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# Notes on the Methodology of China's Economic Reforms

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*Since 1979 the Chinese economy has sought to modernize, that is, grow efficiently, through systemic change. The methods used to bring this about have included pragmatic gradualism, partial marketization, diversification of property rights, and partial opening to external trade and finance. First, marketization of the domestic incentive, information, and coordination mechanisms has been qualified by numerous formal and informal restrictions. Second, outright privatization has been avoided in favor of various forms of diversification of property rights. Third, with the exception of advanced technology-embodying capital, the door to external economic relations has been more open on the export than the import side. Despite occasional government protests to the contrary, the objective of the reforms is a transition toward a modern, information technology-driven market system.*

**KEYWORDS: Intersystemic reforms; intrasystemic adjustments; pragmatic gradualism; partial marketization; formal and informal regulations; foreign direct investment; third way**

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## Basic Concepts

Since 1979 China's* economy has been going through two connected and concurrent transitions: (1) from Third World underdevelopment to

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*For the sake of brevity, "China" will be used to denote the People's Republic of China.

First World modernization, and (2) from centrally planned socialism to some variant of an advanced, information technology-driven market system (systemic reform). *Modernization* is taken to mean the measurable phenomenon of efficiently rising per capita production, with goods and services produced and distributed with rising quality and lowered cost. An *economic system* is an organization of ideas and institutions where the task is to deliver wanted goods and services by allocating relatively scarce resources among competing alternative uses. Two sets of ideas are involved: positive theories (economic analysis) and normative prescriptions (codes of business ethics). *Institutions* are socially agreed-upon ways of putting ideas into practice. In simplest terms, institutions are ways of doing things—*methods*. Economic institutions are methods of allocative choice.

*Centrally planned socialism* is the economic system inspired by Marxist theory as interpreted and embedded in state power by Lenin, institutionalized by Stalin, and periodically adjusted ("perfected" used to be the word before the system expired in 1989-91) by various post-Stalin leaders in the Soviet Union and other places, China included. Systemic *adjustment* means intrasystemic change: repairs and alterations carried out within the existing systemic arrangements. Systemic *reform* means intersystemic change, measures that alter the institutions and thought processes of the system in fundamental ways. The change is revolutionary but, as in China, can be accomplished incrementally, in an evolutionary way.

There have been intimations and occasional sightings of a third transition that is relevant to the long-term viability of the first two. This is the passage from autocracy to a democratic representative polity and civil society subject to the rule of clear, credible, impartial, predictable, reasonable, and apolitical law—a movement toward what I have elsewhere called "modernity": a humane condition of equal justice, fairness, ordinary decencies, civic virtue, and civility.[1] How far China has traveled along this road since 1979 is uncertain. Certain, however, is that the distance covered has been shorter than that traversed in the two economic transitions. This im-

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[1]Jan S. Prybyla, "Modernization and Modernity in the Process of Economic Growth and Development," *Issues & Studies* 31, no. 4 (April 1995): 1-27.

portant topic of not just growing but growing up is concerned mainly with virtues, and can be alluded to here only tangentially.

The reason for systemic reform (the second transition) was that centrally planned socialism, notwithstanding much revisionist nibbling around the edges, resting as it did on a profound error of logic and a fatal design flaw, proved organically incapable of delivering on its promise of modernization. The only workable alternative at hand was the market system available in an array of operational models: (1) individualistic American (or "Anglo-Saxon") capitalism; (2) Japanese corpocratic "harmony economy" based on social consensus (but perhaps more on collusive networks of politicians, *keiretsu* business figures, and their associated bankers); (3) South Korean corporatism (a kind of capitalist central planning through highly-leveraged, family-run conglomerates or *chaebol*); (4) West German social market (sometimes called the "welfare state"); (5) the Singapore free market with authoritarian politics; and (6) Hong Kong's unfettered markets with active nonintervention by a nondemocratically constituted government that used to adhere to the rule of law.

## Methods

The methods used in China's economic reform as they crystallized over the years are: (1) *pragmatic gradualism*; (2) *partial marketization* of the domestic economy's information, coordination, and incentive mechanisms; (3) *diversification of property rights*; and (4) *partial external marketization*, or the policy of the half-open door. In addition, there is a fifth method, verging on political principle emphasized by China's officialdom, namely the monopoly of political power in the hands of the Communist Party ("One Party Under Heaven") to ensure "social stability" and, *en passant*, reassure the wavering adherents of historical materialism that the Will of History shall, indeed, be done.

### *Pragmatic Gradualism*

*Pragmatism*—an understandable reaction to the excesses of Maoism—stands in opposition to dogmatism. Ready-made models are eyed with suspicion. Because a sense of direction is needed for any reform, the official line is that China will evolve into a historically unique blend of "market socialism with Chinese characteristics"—a formulation both appealing and ambiguous. In the course of daily life, the "Four Cardinal Principles" (Communist Party leadership, the socialist road, dictatorship of the proletariat, and Mao Zedong Thought) have given way to what might be called Deng Xiaoping's "Four Pragmatic Principles": (1) the main purpose of an economic system is to make the people rich, and (2) the country strong, which (3) can be brought about only by a (new-style) Communist Party in monopolistic control of politics, (4) one actively involved in formulating and supervising market-oriented policies. The first principle is popular, of course. The second appeals to the aggrieved sense of Chinese nationalism and deep sense of cultural identity, filling a void left by the insufficiency of Marxist-Leninist dogma of proletarian internationalism. It finds a good deal of resonance in overseas Chinese communities. To justify the third, reference is made to China's rapid and sustained economic growth since 1978. The fourth reflects a belief, widely shared especially in Asia, in the necessity of and benefits to be derived from government intervention in economic development, especially but not exclusively in the early take-off stages, and the rejection of, or at least a high dose of skepticism about, the capacity of market automatism to spark, sustain, and calibrate this process.[2]

*Gradualism* stands in opposition to leaping, storming, and bludgeoning one's way to reform. No massive instantaneous transitions and shock therapies occur, but rather incremental change is sought, without mass mobilization movements. The guiding slogan has been: "Let's cross the

[2]"To suggest that government intervention leads to successful economic development is nothing new. The many studies of state-led development in Japan and the East Asian newly industrializing countries (NICs) have highlighted the importance of government policies and institutions." Jean C. Oi, *Rural China Takes Off: Institutional Foundations of Economic Reform* (Berkeley: University of California Press, 1999). What is new in China (Chinese characteristics?) "is to cast *local* government in the lead role of the development process. Even more surprising is that these governments are communist. Such systems have generally been assumed to be incapable of reform." Ibid., 3. At its present stage of evolution, Professor Oi thinks, China's economic system, certainly at the base and up to the county level, can best be conceptualized as "local state corporatism," not as a market economy.

river while groping for the stones," zigzag our way forward, and pause or retreat a step or two if need be. Adapt to changing circumstances. Learn by trial-and-error, or as the late Chairman would say: "Learn by doing" (but without predefining what error is). Allow, indeed facilitate, local initiative through fiscal decentralization and other economic applications of one-party pluralism. Try out promising (not harebrained) ideas on a small scale in a given area, and if they work there, extend the successful experience so gained to wherever it fits best and might do the most good. Under Mao the people and the Party bureaucrats went through many painful, sometimes calamitous, mass movements intended to solve huge problems at once, a procedure borrowed from Stalin's Russia. The post-Mao reformers rejected this approach, a decision which seemed reasonable on its own merits and in the straitened material circumstances of the time.

