PETER NOLAN

The China Puzzle: "Touching Stones to Cross the River"

Why did China perform so well in the first decade and a half of reform, despite the fact that its economic institutions and policies were gravely inadequate in relation to mainstream Western economic theory and policy?

China's approach toward post-Stalinist reform contrasts markedly with that of most other former centrally planned economies. Eastern Europe and Russia have tried to move rapidly towards a market economy ("one cut of the knife"), whereas, after Mao's death in 1976, China adopted an incremental reform path ("touching stones to cross the river"). Many observers considered China's program to be poorly designed. It seemed to have led to an unsatisfactory "halfway house" that was neither capitalism nor socialism—an institutional framework which perpetuated bureaucratic interference in the economy and was expected, therefore, to have produced poor results. Moreover, the Tiananmen massacre in 1989 was connected closely with the tensions of economic reform. It was widely felt that this signaled the end of reform, and that China would lapse into low-growth authoritarianism.

But China confounded the consensus of critical opinion. Even after the Tiananmen massacre, neither reform nor economic growth was halted. In most important respects, the "halfway house" economy has performed extremely well since the death of Mao Zedong in 1976. At each stage of the reform, critics argued that the reforms had run out of steam and that short-term gains had been won through "easy" institutional change which would damage long-term performance. After a decade and a half of sustained growth, these arguments have worn thin. And now, this growth presents a puzzle for mainstream economic theory and policy.

The consensus view

While there was a minority who dissented, rarely has there been such agreement about a fundamental issue of economic policy. Several broad areas of agreement about basic propositions among economists advising the former communist countries in the early post-communist phase can be identified:

• *Market socialism cannot work.* János Kornai wrote: ". . . the basic idea of market socialism simply fizzled out. Yugoslavia, Hungary, China, the Soviet Union, and Poland bear witness to its fiasco. The time has come to look this fact in the face and abandon the principle of market socialism." (See *The Road to a Free Economy* in For Further Reading.)

• *Institutional reform cannot be successful unless there is macroeconomic stability.*

• *Enterprises will not respond in desirable ways to market signals unless private property rights are established.*

• *Enterprises' attempts to make profits will not produce socially desirable outcomes unless prices are determined by market forces.*

• *Economic progress will be greatly inhibited*

PETER NOLAN is a Fellow, Director of Studies in Economics, Jesus College, Cambridge, England and Lecturer in Economics and Politics at Cambridge University.

unless there is full integration into the world economy. In *The Economy of the USSR: Summary and Recommendations*, the World Bank urged, "It is. . . essential to move as rapidly as possible to a transparent and decentralized trade and exchange rate system, in order to hasten the integration. . . into the world economy."

• *The pace of the transition from central planning needs to be rapid.* In the opinion of Anders Aslund, "Common sense suggests that if you are sliding into a chasm, you should jump quickly to the other side. . . and not tread cautiously. There is no theory supporting a gradual switch of system." (See "Gorbachev, Perestroika, and Economic Crisis" in For Further Reading.)

• *Democratic political institutions are a necessary condition of success with economic reform.*

The Chinese approach

Market socialism was the overarching philosophy of the Chinese economic system in the 1980s, though the term "socialist market economy" was not enunciated formally as the guiding principle of economic organization until as recently as 1992. The overall framework strongly resembled that of the NEP (New Economic Policy) in the Soviet Union in the mid-1920s and in China itself in the early 1950s. The old Stalinist system of direct administrative planning was rejected decisively in favor of one in which markets and their related incentives were viewed as necessary to effective functioning of the economy. In the 1980s, public enterprises were given greatly increased independence in production, marketing, and the disposal of their income. However, key Communist Party documents spoke unremittingly of the economy as one in which public ownership, planning, and "socialist" values were central to socio-economic life. Throughout the reform period, there has been a continual reference to the need to combine the virtues of markets and planning—in striking contrast to the economic ideology of post-communist countries in Eastern Europe and Russia. There, the economic functions of the state were looked upon with hostility from the moment the Communist Parties were overthrown.

For a large number of observers of the Chinese economy, this "market socialist" mixture of market and plan under a system in which the Communist Party remained in power made it impossible to imagine that the economy could perform well. China in the 1980s, like post-1968 Hungary, was regarded as a negative example for the reforming Eastern European countries and for the former USSR after their anti-communist revolutions.

