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“Globalization and the Reform of the Chinese Economy”

Much about the interplay between globalization and China economic development becomes easier to understand if one is aware of the broad context of Chinese economic reform. The following presentation, although somewhat expanded from my oral remarks, still barely skims over the surface of a complex reform movement initially launched in 1979. While noting some of the extraordinary successes in China reform effort, I will ultimately be concerned with its failings. I do because I believe that the Chinese decision to make the many concessions necessary to join the World Trade Organization – which may be perceived as a vital decision to “globalize” the PRC economy – was motivated in large part by the perception WTO could solve nagging structural problems that had either proved intractable or were themselves caused by the earlier efforts at reform.

The Basics of Reform. China's extraordinary economic performance in recent years is directly attributable to a package of reforms championed by Deng Xiaoping and his allies beginning in 1979. The basic nature of early Dengist reform reflected the understanding – now all the more obvious – that stifling political controls during the Maoist period also stifled economic initiative, contributing to the long periods of inefficiency and poor production under China's centrally controlled economy. With the Chinese communist party's legitimacy at risk following Mao's disastrous Cultural Revolution, Deng boldly dismissed hardliners' claims that only centrally controlled economies could ensure an equitable sharing of wealth. Even in the best of times, he noted, China had lagged behind capitalist countries in *per capita* production, adding bluntly: “socialism should not mean poverty.”

Deng's early reforms featured three major, closely related approaches, each of which was aimed at restoring a reasonable standard of living for a dispirited Chinese public:

- 1) A move away from central planning and toward a system that had more decentralized economic control and was more responsive to market forces. Significantly, China consciously avoided the big bang approach taken in the former Soviet Union in favor of what Barry Naughton has called “growing out of the plan.” In simplest terms, this was a gradualist approach in which China sought to “surround” inefficient, Maoist-style state owned enterprises (SOEs) with more nimble, export-oriented enterprises, with the goal of creating a critical mass of the latter that would move China inexorably toward market forces;
- 2) The reintroduction of individual and institutional incentives;

3) An abandonment of the Maoist focus on self-reliance to open China to foreign trade and investment.

The former two deserve a bit more discussion, for both the decentralization of economic control and the reintroduction of incentives had an extraordinary impact on the “economic miracle” that began in Dengist China.

Individual incentives: Production almost always increased in the PRC when the party removed ideological constraints against production and rewarded increased production. This pattern held when Deng and his allies abandoned Mao’s failed emphasis on non-material socialist incentives (love of the nation and party, etc.) after the Great Leap Forward. It was all the more true when the party made a more wholesale move toward policies that provided people, factories and provinces with clear and predictable material rewards following the Cultural Revolution. Deng also put more responsibility on individual units for the level and quality of production, a reform that helped to shift decision making from ideological to objective economic criteria.

The best single example of increased individual responsibility was the so-called “household responsibility system” in agriculture, which spread rapidly after experiments in a few key provinces, significantly bolstered production. In simplest term, the HRS recreated an identity with the land by abandoning communal ownership in favor of long-term leases granted to individual families, and replaced a system in which all production went to the state in favor of a system that allowed families to control everything they produced above a reasonable (i.e., low) quota that was sold to the State at fixed prices. By returning to a more traditional farm structure and creating effective new incentives, the household responsibility system revitalized rural China, not only doubling both grain production and peasant incomes in five years, but keying a diversification of the rural economy that helped to transform the Chinese countryside.

Diversification ensued when people were allowed to use the income they earned from over-quota production to engage in non-agric sidelines that had been banned as “bourgeois capitalism” in the last years under Mao. This led to a proliferation of handicraft, transportation and (initially) other farm-related enterprises that brought new income streams to rural residents. Soon, overt signs of wealth (new houses primary among them) sprang up wherever there were sufficient natural resources for families to compete. The move away from communal farming has had some negative effects, among them the loss of good farmland to houses and factories, the proliferation of small plots that have mitigated against economies of scale, and a short-term mentality that has reduced investment in vital agric infrastructure. But initially, the benefits of the HRS far outdistanced its shortcomings, helping to bring new life to the countryside.

Enterprises: As the Dengists gave both more freedom and responsibility to the rural population, they did the same for urban enterprises. This was done most directly in the so-called factory manager responsibility system. The latter system represented a significant departure from Maoist practice in that it de-politicized enterprise management by mandating that decision making be transferred from party committees – many of

which were dominated by party hacks who had no particular expertise in production or management – to more highly skilled factory managers, who were given the mandate to run their enterprise on economic criteria, but were also made *responsible* for factory performance, profit, and loss. As key aspects of the production process initially remained beyond their control – for example, material supplies and pricing – this wasn't always fair or effective. But, particularly in smaller, non-state owned enterprises, it had an important impact on both the quality and level of production.