*Sequencing of reforms*. There are, however, different possible time frames for hurrying slowly, and gradualness raises the question of the optimal sequencing of the reforms. The Chinese reformers proceeded from agriculture to industry, external commercial relations, and now to the financial sector. They chose to sideline and defer the tackling of the really tough and potentially disruptive problems (e.g., across-the-board price liberalization and change in the ownership structure of large state-owned industrial firms) to a later time, when presumably the national pie would be larger, and hence the shock of institutional reconstruction less traumatic for those proximately affected by the changes. However, among the costs of action delayed are logical inconsistencies and institutional disjunctures within the embryonic market system that hamper and distort rational resource allocation and provide opportunities for socially wasteful (and morally questionable) arbitrage and rent-seeking activities. This behavior occurs in the privileged elites whose privilege derives from monopolistic political power and the feebleness of civic society.

Pragmatic gradualism in transitions from dysfunctional socialist central planning has enjoyed good press because of China's impressive growth since 1979 (efficiency of that growth remains a subject of controversy) and the usefulness of reforms to a very large number of final consumers in a historically short period of time. Practicality has a way of slipping into expediency and gradualism into procrastination, however. Problems neglected tend to exfoliate. It is therefore "far from clear that China's more gradual approach to economic reform is superior to the more rapid transformations attempted in some of the states of Eastern Europe," as has often been alleged. "Those states absorbed the costs of restructuring quickly and were able to put in place systems for allocating resources efficiently. That provides the most promising basis for sustaining long-term economic growth."[3]

*Partial Marketization of the Domestic Incentive, Information, and Coordination Mechanisms*

The economic decisionmaking (allocative choices) of two or more entities (persons or organizations) must in some way be motivated, informed, and coordinated into systemic coherence. Two major methods of motivating, informing, and coordinating the economic decisionmaking of buying and selling entities so as to bring about modernization have been: (1) unsuccessfully by *centralized bureaucratic means from above*, and (2) successfully by *decentralized market prices from below*. The bureaucratic or administrative method of motivating, informing, and harmonizing the activities of the system's participants through one-dimensional, mostly physical/engineering, unconditional commands is the main information, coordination, and incentive mechanism of socialist central planning. In a capitalist market system, however, the dispersed, self-interested (rational, not narcissistic)[4] allocative decisions made by autonomous competing buyers and sellers are informed and synchronized by multidimensional market prices expressed in monetary terms.

Bureaucratic information, coordination, and incentives involve far-reaching demonetization of the economy, originally envisaged in its pure form by Marx for, as it turns out, the illusory stage of full communism. In

[3]Nicholas R. Lardy, "China's Economic Transformation" (Paper prepared for the U.S. Army War College Annual Strategy Conference, April 1996, Carlisle Barracks, Pennsylvania [mimeographed]), 19.

[4]The "self" in self-interest is understood to cover not only the individual but the household, or what used to be called the family. "Rational" means that the buyer seeks to maximize his satisfactions and the seller his profits. Both may settle for something short of perfect maximization, a position known as profit "satisfizing" in the case of the seller.

the Soviet-Stalinist model of actual (not cerebral) socialism, the role of money as the motivator of allocative decisions-cum-conveyor and co-ordinator of economic information is passive. The central bank and its branches (i.e., the whole banking system) act as bookkeepers and financial auditors/controllers of the material balances of central planners (a crude form of input-output accounting). Domestically, at the consumer end of the production-distribution chain, demonetization takes the form of the inconvertibility of money into goods. This is either because by decision of the planners the goods are not there, or because such goods as are there do not meet minimally acceptable quality standards in the estimation of even the most deprived consumers. For domestic producers money is inconvertible into foreign goods because of administrative import restrictions and the state foreign trade monopoly's control over multiple foreign exchange rates. In the model's demented Maoist version (e.g., the Great Leap Forward at its peak), the functions of money are altogether extinguished and the economy reverts to a primeval condition of centrally misplanned barter. The bureaucratic method has proved itself to be of limited information-carrying capacity. Its ability to blend the diverse ingredients of the plan was confined to an infrequent—and for the most part fortuitous—rough approximation of planners' decisions to internal consistency without, however, any indication of the real economic cost of the choices made. Incentives were for the most part negative and perverse, inducing agent behavior at odds with the commands of the principal (central state planners).

*Marketization* of the economy's incentive, information, and coordination mechanisms means the replacement of plan-integrated administrative commands (punishments and rewards from above) by money market price-informed and -coordinated, profit- and utility-maximizing decisions. These decisions are made by autonomous, rationally self-interested individuals and voluntarily-constituted, legally sanctioned and protected associations of individuals (companies, partnerships, and cooperatives). Moreover, the prices are spontaneously generated, *en allant*, by competing buying (demand) and selling (supply) actions of transactors. Marketization implies, ipso facto, remonetization of the economy, followed by continuous development of the financial system as the economy becomes more high-end service-oriented and knowledge-driven. In its advanced form, the system may be likened to an information-generating, -disseminating, and -processing machine with no moving parts; a collaborating, conflict-resolving medium. Its essential ingredients are (1) freedom of transactors to enter and leave the market and to accept or reject purchase or sale offers; (2) prevalence of multidimensional, decentralized, take-it-or-leave-it price information (pure information) about alternatives (opportunity costs) available in the system; (3) maximizing behavior (rational self-interest) by buyers and sellers; and (4) effective competition—price and nonprice, actual and potential, carried out through the intermediation of commercially-oriented financial institutions. I will argue that broad, clearly defined, protected, and enforced private property rights are another essential ingredient of the system, as is verifiable trust.

*Partial marketization* means that some now economically pointless information, coordination, and incentive encumbrances of the central plan remain in a pubescent market system, and that new nonmarket administrative restrictions are imposed by the government on the emerging market prices. The restrictions are both formal (officially sanctioned, but not always made public) and informal (unspecified but widely understood and enforced with "one eye open and the other closed").

An interesting difference between pre- and post-reform restrictions is that before the reform *formal restrictions* issued principally from the Marxist-Leninist creed as presented in the Party's teachings of the moment and were comprehensively exclusionary. In other words, they were intended to marginalize, and often—as in the case of capital goods—obliterate market price information, coordination, and incentives, and replace them with plan-generated scarcity signals, orchestrations, and inducements to bring about internal consistency of plan-mandated decisions. After the reform began, the introduction of formal administrative limits on the operation of emerging markets and their prices was motivated mostly by practical considerations of market management. The restraints tended to be partial and selective, and subject to reconfiguration or recall as inflationary, deflationary, or other circumstances seemed to warrant. Marxist-Leninist prescripts no longer served as the economy's theoretical reference points. Instead, faith—shared by most Asian "tigers" (pre-July 1, 1997 Hong Kong excepted)—in the necessity and virtue of activist state involvement in a capitalist economy became the theoretical justification for government interventionism.

*Informal restrictions* are very widespread in China. They inhabit the regulatory gray areas and are traceable in part to the need felt by potential market transactors (local government entrepreneur-officials included) to cut through the tangled web of formal and discreet administrative regulations introduced since the reform. They are also traceable in part to the existence of gaps and incompatibilities between the new market information, coordination, and incentive mechanisms and remnant administrative command structures and, not least, by poor commercial hygiene carried over from a more distant past. The last includes considerable cross-dressing between businessmen and Party, government, and army bureaucrats; influence peddling through networks of connections within a culture of superficial compliance, cronyism, transactional friendships, and favor swapping (a form of demonetization through delayed barter); sub rosa taxation ("squeeze") of peasants by grass-roots officials and higher-ups not always so high-minded as Western field research interviewers perceive them to be; a penchant for opacity and fudging (the enemies of market efficiency); considerable rule-by-fiat; and swarms of devious tactics and insider practices sometimes admiringly referred to as "enlightened bribery," a sort of invisible hand under the table in conditions of semi-socialism.