Jan S. Prybyla has written: "The sad chronicle of China's post-Mao attempt to introduce a modern economic system contains a useful lesson which others, notably the East Europeans, are taking to heart. The lesson is that to address the economic problem in a modern way in the context of a low-calibre, inefficient, slothful, wasteful, cronified socialist system, one must go all the way to the market system, do it quickly, and not stop anywhere on the way. To go part of the way slowly, 'crossing the river while groping for the stones' as the Dengists put it, is to end up the creek to nowhere."

Property rights

Instead of moving rapidly toward a system in which private property is the dominant form of ownership, China was committed to experimentalism and gradualism in ownership reform in the 1980s. Transparent, legally protected, individual property rights were the exception, not the rule in all important areas of the economy. Public ownership (with confused property rights) was the norm.

In agriculture, the "decollectivization" of farmland was not followed by the establishment of private property rights in land. The Chinese Communist Party (CCP) did not wish to allow the emergence of a landlord class; therefore, land could not be bought and sold. Rather, the village community remained the owner of its farmlands and controlled their operations. It endeavored to ensure that farm households had equal access to farmland, and obtained part of the Ricardian rents from the land to use for community purposes. The relative equality in local access to farmland was a major reason for the fact that the Gini coefficient of rural household income distribution remained so low. The rural reforms of the late 1970s and the early 1980s left property rights in land unclear. A commentator wrote in the *Cambridge Journal of Economics:* "Every member of a village community has a share in the property rights to the land of his/her community but the share is not embodied in any tangible form, such as a title deed

Table 1 **Share of Industrial Output (gross value) Produced in Enterprises with Different Types of Ownership***
(%)

	1981	1985	1990
State	78.3	70.4	54.5
Collective	21.0	27.7	35.7
Individual	neg	0.4	5.4
Other	0.6	1.5	4.3

* Data for 1981 and 1985 are both at 1980 prices; data for 1990 are at current prices.
Source : State Statistical Bureau, 1986 and 1991.

or stock, so it seems that no one is a real owner of land." Moreover, even the way land was operated continued to be heavily influenced by state instructions. The state's compulsory deliveries for some key products (notably grain) remained in force, so that providing grain for self consumption and compulsory delivery preempted around 70 percent of farmland.

In industry, although the reforms allowed individuals to set up businesses, state policies strongly preferred the publicly owned sectors (for example, the allocation of credit, power supplies, public transport, and foreign exchange). Public ownership of industrial assets took both the "all people" (state) and the "collective" (often the local community) form. Still, at the end of the reform decade, around 55 percent of industrial output came from the "all people"-owned sector and 36 percent from the collectively owned sector (see *Table 1*). The genuinely privately owned sector occupied only a tiny fraction of total output.

The reforms decentralized control over financial capital. A rapidly growing share of industrial enterprises' finance came from the enterprises' retained profits, from banks, and from other sources—inter-enterprise investment, and investment by groups of enterprises in joint projects. Furthermore, much of the control which formerly had been in the hands of central or provincial authorities was decentralized and given to local authorities, often with ill-defined rights to claim a share of enterprise profits.

In its 1990 report on the Chinese economy, the World Bank lamented the confused position in respect to property rights in the state-owned sector: "[T]he ownership of Chinese 'state-owned' enterprises is becoming increasingly ill-defined. Ten years ago, all industrial assets in the state-run economy were clearly controlled, and effectively 'owned' by various levels of governments, which exercised both ultimate management power and final claim on residual income. Today, managerial authority and claims on income are split between government and the enterprise itself, as well as, to a lesser extent, the banking system. The uncertainty attending on the ownership system is putting serious obstacles in the way of improved performance." Bankruptcy in the state sector was virtually unknown. The "soft budget constraint" was dominant, with a rapidly increasing share of finance coming from a highly politicized banking system.

The rural collective sector was the fastest-growing part of the Chinese industrial economy in the 1980s. The vast bulk of assets in this sector was owned by the local community, with the community's asset management board arranging, on the community's behalf, the key aspects of the use of the property under their control. The World Bank's study of this sector concluded: "[This is] an environment in which ownership and property rights with respect to industrial assets are not clear and pure private ownership is rare except in the smallest concerns. . . Thus, the most powerful reward for small-scale entrepreneurs in other countries—the ability to reap large gains from the 'capitalization' of entrepreneurial success in their firms—is absent or at least sharply circumscribed."