The Dengists also increased individual incentives in industrial production by moving away from a longstanding policy of stressing heavy industry to a more diversified production strategy that gave greater emphasis to light industry (to feed exports) and to consumer goods. They thus abandoned the old policy of enforced simplicity and frugality, symbolized by the ubiquitous blue cotton Mao suit, to create a new range of products that ranged from colorful clothes to refrigerators and color televisions. In so doing, they created merchandize that ordinary Chinese actually wanted to *buy* with their increased earnings. In the short term, pent up consumer demand fed skyrocketing inflation, but this subsided as people realized the policy would not be reversed. Longer term, the new emphasis on consumer goods led to a sustained and extraordinary increase in overall production.

Provinces: A final beneficiary of decentralized political control in the early period of Dengist reform were the localities, which, over time, were not only given permission to make special concessions to western investors but allowed to retain a considerable portion of their profits to reinvest in modernization. China's coastal provinces, which enjoyed the special advantage of location (i.e., access to the sea, and thus foreign capital and markets), abundant human and natural resources, and which for cultural reasons had a more freewheeling attitude than the interior, used this new-found freedom to become the shock troops for the economic renaissance that occurred during the Dengist reform.

Opening China to outside trade, investment. Following a following a classic policy of export substitution in which China protected many key industries with rigorous tariff and non-tariff controls, China's gradual opening to the international market has had a remarkable impact:

a) In a raft of industrial fields, it gradually forced Chinese factories to compete to an international standard. For example, whereas a Chinese factory might previously sell junky watches because they were not subject to competition, it was forced, through reform and opening, into a market that had cheap, colorful Swatches, and thus had to produce at that standard or pay the price through reduced sales.

b) Deng's policy of "reform and opening" not only forced China to offer preferential terms to foreigners to attract sorely needed technology and investment,¹ but to strive to provide the other ingredients vital to production in modern factories. These included reliable material and energy sources, skilled workers, and more broadly, the necessary

¹ This it did, initially on a limited basis in special economic zones on the coast and then increasingly inland, along the Yangze river basin.

legal and regulatory framework to support joint ventures and other business associations with foreign concerns. China still has room to improve and rationalize its labor, energy, material, and parts supply. Likewise, while it had developed some of the necessary legislation to support foreign trade and investment, a frantic game of “catch-up” is currently underway. Finally, much remains to be done on the enforcement side (as for example, on the issue of patents and copyrights). Nevertheless, the PRC has come an extraordinary distance in about 20 years of reform, and entry into WTO is gradually forcing them to come into fuller alignment with international standards.

Reflecting a hallmark of the Dengist approach, the above reforms (and nearly all others) were pursued with a pragmatism that stood in stark contrast to the rigid ideological approach taken much of the Maoist era. Under Deng’s direction, nearly all reform was acknowledged as an experiment, and nearly anything justified in ideological terms if it worked – often standing Marxist-Leninist-Mao Zedong thought on its head in the process. This approach was summed up in Deng’s classic statements that likened reform to “reaching for stones beneath the surface of a river” and revealed his low tolerance for stifling ideology by declaring it didn’t matter if one had “a black cat or a white cat, as long as it caught mice.”

The fruits of Deng's so-called economic miracle are well known, but they include:

- a) 10% annual growth over 20 years;
- b) A quadrupling of *per capita* income;
- c) Foreign direct investment (FDI) peaking at > \$50 billion/year;
- d) The virtual disappearance of doctrinaire socialism in the economic sphere.

The Contradictions Stemming From Reform: What is less well known are the problems associated with reform, though Chinese economic and social change under Deng was of a speed and magnitude that dislocations were virtually inevitable. Despite Deng’s best efforts, by the late 1980s there was still much that had not been changed; China had, in effect, become “stuck” between Mao’s central plan and a true market system. In addition, a web of rapid and encompassing reforms created its own set of new problems. I will conclude by briefly addressing some of those “contradictions” and noting the role they played in China’s decision to pursue membership in the WTO.

Problems generated by reform:

- a) Corruption – This was fed by a huge volume of foreign investment, the decentralization of control, and the severe erosion of the socialist ideological “anchor,” especially after the disillusionment caused by the suppression at Tiananmen;
- b) An unequal pattern of development between coastal China and the interior – This gulf was produced not just by sharp differences in the resource base between the coast and

poorer interior but by Zhao Ziyang's "coastal development strategy," which in the mid 1980s gave unequal benefit to China's most developed areas and envisioned wealth "trickling in" to the interior once the coast had become fully developed;

c) The struggle between the center and China's localities. In Deng's effort to create incentives, he may have given up too much control to the localities, and his successors have been put in a position of trying to get it back. This is seen in the problems in creating a workable central bank, in tax collection, in the struggle to control smuggling and copyright violations, in the continued presence of regional blockades, etc.).

