reform of their own, sometimes even guiding government reform policies, and sometimes serving as a supplement to government reform. The former is illustrated by the introduction of the household re-

sponsibility system in Chinese agriculture from the grassroots, and the latter by the rapid growth of township and village enterprises in China as a supplement to state-owned enterprises.

Thirdly, if one is to understand the important roles of the government and the nongovernment sectors and their interaction in shaping the transformation of an economy, it is necessary to understand the historical, cultural, and institutional factors that affect the actions of government officials and the people. Government officials and the important players in the nongovernment sectors are guided in their behavior by historical and cultural factors, in addition to economic calculations. Economic reform in China and Russia has taken different directions partly because of the differences in historical and institutional factors. For example, China's reform in the agricultural sector succeeded because Chinese farmers in 1978 still remembered private farming – the commune system was introduced in China only in 1958. Collectivization of agriculture in the Soviet Union took place in the early 1930s and Russian farmers in the early 1990s did not know how to operate as private farmers. It was difficult to privatize the agricultural sector in Russia. The success of agricultural reform in China provided the economic foundation for reform in other sectors.

Concerning the historical institutions of China, there is a long tradition of the use of social networking known as *guanxi*. *Guanxi* determines many social interactions, including economic transactions. It affects the reform of the legal system, as we will see in chapter 20. There is also an established bureaucratic tradition which affects the behavior of government officials and of state-owned enterprise managers. This tradition, further modified and developed under the government of the People's Republic of China, affects the reform of the banking and financial system, of state-owned enterprises, and of the nonstate sectors, as we will see in chapters 13, 15, and 16 respectively.

A fourth feature of the economics of transformation is that, since the government plays such an important role and the government's reform policies depend on historical and institutional factors, many aspects of the transformation process need to be studied as isolated events. Economists, following the lead of natural scientists, would like to find general laws that can be applied to explain economic behavior in general, regardless of time and space. There are such laws in economics, some of which will be illustrated in this book. However, while laws can explain economic behavior under a given set of economic institutions and may even be valid for a variety of economic institutions, they do not as a rule explain why economic reform started in China in 1978 and why it proceeded the way it did. The explanation has to rely on the historical circumstances in 1978. The nature of the economic reform that followed was subject to the constraints of the historical, institutional, and political factors affecting the actions of the Chinese Communist Party leaders. It also depended on the personal characteristics of the leader, Deng Xiaoping, himself.

The discussion of China's historical tradition in chapter 1, of its planning system in chapter 2, its general reform process in chapters 3 and 4, and the transformation of the individual sectors later on in this book illustrates the above important features in the study of the economics of institutional transformation. The individual sectors include consumption in chapter 9, western development in chapter 10, population policies in chapter 11, human capital in chapter 12, the banking and financial system in chapter 13, state enterprises and the nonstate sectors in chapters 15 and 16, for-

eign trade and foreign investment in chapters 17 and 18, and the legal system and the education system in chapters 20 and 21. These chapters emphasize in many places the important role of the government and of the historical and institutional factors affecting the reform process. Many take into account the interaction of government and nongovernment influences, and the nature of Chinese society, including bureaucratic behavior. Such are the important considerations in the study of the economics of institutional transformation.

In this book traditional economic tools are also applied to study the Chinese economy. Examples are a model of aggregate economic growth in chapter 5, theories of economic fluctuations in chapter 6, macroeconomic policies in chapter 7, an econometric study of the macroeconomic effects of the Great Leap Forward movement and the Cultural Revolution in chapter 8, analysis of consumer behavior in chapter 9, population growth and investment in human capital in chapters 11 and 12, and an economic analysis of behavior of individuals controlling state-owned assets in chapter 19. Even if the important concepts of economic incentives and self-interest cannot explain the transformation of economic institutions as isolated events influenced by historical circumstances and political considerations, these concepts can be applied in evaluating the incentive effects and economic efficiency of particular reform measures. Such applications can be found in many places in this book.

What remains to be discussed in this introduction are the nature of China's government and its historical and cultural tradition. People outside China today still think of it as essentially a Communist country having the typical characteristics associated with Communism as it was understood during the period up to 1980. These characteristics include a totalitarian regime in which government leaders attempt to manipulate the people as Chairman Mao did. There is no freedom. There are many labor camps. The government can change public opinion at will by controlling the press and the TV stations. That it is oppressive is evidenced by, for example, the tragic event on June 4, 1989, in Tiananmen Square.

