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Demystifying the Chinese Economy

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Since beginning its transition 32 years ago, China's economic development has been miraculous. The average annual growth rate of GDP reached 9.9 percent, far exceeding the expectations of most people in the 1980s or even early 1990s, including Deng Xiaoping who initiated the reforms. Deng's goal was to quadruple China's economy in twenty years, implying an average annual growth rate of 7.2 percent per year.

In 1979 China was inward-looking and its trade as a percentage GDP was only 9.5 percent. Now China is the world's largest exporter and the third largest importer, with trade contributing around 60 percent of GDP. Over 30 years, more than 600 million people got out of poverty.

China's miracle raises the following five questions.

I. What was behind China's extraordinary performance?

After the industrial revolution, sustained growth in any economy depended on continuous technological innovation as well as industrial diversification and upgrading. As Angus Maddison shows, before the 18th century, the average annual growth rate of per capita income in the West was only 0.05 percent for years. That means it took 1,400 years for Europe's per capita income to double prior to the 18th century. In the 19th century, it took about 70 years; and in the 20th century, 35 years.

The industrial revolution sped the move away from an agrarian society where 85 to 90 percent of the labor force worked in traditional agriculture. The move from agriculture to nonagricultural and manufacturing sectors was gradual but inexorable. In the manufacturing sector, it was at first very labor-intensive, and then became more capital-intensive as technology advanced. Ultimately, the service sector dominated. Overall, the process was one of continuous structural change.

As a late-comer to this modernization process in 1949, China had the advantage of backwardness. To innovate, China did not have to invent the technology or industry by doing R&D. It could borrow technology, industries and institutions from the advanced countries with low risk and costs. East Asian economies, including Japan and the four small dragons as well as China after the transition in 1979, all tapped into this advantage.

II. Why Did China Fail before the Transition in 1979?

China didn't tap into that potential until 1979 because it adopted a misguided modernization strategy.

Revolutionary leaders such as Mao Zedong and Zhou Enlai hoped to make China an advanced country immediately after the founding of the People's Republic of China in 1949. They adopted a strategy to build up advanced capital- and technology-intensive industries even though China was an agrarian economy.

The government's priority industries went against China's comparative advantage. The government needed to protect them by giving them monopoly positions and subsidizing them through various price distortions, including suppressed interest rates, over-valued exchange rates and so on. The price distortions created shortages and the government was obliged to use administrative measures to mobilize and allocate resources directly to the non-viable firms in the priority industries. Through those interventions the government was able to set up modern advanced industries, but the resources were misallocated and the incentives repressed. Economic performance was very poor. Haste made waste.

III. Why Didn't Other Transition Economies Perform Equally Well?

Not only China but also all the socialist countries and most developing countries after WWII adopted a similar development strategy. In the 1980s and 1990s, they all engaged in reforms to transit to a market economy. However, their governments did not realize that the existing distortions were endogenous in a sense that they were instituted to protect the non-viable firms in the priority sectors. Some of them eliminated the distortions immediately. The priority sectors collapsed, causing a contraction of GDP, surge of unemployment, and acute social disorder. Others, to avoid this, continued to subsidize those non-viable firms through disguised subsidies and protection, and efficiency suffered.

China adopted a pragmatic, gradual, dual-track approach. On the one hand, the government continued to provide transitory protection to the non-viable firms in the priority sectors, and on the other hand, it liberalized private enterprises and allowed joint-ventures' entry to labor-intensive sectors-areas in which China had comparative advantage, but were repressed before. In this way, China achieved stability and dynamic growth simultaneously.

IV. What Costs Did China Pay for Its Success?

One of the main drawbacks of China's gradual, dual-track approach to transition is the widening of income disparities. From a relatively egalitarian society in 1979, the Gini coefficient reached .47 in 2007. The reason was the continuation of distortions in various sectors, including the overconcentration of financial services by the four large state-owned banks, the almost zero royalty on mining, and the monopoly of major service industries, including telecommunication, power, and finance.

Those distortions are used to subsidize or protect the non-viable firms in the old priority sectors. They also favor big corporations and rich people. For example, the interest rates that big banks charged are kept artificially low, allowing big companies and rich people to benefit at the expense of middle class depositors who have limited access to credit services. The result is a widening of income disparities.

The large corporations and rich people have a higher saving propensity than low-income households. The widening of income disparities also contributes to the saving-consumption imbalance and China's large trade surplus, which reflects the disparity in saving and consumption in recent years. Therefore, it is imperative for China to remove the remaining distortions and complete the transition to a market economy.

V. Can Other Developing Countries Replicate the Miracle?

Other developing countries can replicate China's performance. Every developing country has a similar opportunity if they know how to tap into the advantage of backwardness, learn to borrow technology from advanced countries and upgrade their industries step by step.

Most developing countries also have all kinds of distortions and non-viable firms due to their governments' past development strategies and inappropriate interventions. In this respect, China's experience in the past 30 years provides useful lessons. In the transition process, it may be desirable to adopt a dual-track approach, providing some transitory protection to those non-viable firms to maintain stability, but liberalizing entry to sectors in which the country has comparative advantage.

Ultimately, however, sustained and inclusive growth requires eliminating all distortions and completing the transition to a well- functioning market economy. ■