Price reform

By 1984, the Chinese government had become convinced of the necessity of comprehensive price reform. However, its approach was to give social stability a high priority. "Social tolerance" (*shehui chengshouxing*) was a key criterion by which reform was to be judged. The government decided to only gradually reform the structure of relative prices and to do so in a controlled, planned fashion. The Central Committee reported: "There is much confusion in our present system of pricing. . . . This irrational price system has to be reformed. . . otherwise it will be impossible to assess correctly the performance of enterprises. . . . As the reform of the price system affects every household and the national economy as a whole, we must be extremely prudent, formulate a well-conceived, feasible programme based on the growth of production and capability of the state's finances and on the premise that the people's real income will gradually be increased, and then carry it

Table 2 **Proportion of Products Sold at Different Types of Prices** (%)

	1978	1986	1990
Share of total retail sales sold at :			
state-controlled prices	97	n.a.	29.7
state-guided prices	0	n.a.	17.2
market-regulated prices	3	n.a.	53.1
Share of total sales of agricultural products sold by farmers at:			
state-controlled prices	94.4	37	25.2
state-guided prices	0	n.a.	22.6
market-regulated prices	5.6	n.a.	52.2
Share of ex-factory means of production for industrial use sold at :			
state-controlled prices	100	64	44.4
state-guided prices	0	23	18.8
market-regulated prices	0	13	36.8

Source: Li, 1992 and Tian, 1990.

out in a planned and systematic way."

Virtually all prices were directly controlled by the state in the late 1970s. By the mid-1980s, there had been a large growth in the role of free markets, but even by 1990, it was still the case that no more than around one-half of the value of marketed goods was sold at free market prices (see *Table 2*). Not much more than one-third of industrial means of production was sold at free market prices. Moreover, for much of the second half of the 1980s, a large part of marketed output was sold under the "dual track" system with different prices for the same product in parallel markets (state-controlled/state-guided and free).

The international economy

The value of the *yuan* was slowly brought closer to its free market rate. But even at the end of the 1980s, it had not become a freely convertible currency. Innumerable bureaucratic restrictions pertained at different points to access to foreign currency in the 1980s.

Unlike the oligarchs of the Maoist period, the leadership of the 1980s was convinced of the necessity of integration into the world economy. But, in the same fashion as Taiwan and South Korea in earlier years, China pursued an explicitly mercantilist path. Exports were "promoted" through a wide variety of subsidies, and they frequently sustained losses at world market prices. Imports were tightly controlled by a wide variety of quantitative controls (see *One Step Ahead in China* in For Further Reading).

Politics

There were important changes in China's political system in the post-Mao period. The most significant of these was the attempt, spearheaded by Deng Xiaoping to create a professional bureaucracy. The intention was to dismiss the old guard of party officials in the government administration into retirement because they did not possess high technical qualifications. This effort parallels those of Bismarckian Germany and Meiji Japan in the late 19th century, or Taiwan and South Korea in the 1950s. In these countries, a key point of the modernization drive was the creation of a professional government administration that was responsible to an unelected executive authority rather than to an elected parliament. And much progress was made in the 1980s.

Notwithstanding these changes, China in the 1980s remained a one-party state, with the CCP firmly in control of political life. The challenge to its authority in Tiananmen Square was repressed brutally. Many analysts felt that the CCP could not lead the centrally planned economy more than a part of the way towards a market economy, since further movement would threaten its power fundamentally. It was felt widely that the CCP could not, of itself, make the transition to secular national rule. It had the double burden of highly centralized traditions of Leninism plus millennia of centralized rule in China. The conjecture was that the CCP had to be removed from its monopoly of political power if the move to a market economy was to be put into effect.

In the euphoria of the post-communist world, it was very hard to believe that such a brutal, undemocratic regime as China's could perform well economically.