In fact, the Chinese Communist Party and the Chinese government have changed a great deal since 1978. Economic reform has led to openness and more freedom. The Communist Party officially accepted "a socialist market economy" for China in 1992. Although the country is still ruled by the Communist Party, the current characteristics of China's political and economic system are becoming very different from those listed in the last paragraph. Since economic reform started in 1978, the Chinese people have continually gained economic freedom. Economic freedom and economic wealth obtained through the market have given the Chinese people much more political power than before. Foreign trade and foreign investment promoted by the open-door policy have increased the contact of the Chinese people and government officials with the outside world. Both ordinary people and government officials are exposed to modern concepts of law and democracy. Some are even convinced of the virtues of many of these ideas. The government has instituted significant reform of China's legal system, as I shall describe in chapter 19.

Three issues often appear in the Western press when the topic of China comes up. These are the treatment of Tibet, Falung Gong, and certain political dissidents. On Tibet, most Chinese citizens (Han being the vast majority) side with the government in making sure that Tibet remains a part of China. Some Han Chinese believe that certain religious leaders in Tibet use the issue of religious freedom as a means to

promote political independence. I may add that some Chinese citizens believe that China should have more religious freedom than the government allows, even when Christian church attendance has been allowed to increase rapidly in recent years. The vast majority of educated Chinese citizens, including those studying and working in the United States, believe that Falun Gong (a “new religion” in China) is a cult and a menace to society. They tend to support the government in taking punitive actions. On the treatment of political dissidents, it depends on which political dissidents and under what circumstances.

China has its own form of representative government. In the selection of representatives to China’s legislature, members of the People’s Congress are indirectly elected by representatives at the level immediately below, until public election determines the representatives at the lowest street district or village level. Unlike the situation before the 1980s, when members of the People’s Congress only rubber-stamped legislation proposed to them by the State Council at the direction of the Communist Party, members of the People’s Congress today are educated and vote according to their own opinion. Truly democratic public elections are held in villages all over China to elect government officials at the village level, although such elections have not reached higher levels.

No single person, like Chairman Mao during his lifetime, can control the Chinese population the way Mao did. The Chinese people have become more mature politically after the movements of the Great Leap Forward of 1958–61 and the Cultural Revolution of 1966–76. Since China is now open to the outside world the people can no longer be so easily fooled. Beside the differences in historical circumstances, Mao was a Chinese political genius unique in his century. Mao designated Hua Guofang to be Chairman of the Party to succeed him, but leadership fell to the hands of Deng Xiaoping instead. Deng was able to assume leadership because he was supported by the top members of the Party. The point is that election within the Party serves as a process to select the able and to limit the power of a potential dictator. Many outside observers had forecasted trouble in the transitions after the deaths of Mao and Deng, only to find that they were wrong. This is a sign of the stability and resilience of the political leadership at the top.

Another occasion when outside observers misjudged the nature of the Chinese leadership is their very pessimistic forecast for the future of Hong Kong after its return to China in 1997. The situation in Hong Kong has turned out to be vastly different from any dire predictions. Yet another example is the devaluation of the Chinese yuan forecasted continuously by foreign commentators for two years during the Asian financial crisis of 1997–9, a subject to be discussed in section 4.4. There was also the prediction during the period of the Asian financial crisis and afterwards of an impending banking crisis, a subject to be discussed in section 4.3. Suffice it to say that positive information about China since 1978 needs to be incorporated into one’s thinking in forming a balanced assessment of the country.

Consider the life of an average Chinese citizen. There is much more freedom than before. Are there labor camps? Yes, if the term is defined as prisons in which inmates are required to work. Prisons exist mainly to detain people who have committed crimes. There are not many political prisoners because there are not many people who are strong opponents of the government. By and large, the Chinese people are happy; and they are happy with their government. Students from China who have arrived recently

can testify to this point. At Princeton in the late 1990s, one speaker was invited to talk about labor camps in China based on his personal experience in the 1960s. The situation is very different today from what the speaker described. The students from China in the audience felt indignant and jeered him. Part of this freedom is the freedom of any university student to study abroad, even when the government recognizes that many have decided to stay abroad after graduation. People are exposed to TV channels outside the mainland, including in particular those of Hong Kong and Taiwan. The internet and fax machines are available to many people. It is difficult for the government to manipulate news effectively even if it wishes to.