In practice, economic systems are institutionally mixed, being a combination of market prices and bureaucratic information, coordination, and incentive mechanisms. What matters is the relative strengths of the components of this mix. Marketization must mean: (1) that in a market system bureaucratic information, coordination, and incentives are subsidiary, not designed to stultify or nullify the efficiency signals conveyed by a uniform system of market prices, except in cases of carefully documented and demonstrated market failure (due to imperfect or asymmetric information on means and ends, intrusion of chance, accident, luck, or behavioral irrationality, for example); but that on the contrary, (2) they be reduced, liberalized, and phased-out; and (3) that effective new indirect monetary and fiscal policy instruments (the last to be restrained in their social engineering compulsions) and market-conforming regulatory mechanisms be developed. Although it is difficult to measure the frequency and intensity of bureaucratic intervention that the market price system can tolerate without becoming seriously weakened, confused, or disabled in its information, coordination, incentive, and other (e.g., efficiency) functions, such critical values do exist.[5] They witness to the fact that beyond a certain critical point and over the longer term, political and special interest-driven interventions in the market price process cause structural deformations, which in a globally increasingly interdependent economy show up in loss of international competitiveness and the erosion of modernization.

China's decision not to remove quickly the pre-reform system of government-set prices but instead to marketize prices gradually is exemplified by the *two-tier pricing* method for agricultural and industrial goods introduced in the early 1980s. The first tier consisted of prices emerging from relatively free interactions of comparatively autonomous buyers and sellers in the market—relatively and comparatively to the situation before the reform or to market conditions in mature capitalist economies. The second tier consisted of prices determined by the state in various ways: through "state order," "state guidance," or "negotiation." The idea was to ease the economy (rather than shock it) into a fundamentally different way of motivating and informing economic entities and coordinating their choices so as to minimize economic and social disruptions and to gradually reduce the initially often wide gap between the two tiers by bringing the state-set, state-controlled, and state-negotiated prices nearer to (quasi) free market prices, thus allowing most of the state prices to wither away. The general, albeit meandering, direction of the price decontrol movement, marked by occasionally backtracking, has been toward an information-coordination-incentive system dominated in principle by workably competitive market prices, but allowing for exceptions dictated by social, political control, and economic policy considerations.[6] According to a Chinese source, the share

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[5]Janos Kornai, "The Hungarian Reform Process: Visions, Hopes, and Reality," in *Remaking the Economic Institutions of Socialism: China and Eastern Europe*, ed. Victor Nee and David Stark (Stanford, Calif.: Stanford University Press, 1989), 48.

[6]For example, natural gas prices are set by the government in a way believed to be designed to shift the country's energy supply away from coal by the year 2015. In August 1998 government-set gas prices were about US$50 per 1,200 cubic yards, compared to the international price of US$100. This differential made natural gas development unappealing to

of agricultural product prices determined by market forces rose from 52 percent in 1990 to 79 percent in 1994. The remaining prices were the result of state order and state guidance. In 1990 the share of market-set industrial commodity retail prices was 53 percent, rising to 90 percent in 1994. Interestingly, for "production materials" (presumably producer goods which in socialist central planning theory should not enter the market at all) the market-priced shares were 36 percent in 1990 and 80 percent in 1994.[7] Although broadly reflective of the pricing trend, these and other figures originating in China should not be taken too literally. The reality of China's transitional economy does not readily fit neat analytical grids. "State guidance," for example, can assume many guises, some of which are so subtle that they elude legal and statistical definition. Because of such interventions in nascent markets by authorities positioned at various levels of the administrative pyramid, "market forces" in China are not always reliable guides to relative resource scarcities. The markets remain markets of sorts, far from the textbook sort. Textbook-type markets require (1) a high degree of firm autonomy, (2) price flexibility over the medium term, (3) strong enterprise profit orientation, (4) strict financial discipline within firms, (5) effective competition among producers, including free entry and exit, and (6) transparency of transactions.[8]

The two-tier price method of transiting from physical commands to market pricing as the principal method of motivating, informing, and coordinating economic choices has met with the approval of some economists.

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foreign oil companies. Without foreign participation, however, the projected transition could take longer and turn out to have been uneconomical due to the price distortion. Retail grain prices charged urban consumers at state retail stores were for a time lower than both the contractual prices paid by the state to the decollectivized farmers and free market prices, constituting a hefty subsidy to urban residents.

[7]Thomas G. Rawski, "Reflections on Three Decades of 'China Watching'," in *Tendencies of Regionalism in Contemporary China*, ed. Yu-ming Shaw (Taipei: Institute of International Relations, National Chengchi University, 1997), 332, citing Guo Jianying, "The Proportion and Changes for Three Types of Prices," *Zhongguo wujia* (China Price), 1995, no. 11:10-12.

[8]William A. Byrd, *The Market Mechanism and Economic Reform in China* (Armonk, N.Y.: M.E. Sharpe, 1991), 31-37. Market prices are "the actual rate of convertibility (or "substitutability") of different resources for one another, whether as means to produce other goods or to satisfy particular human needs." See F. A. Hayek, *The Fatal Conceit: The Errors of Socialism*, ed. W. W. Bartley III (Chicago: University of Chicago Press, 1988), 99.

While possibly wasteful in the short run compared with accelerated across-the-board price liberalization, many think this method confers important longer-term benefits on an economy in the process of systemic transformation. Among these are (1) experience gained via functioning markets, (2) the development of commercial channels over time, including their legal, accounting, and other indispensable infrastructures, and (3) improved allocative efficiency as firms make a growing share of their production decisions at the margin in response to quasi-market price signals in an increasingly buyer-ruled market environment. A buyers' market (equilibrium or excess supply) is necessary for firms to have the incentive to respond to demand, become cost-sensitive, and improve efficiency. This does not happen to be the case in a sellers' market (excess demand) where the buyer is routinely ignored—a normal condition of centrally planned socialism.[9] Other economists have criticized the two-tier method for being symptomatic of the Chinese reform's tendency to defer the tackling of intricately interrelated economic (and politically sensitive) problems to a later time, thereby compounding the difficulties. They argue that the stewpot capitalism of market and administered prices has encouraged investment decisions in the state-owned industrial sector which strengthened and enlarged in absolute terms (i.e., in terms of labor and fixed asset employment) the pre-reform socialist industrial structure that is not viable on the long view. By virtue of this, the long-term cost of economic restructuring has been significantly increased. Chinese average annual growth rates, impressive as they have been during the two reform decades (ca. 9.5 percent in real terms), are not impressive when related to China's high domestic investment rate (30-40 percent of gross domestic product [GDP] on the average), that is, if judged by the criterion of investment efficiency. They also argue that the two-tier price method tends to encourage competitive rent-seeking behavior in friable markets. Where multiple conflicting prices for the same good exist, producers with access to inputs at the lower state-fixed prices

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[9]Byrd, *The Market Mechanism*, 226, and "The Impact of the Two-Tier Plan/Market System in Chinese Industry," *Journal of Comparative Economics* 11 (1987): 295-308; Barry Naughton, *Growing Out of the Plan: Chinese Economic Reform, 1978-1993* (Cambridge, U.K.: Cambridge University Press, 1995), 220-27.