The Remnants of the old system. If reform spawned its own problems, China remains plagued above all by holdover policies and institutions from the Maoist era, many of which have become so encompassing and deeply imbedded they continue to defy efforts at reform:

a) The Maoist legacy of self-sufficiency has joined with poor transportation infrastructure to stunt the growth of distribution networks;

b) Lingering price controls (especially in raw materials), fed shortages and irrational distribution;

c) Above all, China has been left with the intractable problems posed by state owned enterprises (SOEs). These include:

- The lack of a market orientation, stemming from their Maoist origins;
- Bloated staffs (the SOEs were not created to be efficient, but to soak up millions of unemployed when the Communist Party came to power);
- Onerous welfare burdens (reflecting their Maoist origins, SOEs were saddled with responsibility to provide workers and their families not only with a wage and a pension, but with housing, health care, education, etc. Despite more than a decade of pressure to reform, all this creates a burden that makes it virtually impossible for them to compete in global markets.
- State financing (reflecting their *de facto* status as welfare entities, SOEs were first funded by direct subsidies and then by loans from state-owned banks that found it politically difficult not to lend to these enterprises, no matter how inefficient. The end result was hundreds of billions in unpaid loans and a national banking crisis that may require no less than a full re-capitalization of China's banks).

The 1997 Reform Initiative and the Asian Financial Crisis.

After nearly two decades of reform, during which China found it politically impossible to force drastic reform on SOEs -- which produced a dwindling percentage of national output but still employed more than 70% of China's urban labor force -- the leadership enunciated a bold plan at the 1997 15th party congress to solve the SOE problem once and for all. Specifically, the Congress called for measures not merely to improve SOE

management, efficiency, and responsiveness to market forces (which has been going on for over a decade) but to get them off the dole – by forcing them to restructure (or close down) based upon economic criteria, by cutting them off from money from state banks unless it made economic sense to provide financing, and, finally, by relieving the SOEs of the tremendous fiscal burden placed upon them when they were created. The latter involved the State’s permission for enterprises to cut loose an estimated 30m underemployed workers they had been forced to employ when it make no economic sense to do so. It also included a landmark policy whereby SOEs were permitted to cease providing the broad range of services – housing, health care, schools, retirement, etc. – that had been mandated for workers under the Maoist system in favor of a U.S.-style system of privatization and shared responsibility.

This mandate was made at time an estimated 150 million urban Chinese were unemployed – and an equal number were probably even worse off in rural areas ravaged by oversupply and deflation. It was nevertheless a time when China’s urban economy was thriving, and the Chinese leadership anticipated record job creation as a result of a mountain of income from flourishing exports and record levels of foreign direct investment.

Reflecting the dictum that “no good deed goes unpunished,” China’s announcement that it would embark on this bold new course of reform was quickly followed by the devastating financial crisis that swept Asia beginning in late 1997. This was particularly crippling because it had a direct effect on two of the three “engines of growth” in the PRC: exports and foreign investment, since well over half of both these vital sources of income came from Asia. The 3rd engine, domestic spending, also suffered, as Chinese stopped spending in anticipation of the new “pay your own way” requirements for housing, health care, and other services outlined in the Party Congress reform.

Ultimately, continued heavy foreign investment (China, although no longer vibrant, offered a better investment option than most of its neighbors), heavy Chinese government investment in infrastructure, and draconian measures to increase exports enabled the PRC to escape the worse of the Asian contagion. But the Asian financial crisis nevertheless showed Chinese GDP growth to about 7-8% -- a level at which its poorer areas were deep in recession. In this environment, China understandably tried to halt its SOE reform initiative – particularly a heavy wave of layoffs—in an effort to avoid political instability. The result, however, was that the SOE problem persisted as the last major obstacle to full market reform.

Why WTO? Reversing a consistent pattern of circling the wagons – of stalling SOE reform and doing all possible to protect Chinese businesses from foreign intrusion – Chinese Premier Zhu Rongji came to the U.S. in the spring of 1999 signaling China’s readiness to agree to a broad range of market opening concessions the U.S. had indicated were necessary to win our support for China’s entry into the WTO. I will explore the Chinese domestic politics behind this bold decision in another paper in this *Proceedings*, but it is clear that China’s leadership risked broad popular opposition and domestic instability for a simple reason: it saw WTO membership, despite the high potential costs,

as the only way China could revitalize foreign investment, bolster exports, create a high volume of new jobs, and jump start domestic spending – all the components necessary to complete the stalled reform of State owned enterprise reform and China’s transition into a global market economy.