The results of reform

In almost all key aspects of institutional arrangements and policy, China's post-reform economy in the 1980s takes on the appearance of an interventionist halfway house that most economists would predict would perform very badly. Throughout the decade, private property rights existed in only a

Table 3 **Changes in the Characteristics of Chinese Economic Growth: Average Annual Growth Rate**
(% per annum, at constant prices)

	1957-75	1978-90
Net material product	5.3	8.4
of which:		
agriculture	1.7	5.6
industry	9.8	10.1
construction	4.6	9.6
transport	5.3	9.4
commerce	2.3	7.2
Net material product per person	3.3	7.0
Gross material product of industry:		
heavy	11.2	10.3
light	8.3	13.9

Source : State Statistical Bureau, 1991.

minor part of the economy; the government continued to intervene heavily in price-setting; the economy remained substantially isolated from the impact of world prices; the Communist Party continued to rule in a sometimes brutal and always authoritarian fashion, and intervened at all levels of the economic process. Indeed, some observers believed that "market socialism" was too charitable a description of this system and that "market Stalinism" was a more appropriate one.

In fact, in the first decade or so of reform, China's economic performance was much better than under Maoist policies. The rate of growth of net national output accelerated sharply (see *Table 3*). China's system of authoritarian political control enabled her to control population growth, despite the bulge in the reproducing-age cohorts in the 1980s. In per capita terms, the annual growth rate of net national output more than doubled. A striking shift occurred in the pattern of growth—away from that which is characteristic of a Stalinist economy. The overall industrial growth rate (already very rapid under Maoism) changed little. However, there were important changes in the efficiency in resource use. There was a sharp reversal of the long-run decline in productivity in state-run industry which China had experienced in the Maoist years, and China's state-owned enterprises began to behave in a cost-minimizing fashion. Moreover, the typical Stalinist relationship between the growth rates of heavy and light industry was reversed, with explosive growth of light industry. The agricultural growth rate accelerated beyond that achieved during the Maoist period, and with much more economy in resource use. The growth rate of commerce and transport increased sharply, as compared to the Maoist years, reflecting the rapid rise in the market economy.

China outperformed almost all developing countries in terms of output growth and export performance (see *Table 4*). Moreover, it remained relatively

Table 4 **Comparative Economic Performance of the Chinese Economy in the 1980s**

	China	India	Low Income Countries*	Middle Income Countries
Av. annual growth rate,1980/89 (%):				
GDP	9.7	5.3	3.4	2.9
Agriculture	6.3	2.9	2.5	2.6
Industry	12.6	6.9	3.1	3.0
Services	9.3	6.5	4.4	2.8
Av. annual real growth rate of exports, 1980/89 (%)	11.5	5.8	0.8	5.5
Av. annual growth rate of population, 1980/89 (%)	1.4	2.1	2.7	2.1
Av. annual rate of inflation,1980/89 (%)	5.8	7.7	14.9	73.0
Debt service as % of exports of goods and services :				
1980	4.6	9.1	11.4	26.1
1989	9.8	26.4	27.4	23.1
Index of average per capita food consumption, 1987/89: (1979/81=100)	128	113	103	101
Daily calories per capita:				
1965	1931	2103	1960	2482
1988	2632	2104	2182	2834
Crude death rate (no./1000):				
1965	10	20	21	13
1989	7	11	13	8
Infant mortality rate (no./1000):				
1981	71	121	124	81
1989	30	95	94	51
Life expectancy at birth (years):				
1981	67	52	50	60
1989	70	59	55	66

* excluding India and China
Source: World Bank,1983 and 1991.

unburdened by foreign debt, and achieved fast growth with relatively low inflation.

It cannot be argued that growth in the 1980s was achieved at the expense of popular consumption. The 1980s saw a revolution in all aspects of real incomes (see *Table 5*). A remarkable improvement occurred in the Chinese population's diet, with considerable improvements in the quality of produce. A vast new fashion industry sprung up in the textile sector. A significant increase occurred in consumer durable consumption (mainly met from domestic production), with huge new industries springing up where there formerly had been virtually nothing. Housing space per person more than doubled over the course of a decade. Large improvements took place in the availability of professional health care. A massive transformation occurred in the number and variety of services available. The reported improvement in the already exceptional figures for life expectancy and mortality rates suggests that the growth in living standards affected most social strata, even if there was greater inequality in consumption than under the extreme egalitarianism of Maoism.

China's economic performance in the 1980s was much better than that in the most relevant comparator countries (such as India) and was vastly better than anyone in the late 1970s could have anticipated. Were Eastern Europe and Russia to achieve remotely comparable advances in the 1990s, their reforms would be regarded as immensely successful.