(fixed formally by decree or accessible informally through bribes) and able to sell these inputs at higher market prices can reap often considerable rent-like profits, which from society's perspective are simply a waste.

On balance, one can go along—but very cautiously—with the most positive construction, that "despite problems, market pricing has become well established and appears at least reasonably reflective of market conditions. . . . Competition has been heated in some industries when producers faced a buyers' market and had obvious benefits to customers, though such competition typically has not focused on cost reduction. Also competition has been restricted by the rarity of exit of state enterprises."[10]

*Diversification of Property Rights*

China has been reluctant to thoroughly *privatize*, i.e., vest in individuals and voluntarily constituted associations of individuals (unincorporated firms, corporations, partnerships, and cooperatives) broad interconnected, but separable rights to free, but not absolute use (management), transfer of (acquisition and disposal), and residual income from productive assets (net income after costs, taxes, and other social imposts). The combination of the *three broad rights of use, transfer, and residual income* is the right of ownership. "Thoroughly" means that these three rights (the "who owns what") are exercised by private entities in fact; that they are predictable, stable, clear, and secure (i.e., embedded in and protected by law); and that they are the dominant property regime in the system. As with marketization of incentives, information, and coordination, the departure from total direct and indirect (Stalinist-style collective) state ownership has been partial in China, meaning that property rights, instead of being widely and thoroughly privatized, have been diversified. Total state ownership has been replaced by various ownership modes in which—with the exception of a small sector of private domestic and foreign (including "overseas compatriot") ownership—the Chinese state at all territorial and hierarchical levels actively participates and dominates the property landscape. This oc-

[10]Byrd, *The Market Mechanism*, 200, 224. And, one might add, by postponing the formal marketization of labor.

curs to the applause, one might add, of declared and closet market socialists everywhere who see in this development a confirmation of their scholarly meditations that privatization may be neither a necessary nor a desirable precondition for successful market reform of socialist central planning.[11]

The reluctance of Chinese reformers to launch wholesale privatization stems from both pragmatic considerations and their Marxist-Leninist upbringing. A major practical reason is the fear of widespread urban unemployment consequent on privatization/rationalization that could lead to social chaos (*luan*). As Marxists, even though fallen away ones, Chinese leaders publicly adhere to the proposition that socialized property is the essence of socialism, the basis of Marx's definition of class on which the whole Marxist analytical edifice of "scientific socialism" rests. Through some of their in-house intellectuals, Chinese leaders are also passingly familiar with Western academic models of market socialism that purport to demonstrate the theoretical feasibility, indeed, allocative and moral superiority of the coexistence of market coordination with state property over what others see as the natural meshing of market coordination and private property. As unrepentant Tiananmen Leninists, they understand that privatization involves the redistribution of power in society—the state's sharing of control with autonomous nonstate groupings—and that economic power is an important component of total power. One gets the impression, however, that the reformers' go-slow tactics are due to the potentially dramatic rise in open unemployment that would follow the shedding of redundant underemployed labor necessary for wholesale privatization of large state-owned enterprises.

Just as partial domestic marketization of the information, coordination, and incentive apparatus through the two-tier pricing device is seen positively by some economists, so too is privatization (diversification of property rights). The technocratic reasoning runs as follows: What really

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[11]E.g., Inderjit Singh, "Is There Schizophrenia about Socialist Reform Theory?" *Transition* (World Bank) 2, no. 7 (July-August 1991): 2. Cf. Thomas G. Rawski, "Implications of China's Reform Experience," *The China Quarterly*, no. 144 (December 1995): 1150-73; and "Progress Without Privatization: The Reform of China's State Industries," in *Changing Political Economies: Privatization in Post-Communist and Reforming Communist States*, ed. Vedat Milor (Boulder, Colo.: Lynne Rienner, 1994), 27-52.

matters is not who owns the means of production, but to what regime of information, coordination, and incentives—market price competition or bureaucratic memoranda—property rights are subjected. On this instrumental view, the legal ownership question is secondary and perhaps best left legally opaque.[12] The explanation holds that the industrial landscape in China is made up of two kinds of enterprises: (1) those subject (in the main) to market pricing, profitability tests of survival, relatively autonomous decisionmaking by managers (private or public), and market competition; and (2) those governed mostly by administrative rules, no matter at what level of government these rules are formulated and/or applied, i.e., enterprises which act as "work units"-cum-social welfare agencies (*danwei*) for their employees, particularly with respect to employment tenure, and are only marginally exposed to dynamic markets, while possessing ready access to administratively allocated bank credit.[13] As noted earlier, however, many markets in China are "markets of sorts," which makes it difficult to winkle out the precise meaning to be attached to notions such as profitability and autonomous business decisionmaking. Moreover, the dividing line between the two types of enterprises is itself sufficiently obscure to flummox the most persistent researcher. Thus, firms and their managers in the first group—those assumed to be subject to market discipline—vary in the degree of exposure to market dynamics according to the quality and reach of each firm's contacts and favors network (*guanxi*). They also vary in the number and consistency of the bureaucratic protective strata that each firm has managed to create for itself, the higher-up the better. Among other benefits, the solidity of such networks—which have to be carefully nursed,

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[12]It is my understanding that the instrumental approach is represented in the work of William Byrd (*The Market Mechanism*); Barry Naughton, "What is Distinctive about China's Economic Transition? Enterprise Reform, Macroeconomic Performance, and Welfare," in *Transformation of Planned Economies: Property Rights Reform and Macroeconomic Stability*, ed. H. Bloomenstein and H. Marrese (Paris: OECD, 1991), 29-49; and Jean C. Oi: "The key variable is not the form of ownership, but the incentive structure for the officials who manage [the] firms" (*Rural China Takes Off*, 56, 62-65). Cf. Louis Putterman, "The Role of Ownership and Property Rights in China's Economic Transition," *The China Quarterly*, no. 144 (December 1995): 1047-64; and On Kit Tam, *The Development of Corporate Governance in China* (Cheltenham, U.K. and Northampton, Mass.: Edward Elgar, 1999).

[13]Xiaobo Lu and Elizabeth Perry, eds., *Danwei: The Changing Chinese Workplace in Historical Perspective* (Armonk, N.Y.: M.E. Sharpe, 1997).

maintained, and constantly renewed—helps determine the ease with which firms can obtain state bank loans and the degree of moral hazard involved in the borrowing. Included in the first group are joint ventures between Chinese government organizations and foreign companies (which in 1996 produced 44 percent of China's exports), and many labor-intensive, technologically middlebrow township and village enterprises (TVEs).[14] As will be noted later, also far from clear is the precise placement in this analytical schema of China's decollectivized minifarms, the tenant peasant families who cultivate them, and the pricing which governs their activities.

Some have suggested that the "as if" (de facto) private sector in industry is larger in terms of production and employment than revealed by the official classification of output and employment by type of ownership. Many firms in the official "collectively-owned" category are for practical purposes private in the sense that they carry on their business with a fair degree of autonomy within a competitive market-price environment. At the same time, however, they prefer to be formally owned by, or in combination with, village and township governments. This leads to a semantic political insurance ploy familiarly known as "wearing the red cap." Whatever the case, the opaqueness of diversified property rights in reformist China does not seem to be one of those sometimes vaunted "Chinese characteristics" that has made the systemic transition successful beyond belief, but rather a useful temporary makeshift arrangement and one of the "unfinished businesses" that will eventually have to be addressed for the sake of economic efficiency. Fudging, in China or anywhere else, ensures more trouble later. In all advanced market economies, to the status of which China aspires, property rights are clearly delineated, enforced, and protected by law, not muddied by fortune cookie aphorisms about clear water not being good for the health of fish ("If the water is clear, the fish die"). In those same economies, institutionally mixed that they are, private ownership dominates the property landscape in both agriculture and industry.[15]

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[14]The output of TVEs has grown prodigiously over the years: ninefold from 1980 to 1987 and more than 26 percent a year on the average in 1978-90.