The government requires the support of the population to achieve its program of economic reform and development. For example, in the reform of state enterprises it may be necessary to lay off workers, and the government has to consider the possible effect of discontented workers on political stability. Chinese government leaders, just like political leaders elsewhere, consider maintaining their political power to be more important than almost any other objective. They applied force to disperse students occupying Tiananmen Square because they thought its continued occupation was undermining their authority and threatening the survival of the government. In situations where government power is not threatened, it is reasonable to assume that the government will try to promote the interests of the Chinese people, in addition to their own interests. When the position of a government official or leader is secure, it is his or her desire to serve the country, the possibility of corruption and self-interest notwithstanding. This desire is derived from a Confucian culture that has lasted centuries, and according to which the Chinese were taught to serve their country; and from the ideal of modernizing China generated by humiliation experienced since the defeat in the Opium War of 1840.

The last sentence leads to the third topic of this Introduction, namely, that China's historical and cultural tradition is an important determinant of the country's economic reform process and policies. Several historical cultural characteristics are important in this regard. First, the quality of human capital in the form of skilled and hard-working laborers and entrepreneurs has contributed to economic growth and enabled the reform process to succeed to the extent that market incentives alone cannot. Second, Chinese bureaucracy is at the same time a useful vehicle for guiding economic transformation and a hindrance to economic progress. Third, the traditional way of conducting business through informal social networks and human relations makes it difficult for foreign investors to enter Chinese markets and slows down the introduction of a modern legal system. Fourth, there is an emphasis on the collective welfare of the country as a whole as compared with the freedom of individuals, making the economy more socialistic. Fifth, there is a sense of nationalism. The current Chinese mentality is a combination of pride and the experience of humiliation. They are proud of a civilization that is over 5,000 years old, with distinctions in science, mathematics, arts, furniture, china, literature, philosophy, ethics, and politics. After the Opium War of 1840–1 and until 1945, foreign powers one after another carved up parts of China and forced it to sign unequal treaties giving concessions. Memories of oppression by Western and Japanese imperialism and the need for national independence are two important components of the Chinese mentality. Nationalism manifests itself whenever the country or any of its components appears to be under attack.

To cite an example of the manifestation of nationalism, consider the controversy in April 2001 over the possible return of the crew of a US spy plane which had landed in Hainan. The Chinese as a nation (including ordinary citizens, and government and military leaders) were very upset by the fact that when a Chinese life was lost, there was no immediate expression of sympathy or regret by the US government. Instead there was only a demand from the spying US side for the Chinese to keep away from the plane and release the crew immediately. In response the Chinese demanded an apology as a condition for the return of the crew. This demand was an expression of the pride and humiliation mentioned above. It was necessary to understand the Chinese mentality in order to resolve the conflict. The final solution took the form of a letter sent from the United States. In this letter the United States did not apologize because the American government and people thought they did nothing wrong. The Chinese felt that they got an apology in the form of two “very sorrys” in the letter, one to the Chinese people and to the family of the deceased pilot for the loss of his life, and a second for landing at a Chinese airport without having first obtained permission. Chinese nationalism and pride were preserved.

In studying the process of economic transformation in China, the roles of the government and of market forces in shaping the changes in economic institutions are important topics. In the course of our study, there are challenging problems that may require the subtle application of existing economic tools or introduction of new concepts and tools. Research on these topics will broaden the scope of modern economics and improve its tools as well, as we discuss in chapter 22. To study changes in economic institutions, one needs to treat some important aspects of the changes as unique events resulting from the efforts of governmental and nongovernmental organizations. The reform process is affected by historical and cultural factors, besides being driven by market forces and incentive considerations.

This book is written in the form of a text for undergraduates, and drafts were used as an undergraduate text at Princeton, but it is written also for the general reader and for graduate students. Graduate students may use supplementary technical material, some included in the references cited in this book. Serious reading is required for an understanding in depth, but a casual reading will be sufficient to get a general picture of China’s economy and the process of its transformation. The level of technical difficulty is low. Algebra and elementary calculus are applied in only a couple of places. Simple mathematics is always accompanied by verbal explanations. The remainder of the book is essentially pure text. However, once again, if the general reader still finds the technical material difficult, it can be skipped and the essential meaning will not be lost.

Readers’ comments and suggestions for improving the book are always welcome. They should be sent to the Department of Economics, Princeton University, Princeton, NJ 08544, USA.