Table 5 **Changes in the Standard of Living in China** (1978-90)

	1978	1990
Index of real per capita consumption	100	208
Consumption per capita of :		
grain (kgs.)	196	239
edible oil (kgs.)	1.6	5.7
pork (kgs.)	7.7	16.6
fresh eggs (kgs.)	2.0	6.3
sugar (kgs.)	3.4	4.9
cloth (meters)	8.0	10.6
Ownership of consumer durables(no./100 people):		
sewing machines	3.5	12.3
watches	8.5	51.6
bicycles	7.8	34.2
radios	7.8	22.0
TVs	0.3	16.2
Retail outlets, catering and service trades:		
no of outlets/10,000 people	13	104
no. of workers/10,000 people	63	255
Doctors (no./10,000 people)	10.8	15.4
Hospital beds (no./10,000 people)	19.4	23.0
Housing space per capita (sq. meters):		
cities	3.6	7.1
villages	8.1	17.8

Source : State Statistical Bureau, 1990.

Disturbing possibilities

The Chinese system of political economy in the 1980s and early 1990s was "market socialist" in any meaningful sense of the word. Yet this was one of the most dynamic in terms both of output and income growth the modern world has seen. This presents economists with a puzzle: Why did China perform so well in the first decade and a half of reform, despite the fact that its economic institutions and policies were gravely inadequate in relation to mainstream Western economic theory and policy? There are a number of possibilities, of different orders of difficulty for mainstream Western economics to digest.

The "easy" answer for economists reflecting on the shambles of post-Stalinism in Eastern Europe and the former USSR is that China entered its reform program with important advantages, compared to Eastern Europe and Russia. These include China's low level of international debt, the special role of Hong Kong and Taiwan, and the fact that China enjoys a strong capitalist tradition stretching back at least a thousand years. It may be argued also that it is easier to reform a low-income, predominantly rural centrally planned economy.

A more disturbing possibility is that China's incrementalist approach to economic reform may have been correct, and the attempt in most of Eastern Europe and in the former USSR to move rapidly towards a market economy may have been a serious mistake. The correct economic advice to the former Stalinist economies may have been to stress that their structural transformation would require a lengthy period of extensive state intervention to cope with probable large areas of market failure. The enthusiasm of post-communist "capitalist triumphalism" among advisers to Eastern Europe and the former USSR may have caused a major mistake in assessing not only the required speed of the transition but also the desirable economic functions of the state over an extended period. The huge tasks of structural transformation in an atmosphere of great uncertainty in the reforming centrally planned economies is precisely a situation in which it is likely, in principle, that market failure will be especially large—with private agents tending more than under other circumstances to look toward the short term and speculation rather than toward longer-term investment. Thus the gap between private and social benefits may be especially wide. The early stage of development economics in the 1940s and 1950s, and indeed, the practical experience of the newly industrializing countries of East Asia, may have been more relevant to the enormous tasks of transition that these economies now face than were the mainstream economics of the 1970 and 1980s, which stressed the shortcomings of the state as a vehicle for achieving socially desirable goals.

An even more disturbing possibility for mainstream economics is that a main part of the reason for the contrast may lie in the realm of politics. A successful reform strategy may require a comprehensive perspective of political economy. A more successful transition away from a communist economy may be easier to achieve with a strong state that is able to tax effectively, maintain national unity, ensure political stability, and place the overall national interest above that of powerful vested interest groups. A self-reforming Communist Party may be the least bad vehicle available to accomplish this. The causes for China's success may lie, above all, in the set of historical factors that allowed the Communist Party to survive in China (as distinguished from Eastern Europe and the USSR, where it was overthrown), and to preside over the introduction of an increasingly competitive economy.

The most disturbing thought of all is that China's explosive growth (and, increasingly, a wider growth process in former Stalinist Southeast Asia) since the 1970s may reflect a huge inherent catch-up possibility. This potentiality may have been latent in all the former Stalinist economies, because of the vast underperformance in relation to their huge physical and human capital inheritance. The reform of the Stalinist economies may be seen by history to have been a knife-edge situation in which correct choices in political economy could produce explosive growth and incorrect ones could send the system spinning backwards at high speed for an extended period.