[15]Tom Bethell, *The Noble Triumph: Property and Prosperity Through the Ages* (New York: St. Martin's Press, 1998).

Publicly-owned enterprises operate in a sea of private sector competitors. Governance by dynamic competitive markets, the linchpin of the instrumentalist thesis, is possible only if (1) publicly-owned firms are not too cozily protected from competition or subsidized by their government owners, and (2) there is credible, strong, actual, and potential competition from privately-owned firms. In addition, not yet clear is how open to market-entrepreneurial transformation are the habits of mechanical routine which over the ages have shaped the behavior of state bureaucrats. Notwithstanding the success of the TVEs in absorbing surplus rural labor in higher value-added employment, the evidence on the efficiency and inner workings of this vast operation is not all available yet. Ambiguously-formulated property rights are an invitation to official profiteering (*guan dao*) and abuse of power by those in charge of assets. Such fuzzily-defined rights have resulted in some transitional economies (China included) in asset-stripping by entrepreneurial bureaucratic managers and their principals, and in numerous cases of official malfeasance.[16]

The massive privatizations of TVEs between 1990 and 1996, the constitutional revision initiative launched in 1997 and approved by the National People's Congress in March 1999, and talk about granting peasant families land transfer rights all seem to point to a growing perception among some influential reformers that private property rights are not an ancillary component of an efficiently functioning market system. These events also point to an implicit rejection of the thesis that such rights may "play a far less important role than is conventionally ascribed to them [by standard economic theory]."[17] Still, the situation of property rights in China remains fluid and obscure. Some of the measures taken since 1994 look like incipient reforms; others more like adjustments. If the liberalizers

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[16]Pao-min Chang, "Corruption and Crime in China: Old Problems and New Trends," *Journal of East Asian Affairs* (Seoul) 13, no. 1 (Spring/Summer 1999): 221-68.

[17]Joseph Stiglitz, *Whither Socialism* (Cambridge, Mass.: MIT Press, 1994), 261. There has always been a "two-line struggle," or at least a lack of a genuine united front, within the top leadership on how far and how quickly the reforms should proceed. In mid-1999 the more liberal group led by Premier Zhu Rongji centered on the State Council. The orthodox communist opposition under Li Peng appeared to have found its voice in the National People's Congress. Matt Forney, "China's Zhu Holds Course on Reform as Markets Worry He Faces a Purge," *Wall Street Journal*, July 2, 1999, A9.

prevail, enterprises that in principle are already open to market forces are to be opened even more in practice. Small and medium-sized firms owned by local governments are to be further exposed to the discipline of market competition by having their bureaucratic protections (such as subsidized bank lending) removed. Their property relations are to be concurrently restructured in de facto privatizing ways through shareholding, sale, and leasing. Uncompetitive, inefficient firms are to be winnowed out by the market. Small family-run businesses are to be allowed to develop into large companies, through merger if need be. All these changes would require that the dimness presently enveloping private as well as "nonstate" (local government) legal rights to the residual income from assets under their management be dissipitated. Central government-controlled, *danwei*-type enterprises are to be consolidated into profit-oriented, globally competitive conglomerates on the model of Japanese *keiretsu* and South Korean *chaebol*, a decision made at about the time that these models were fast losing their reputation for miracle-working under the onslaught of the East Asian economic and financial crisis. The exhortatory slogan attached to the two-pronged policy is "grasping the large [centrally-owned firms] and letting go of the small [local government-owned ones]," the postulate being that—notwithstanding the accumulating evidence to the contrary—the government was better placed than the market to pick the winners among the large firms.

At the time of agricultural decollectivization, considerations of immediate incentives to farmers and equalitarianism of land allotment were more important than optimal farm size. The result has been a very large number of very small farms whose size has been mostly determined by the social criterion of the number of working members in a household. Much needed farm consolidation could be achieved by removing the existing restrictions on household transfer rights through privatization. There have been occasional indications that the government is considering extending land leases which are up for renewal to thirty years as an incentive to peasants to improve farm management and productivity. Such contract extensions have been made in many but not all areas of the country, often to the accompaniment of celebratory speech-making and the clash of gongs and cymbals reminiscent of olden times. Such measures would qualify as liberalizing adjustments rather than reforms, since they do not bring into being a cadastre clearly and securely specifying the families' title to the land. At the end of 1998 an official of the Ministry of Agriculture was quoted by the government periodical *China Business Weekly* to the effect that the state might eventually lift control over farmland ownership, i.e., fundamentally reform the land code. On the instrumental view, agriculture is only partially exposed to dynamic markets. The agricultural industry as a whole, particularly the grain trade, remains highly bureaucratized and regulated.

*Partial External Marketization:*
*Policy of the Half-Open Door*

Export aversion and the method of self-reliance (*zili gengsheng*) bordering on autarky were abandoned. They had been borrowed from Stalin but the resulting shuttered society was in China's instance also a mostly self-willed exclusion with little redemptive quality to it. They were replaced by active involvement in (1) *external trade*; (2) inward *foreign direct investment* (FDI), and, in due course, officially-sanctioned *investments abroad* (mainly in Hong Kong); (3) *borrowing* from international financial agencies and foreign government-related sources at preferential and concessional rates by reason of China's developing status, as well as from commercial banks at the going market rates; and (4) *extension of loans* to unfortunates like Russia (US$540 million offered in 1998) and for Thailand and Indonesia which had fallen on hard times (US$1 billion pledged through the International Monetary Fund [IMF]). China also reentered the *international bond and equity markets*. It bought more than US$1 billion Fannie Mae bonds in 1997, for example, and contracted for US$8 billion worth of oil concessions in Venezuela, Sudan, Iraq, and Kazakhstan. Domestic-only "Class A" shares and "Class B" shares—stocks in Chinese companies priced in U.S. dollars and formally reserved for foreign investors (but informally available to some Chinese buyers)—are traded on the Shanghai and Shenzhen stock exchanges, both of which are highly manipulated by the state. Government bureaucrats select which companies are to be listed, and in the process favor state-owned enterprises. As of mid-1999 there were roughly 40 million accounts, many with multiple—mostly urban—investors, and market capitalization was equal to about 30 percent of annual economic output.[18] Like in many other developing economies, trading volumes relative to capitalization have been high, their pace frenzied, prices volatile, and prudential supervision lackadaisical.

Liberalization of external economic relations has been accompanied by an off-and-on devolution of not precisely clarified authority in these matters. Power has been transferred down to provincial and lower-level governments, even as far down as individual state and state-related enterprises. Liberalization has also been accompanied by a reduction in the number of state trading companies with a concurrent diminution of these traders' monopolistic powers in the designated areas of their competence. When such *decentralization* was abused, as was often the case, or when external events beyond China's control (e.g., the East Asian financial crisis of the late 1990s) threatened the trade balance and the exchange rate, varying degrees of recentralization followed.[19]

The opening-up to the outside world (*kaifang zhengce*) has been partial, greater on the export than the import side (technology and capital imports apart), more open to the coastal provinces and the south than to the rest of China, and subject to cyclical bouts of opening and partial closing. Considerable elements of *protectionism* remain. They appear to be inspired in part by Japanese, South Korean, and Taiwanese neomercantilistic growth strategies of the 1960s through the 1980s. China also constructed a modified version of the Taiwanese and South Korean export processing zones (renamed "special economic zones," SEZs). These zones allowed opening-up policies to be tested in a controlled environment, and later extended to several coastal cities, the deltas of major rivers, and science/technology development zones in a number of urban areas. Since their foundation in 1979, the SEZs have averaged 30 percent annual growth and with 0.01 percent of China's population were responsible for about one-fifth of total exports in 1998. But their boom years seem to be over due to

[18] *Wall Street Journal*, July 6, 1999, A10.

[19] Zhing Zhu Ding, "Decentralization and New Central-Local Conflicts in China," *American Asian Review* 16, no. 4 (Winter 1998): 63-94.

(1) rising land prices and labor costs compared with the interior of the country; (2) Asian crisis-induced decline in exports; (3) concern by foreign investors about the soundness of China's financial system pockmarked with bad debts owed by de facto bankrupt but still operating state-owned enterprises of the *danwei* type; and connected with this, (4) the center's crackdown on freewheeling local authorities.

With an average rate of 33 percent in the early 1990s, Chinese *tariffs* were high. However, because of the many tariff exemptions on capital and intermediate goods introduced at that time, China claimed that the actual tariff rate amounted to only 3.2 percent. Between early 1996 and October 1997, the average nominal tariff was cut by half—down to about 17 percent. Concurrently, however, most of the tariff exemptions were done away with, while some—those connected with FDI inflows—were later reintroduced. With an eye toward future entry into the World Trade Organization (WTO), China has communicated its intention to reduce average nominal tariff levels to 15 percent by the year 2000.

The problem, however, lies not so much with tariff levels as with less visible, more *informal obstructions* to entry by foreigners into the China market. A short list of these would include (1) refusal to accept international safety certificates for a variety of goods and the requirement that foreign companies be certified by Chinese inspectors only; (2) unilateral changes in letters of credit; (3) perplexing technical standards including sanitary and phytosanitary ones applied to imports of farm products; (4) testing, labeling, and certification requirements that are stricter for imports than for comparable domestically produced goods and often lack scientific validation; (5) foggy import laws and regulations (some of them secret, like Stalin's railroad timetables) differently applied by different authorities in different places at different times; (6) refusal to issue business licenses to foreign insurance companies; (7) ban on foreign firms engaging in direct (door-to-door) marketing (e.g., Avon, Amway); (8) prohibitions placed on the import of small and medium-sized power plants (under 600 megawatts); (9) exclusion of Chinese-foreign joint ventures from telecommunications; (10) pro forma investigation of dumping allegations made by Chinese firms under China's anti-dumping laws; (11) restrictive ocean shipping practices, and many other impediments (e.g., in the pharmaceuticals field) to foreign access to China's domestic market. A restrictive licensing system under which only licensed trade companies are allowed to conduct business abroad is still in effect, breached occasionally by considerable smuggling of consumer goods—mainly automobiles, cigarettes, and electronic goods.

*Pirating* of foreign intellectual property is endemic. According to the International Planning and Research Corporation, China is the world's second largest (after Vietnam) shoplifter of business-related software, with estimated worldwide losses in 1997 put at US$11.4 billion. That year 98 percent of China's software market was made up of pirated goods, outdoing even Hong Kong (at 70 percent).[20] In tune with Deng's Second Principle ("Make the country strong"), China has reportedly transferred from the United States at zero cost militarily relevant, highly classified, leading-edge nuclear technologies. Despite these incrustations on China's open door, the country's sovereign *credit rating* has been generally good and its debt service ratio (the ratio of repayment of foreign debts—principal and interest—to exchange receipts during the year) has fluctuated between 10 and 12 percent, below the 15 percent considered a danger signal. China's total cumulative *foreign debt* in 1998 came to US$162 billion, most of it was medium- and long-term in nature. The State Administration of Foreign Exchange (SAFE), however, believes that substantial informal borrowing has been occurring and that foreign assets which formally belong to domestic entities but have not been registered with SAFE are in reality foreign exchange debts. The problem is to uncover this debt and estimate its value. Estimates hold that in 1997 the amount of informal debts was nearly half of China's formal exposure to foreign currency debt (then at US$138 billion) and that the grand total of external obligations was around US$200 billion. Who borrowed all this hard money? First, there are the offshore borrowings of the shell companies owned by Chinese enterprises but registered in Hong Kong, and of foreign affiliates or subsidiaries of domestic

[20]*The Economist* (London), June 27, 1998, 108. It should be noted that probably the greater part of such goods coming into the United States from China is produced in Hong Kong- and Taiwan-invested factories on the mainland. *Free China Journal* (Taipei), March 5, 1999, 3.

business and financial companies operating farther afield. This is called "nonresident borrowing from nonresident institutions."[21] An unknown but certainly sizeable slice of this foreign currency-denominated debts dressed as FDI finds its way into China, where it receives privileged tax treatment and ends up in the laps of local governments, their commercial ventures, and their ITICs (international trust and investment corporations).[22] Second, toll roads, tunnel and bridge construction, power and water treatment plants, and other infrastructural projects, and in some cases low-cost apartment house-building financed by foreign capital and registered locally in China as equity should also be included as part of foreign debt. This is because normally the foreign investors have been guaranteed minimum return on their investments by local Chinese governments, and in the case of toll roads, full recovery of the capital invested plus interest and profit from tolls. Alas, these local government guarantees have come a cropper with the September 1998 ban on such practices by SAFE and repudiation of the guarantees because these allegedly had never been approved by the appropriate central authorities. Third, there is also apparently a lively traffic in short-term loans that are not registered with SAFE and, therefore, not counted as such in official statistics.[23] Despite the fact that the foreign debt is presently manageable as a ratio of GDP and in its predominantly medium- and long-term structure (adjusted for unregistered short-term loans), and even though China's foreign exchange reserves are comfortable, SAFE and the central bank have taken steps to track down and tighten supervision of international commercial borrowing by domestic business and financial institutions. The concern is with losing control over the country's foreign currency debt in the context of deficient statistical knowledge

[21]Nicholas R. Lardy, *China's Unfinished Economic Revolution* (Washington, D.C.: Brookings Institution, 1998), 290 n. 85.

[22]E.g., the now defunct ITIC of Guangdong, which at the time of expiry had US$2.4 billion in foreign debts.

[23]Lardy, *China's Unfinished Economic Revolution*, 208-9; Economist Intelligence Unit, *Country Report: China*, 4th Quarter 1998, 11, 40-41; *Wall Street Journal*, March 25, 1999, A23. The main reason for local governments' guaranteeing returns on foreign investment in local infrastructure and social projects such as low-cost housing seems to be the still undeveloped state of China's bond and equity markets, and almost exclusive reliance on bank loans, with rarely more than three-year maturities.

of the real dimensions, composition, location, and aliases of this indebtedness.

Since 1996, eighteen years after the inauguration of the reforms, the Chinese *renminbi* has been *convertible* on current account, i.e., on trade-related transactions (payments for goods and services), but not on capital account, nor is it likely to be so for an extended time. Foreign investors can generally convert profits made in the Chinese *renminbi* into foreign currencies at Chinese banks and remit them abroad. Because of what seem to be significant illegal transfers of hard currencies abroad by Chinese firms and individuals involving merchant adventurers at the highest bureaucratic levels, there are occasional clampdowns on profit remittances abroad and crackdowns on the less well-connected remitters. Unregistered capital outflow can be read into the unexplained "errors and omissions" rubric of China's balance of external payments. Some estimates put the annual capital exodus at US$35-45 billion, about the same as the officially reported FDI inflow, the latter being probably overreported (see item #6 in the discussion of FDI below). The flight takes the form of fake customs documents via underinvoicing exports, especially as they pass through the hands of Hong Kong intermediaries, and inflating the value of imports. In these cases, the profits from the combined operation are deposited in foreign bank accounts or used for speculative real estate investments offshore.

By the early 1990s, exports, FDI, and developmental loans had become important contributors to China's economic growth and modernization mainly through exports and inward transfers of modern technology and business know-how (especially finance and marketing). By the end of the decade, the economy was more closely related to, if not yet securely integrated in or always playing by the rules of, the global market. China has become a member of several *international financial agencies* (e.g., the IMF, the World Bank, and the Asian Development Bank). Some of these organizations allow Taiwan to retain membership via face-saving appellations but without sovereign nation standing. In the absence of further strains in China's foreign relations, China is likely to enter the WTO in a not-too-distant future. Some argue that assimilating China's large and rapidly developing economy into the world market is desirable, if only because such a move would tend to facilitate and consolidate China's transition to a domestically less ambiguous market system. However, at the same time the world must not grant China special exceptions from the rules governing proper conduct in the global market.

With physical capital at its core, *FDI* requires special notice because of (1) the importance of its contribution since the early 1990s to China's growth and modernization, (2) its absolute size (despite its relatively small —10-14 percent—share of China's annual domestic investment), and (3) peculiar provenance. Based on current prices, at the end of 1998 the cumulative actual FDI in China came to about US$270 billion. Most of this FDI has accumulated since 1992, three years after the Tiananmen incident, when foreign (including Hong Kong and Taiwan) private investment skyrocketed. Of the US$270 billion actually invested from 1979 through 1998, nearly US$250 billion arrived after 1991. Some claim that during the entire period from 1979 to 1998, China was the world's second largest recipient of FDI after the United States (but see below, item #6), attracting more such investment than any other developing country. For comparison, cumulative FDI in Russia since the evaporation of the Soviet system in 1991 was under US$10 billion, or a little more than two-fifths of what China received in the year 1998 alone. Altogether in early 1999 nearly 230,000 foreign-invested firms (either wholly foreign-owned or, more usually, joint ventures with Chinese partners) employed about 17 million people equivalent to 10 percent of the urban labor force. Interestingly, reports in 1998 held that more than half of the multinationals operating in China were not making money. About 60 percent of FDI has been poured into industry, and another 30 percent into real estate, public utilities, and services.[24]

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[24] *The Economist*, October 24, 1998, 42. The report that multinationals are not making money is attributed to A.T. Kearney, a firm of management consultants. For statistical data on FDI: International Monetary Fund, *People's Republic of China: Recent Economic Developments*, Country Report 97/21 (Washington, D.C.: 1997), 88-89; State Statistical Bureau, *Statistical Yearbook of China*, various years; Lardy, *China's Unfinished Economic Revolution*, 198; World Bank, *World Development Report 1998/99* (Washington, D.C.: 1998), 230; World Bank, *China 2020: Development Challenges in a New Century* (Washington, D.C.: 1997), 157; Zhaoyong Zhang, "A Comparative Study of Foreign Direct Investment in China and Vietnam," *American Asian Review* 17, 2 (Summer 1999): 131. For Russian FDI inflows, see *Wall Street Journal*, March 8, 1999, A1.

Several characteristics of FDI in China to date deserve notice:

1. A substantial portion of the FDI is export-oriented. Firms with foreign (including overseas Chinese) investors account for more than 40 percent of China's exports, as well as 13 percent of national tax revenues and 18 percent of "industrial added value" (i.e., industrial productivity). Additionally, FDI contributes to the improvement in the quality of exports and raises—through intersectoral spillovers—industrial capital productivity not just in the tradable goods (export) sector, but of domestic industrial capital in general. This is so because, as is often the case with FDI flowing into developing countries, foreign (but not Russian) capital embodies more advanced forms of technology than does domestic capital; i.e., domestic and foreign capitals are not perfect substitutes. FDI in China has also contributed to trade surpluses and the accumulation of record foreign exchange reserves, which have helped China to weather the financial crisis that decimated several national economies in the region after mid-1997.[25]

2. Until now FDI has typically accounted for 75-80 percent of total financial flows into China. There is a basic difference between foreign direct investment and foreign financial investment in the form of equities, bonds, loans, and bank deposits. FDI is illiquid (plant and equipment) and is intended for the longer term. Financial investment often has short time horizons and short terms, and can be reversed with relative ease through sale in the market or creditor refusal to roll over maturing debts.[26]

3. Thus far most of the FDI (nearly 70 percent in the period 1979-96) has come from Hong Kong and Taiwan. This phenomenon is without parallel in history, particularly since the "compatriots" do not always get along politically or ideologically with the "motherland." However, the most persuasive reason for Hong Kong and Taiwan investment on the mainland may be gleaned from a study of the cost differentials for land and labor between Taiwan and Hong Kong on the one hand and the mainland on the other. For example, practically the whole Taiwan labor-intensive export-oriented fashion shoe industry has by now migrated across the Tai-

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[25]"China's Private Surprise," *The Economist*, June 19, 1999, 79.

[26]Lardy, *China's Unfinished Economic Revolution*, 199.

wan Strait. Investment from Singapore has contributed just over 3 percent of total FDI during 1978-96.

4. Over most of the reform period the lion's share of FDI (close to 75 percent) has gone into the two southern coastal provinces of Guangdong and Fujian. The share has been especially large for FDI from Hong Kong and Taiwan, and has contributed to phenomenal growth rates in both provinces. The nine coastal provinces and three municipalities (Beijing, Tianjin, and Shanghai) have regularly absorbed more than 85 percent of all FDI. Recently the number of investing countries, the type and size of projects, and the location of the investment have widened to include some interior provinces. So long as the FDI in China was dominated by Hong Kong, Taiwan, and (to a lesser extent) Singapore capital, the average size of projects was relatively modest (ca. US$1.5 million) with an emphasis on exports and only partly for the domestic market. Since 1992, however, the per project investment outlay has grown (average FDI per project was US$2.3 million in 1997), become more technology-intensive, and diversified in terms of product lines and geographical location. Much of this new investment is initiated by medium-to-large firms, including member companies of large business groups and multinationals with capital outlays for individual projects running to the hundreds of millions of dollars. The largest joint venture in China as of April 1999 was a US$1.5 billion General Motors plant operated with the Shanghai Automotive Industry Corporation.[27] American and Japanese investment in China from 1978 through 1996 represented a little more than 8 percent for each of the total FDI.

There are signs that the euphoria which formerly gripped foreign investors when they contemplated China's potentially vast domestic market has abated of late. The continuing impediments raised by the government to the foreigners' entry into China's home market is one reason, even though from time to time the protectionist policies are relaxed a little, as when China wishes to demonstrate that it is ready to enter the WTO.[28] An-

[27]Major American corporations doing business with China (which does not necessarily connote FDI) include IBM, Boeing, Enron, Hewlett-Packard, Sun Microsystems, Hughes Electronics, Intel, Sprint, Raytheon, Lockheed Martin, and Loral Space and Communications.

[28]On July 8, 1999, the *People's Daily* published rules which implied that foreign companies

other reason for the decline in FDI inflows that has become especially noticeable in 1999 may be that, according to a survey (conducted by researchers at the City University of Hong Kong), the average return on equity of foreign-funded companies is only 3.1 percent. It is possible that at the present halfway stage of reform, the Chinese economy is in fact unable to absorb additional large doses of foreign capital.[29]

5. During the period 1979-96, more than half the actual (realized) FDI took the form of equity joint ventures, this share rising gradually from less than 30 percent in 1985 to 50 percent in 1996. The most common mode in the early years was the contractual joint venture, a comparatively looser and shorter-term form of cooperation between foreign investors and Chinese partners on projects specified in the contract. For the period 1978-96, this organizational form accounted on the average for about 20 percent of actual FDI (32 percent in 1985). Wholly-owned foreign enterprises, almost insignificant in the early years, began to gain in importance in the early 1990s and constituted almost 30 percent of actual FDI over the period 1978-96. Yet another mode is represented by cooperative exploration for and production of oil. After an initial (1979-85) flurry of activity, this form became less attractive to foreign investors because of the tight restrictions that apply to this and other energy-related industries. Over the relevant period, the share of FDI in this area was about 2 percent.[30]

6. There is much evidence showing that a significant portion, perhaps as much as one-third (some sources suggest one-half),[31] of total FDI in China is composed of domestic Chinese capital exported by Chinese national, provincial, and local government firms to Hong Kong and then round-tripped via shell companies back to China to take advantage of tax concessions and other privileges extended to foreign investors. If true, this would necessitate a downward revision of China's claim to be

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would be able to conduct retail joint ventures in more cities than were previously allowed, and to engage in wholesale business for the first time. See Leslie Chang, "China to Further Open Markets Lifting Chances for WTO Entry," *Wall Street Journal*, July 9, 1999, A12.

[29]See note 25 above.

[30]Zhang, "A Comparative Study," 122-24.

[31]See note 25 above.

the world's second largest recipient of FDI. However, this would also mean that during a regional financial crisis such as the one that followed the devaluation of the Thai baht in mid-1997, the recycled portion of China's FDI would remain largely unaffected by the crisis. Nevertheless, the central authorities are intent on stamping out or at least reducing this practice.

7. While nominally FDI represents a relatively small share of China's annual domestic investments, actually the share is probably smaller. This is so because large portions of the total capital inflows from abroad comprised of FDI, equity sales in Chinese companies, and borrowing have found their way to three uses other than fixed investment in the economy: (1) additions to the country's foreign exchange reserves—apparently a not unimportant reason for China's interest in FDI, (2) officially-sanctioned investment abroad,[32] and (3) significant unregistered capital outflow noted earlier.

*Imbalanced growth.* The opening-up policy with its more or less free exchange of goods[33] and the influx of investment funds from the near- and far-abroad implicitly recognized the benefits China could gain from adhering to the law of market-driven comparative advantage on an international scale. This prospect ran counter to the formerly followed administrative policy of regionally balanced growth in the process of economic development, which was motivated (1) at the ideological level, by socialist equalitarianism and Mao's concept of a self-enclosed and self-reliant China; (2) on the class warfare side, by the regime's desire to teach a lesson to bourgeois-infected, relatively more developed metropolitan centers on the coast, Shanghai and Canton in particular; and (3) from the time of the break with the Soviet Union in the late 1950s until shortly after Mao's death, by Mao's military doctrine of the Third Line which dictated heavy investments and the placement of military and defense-related industries in the country's economically least developed and logistically most inaccessible areas

[32]The cumulative amount of officially-sanctioned investment abroad has been put by the United Nations Conference on Trade and Development (UNCTAD) at roughly US$20 billion by 1996.

[33]Except for mid-level to high technology and inputs used in the manufacture of export goods.

of the interior. Prior to the reforms, roughly three-fifths of fixed asset investments were channeled into interior regions.

Imbalanced growth emphasizing the historically more developed coastal regions where FDI monies were initially (and still are today) willing to take root became associated with premier and later Party general secretary Zhao Ziyang, who was put under house arrest after the Tiananmen annoyance in 1989. Zhao's became known for a time as the "golden coast" strategy, which in effect followed the prescripts of the law of comparative advantage. It predicted that the wealth and efficiency benefits of more rapid coastal development would, by and by, disperse outward (or trickle down) to the poorer inland provinces, those which in addition to the drawbacks of location suffer from still being the preserve of state planners who directly control between 60 and 80 percent of industrial output in those areas. The hands-off method imposed by force of events and market logic was accepted by the leadership, albeit reluctantly and divisively. To this day, official but muted policy on this subject notwithstanding, the bureaucratic selection of companies for listing on China's stock exchanges favors state-owned enterprises located in underdeveloped areas. In fact, despite significant regional wealth, income, and structural disparities and the associated concerns about centrifugal political forces that this duality might produce, gains from growth appear to be gradually filtering down to China's poorer provinces.

## Outlook

Economic reforms in China are still continuing; the transition is not over.[34] However, proponents of a "third way," among them some reformers, insist that both the ditching of central administrative command planning and resort to selected ingredients of market methodology do not mean that China must or will eventually arrive at any one of the presently work-

[34]Annette N. Brown, ed., *When Is Transition Over?* (Kalamazoo, Mich.: W.E. Upjohn Institute Publications, 1999).

ing variants of advanced capitalism. Indeed, the very notion of systemic transition toward some fixed capitalist objective is often disputed. If there is transition, it is away from a system that failed to deliver on modernization. Some facets of this system, however, still appeal to the political leadership or sections of it, and—with appropriate adjustments—can be retained and commingled with selected elements of the system of markets precisely because the latter have proved themselves to be effective in fostering modernization. Bits and pieces of capitalist methodology can be used for "higher-order goals—namely stability and economic growth for the state and society as a whole."[35] However, the systemic destination is left open, fluid, and oblique. The position is that, contrary to an allegedly widespread Western presumption, most forcefully expressed in Francis Fukuyama's 1991 *The End of History and the Last Man*, modern capitalism in both its modernization and modernity (especially democratic) incarnations is not a final, immutable goal. On its sinuous course away from central planning, China will create its own system of original, culturally unique, post-capitalist economic organization, drawing on but not replicating the existing range of functioning advanced capitalist models.

This stance may be culturally flattering, good for the national morale, and liberating in the sense that it frees national development of Marxist and New World historical determinisms. But this view is based on a misunderstanding compounded by platitude. To be sure, over the long term economic systems, like other living things, adapt and evolve. Unchanged, they stagnate, shrivel, and die. Their fitness to transform themselves depends on receptivity of their institutions to the forces of change and the open-mindedness of those who within the system translate ideas into efficiently produced and delivered economic outcomes. In our times the most powerful agent of change has been information technology, which was developed and found the most receptive and congenial environment in the competitive free enterprise, private property arrangements, and economic philosophy of the modern capitalist system. That this system will continue to evolve is

[35] I borrow this phrase from Oi, *Rural China Takes Off*, 12, where she refers to China's choice of what she calls "local state corporatism" to organize "narrow interests," which presumably is emphasized by the market way of organization.

not in doubt. Granted that the future direction that the technology juggernaut will take cannot be predicted, what can be said with assurance is that the market system in its various cultural configurations is the best suited contemporary vehicle to generate and accommodate technical advance for the achievement of modernization. In this sense China's pragmatists would be well advised to stay aboard for the ride.