Why China Booms While Russia Bombs

By WILLIAM OVERHOLT

HONG KONG — If Russia and the other former socialist economies of Eastern Europe are ever to escape their economic dungeon, they should take a hard look at how China has transformed its formerly controlled and paralyzed economic system into one of the fastest growing economies in history.

Following the examples of South Korea, Taiwan, Hong Kong and Singapore, China gave priority to industries and sectors where limited government investments would produce rapid growth. The government gave the farms back to the farmers, generating huge increases in productivity, income and output with very little state investment. Second, China was very encouraging to foreign investment, attracting $20 billion of foreign direct investment in the first decade of reform. This produced enormous gains in both outputs and exports at negligible cost to the government. Finally, China gave priority to light and medium industry, where limited initial investment quickly yields a surge of output.

In contrast, the Soviet Union neglected agriculture, was so ambivalent about foreign investment that it attracted very little, and devoted excessive attention to heavy industry. Mikhail Gorbachev's early programs emphasized massive equipment imports into capital-intensive industries – building more machines, intensified use of machine tools, organization of industry under super-ministries, improvement of the petroleum industry, and reorganization of the automobile and high-technology sectors. The later debate over privatization also focused excessive attention on industries with huge capital requirements and long lead times, rather than the sectors of low costs and quick payoffs.

The result of the Soviet strategy, and of most of the East European strategies, was a collapse of production simultaneous with unbearable inflation. One scholar, Marshall Goldman, argues that Mr. Gorbachev achieved a first in economic history: a depression caused by lack of supply rather than inadequate demand. Most of the East Europeans achieved a similar result.

Explosion of Initiative

The more fortunate Chinese ignited their economy with an explosion of peasant and entrepreneurial initiative. Relying upon energy from below came naturally to legatees of Mao Tse-tung – even though Mao would have despised the private enterprise and foreign presence that accompanied this particular energizing of the masses. The result of these opposing strategies is that China's growth curve after reform resembles an airplane taking off. The former U.S.S.R.'s resembles a submarine descending.

An important reason China succeeded where Russia has so far failed is that it built public support for reform. Mr. Deng's initial farm reforms roughly tripled the incomes of China's farmers, winning the support of a group that comprises more than 800 million people – not a bad start on a coalition. He then facilitated the rise of a class of small-scale entrepreneurs and stimulated the takeoff of light and medium industry, thereby gaining the support of tens of millions more workers and managers. Mr. Deng revolutionized China's financial system and loosened the restraints on travel and exchanges of ideas by China's intellectuals and students, thereby winning over these smaller but extremely influential groups. (After Tiananmen, he decisively lost the support of intellectuals and students for his personal power, but they remained enthusiastic supporters of economic reform.)

Deng Xiaoping even managed to obtain the support of a majority of the military leadership despite severely constricting military budgets. He persuaded much of the military leadership that the army's salvation lay in access to Western weaponry. This in turn required economic success to finance the trade, accommodation with Western countries to obtain access to weapons, and drastic cuts in the PLA's budget and manpower in order to fund domestic economic progress.

Likewise, most of the top leadership of the Communist Party became advocates of reform. Chen Yun, the most conservative of the octogenarians, actually was the leader of the first phase of reform. Li Peng, one of the few conservatives among younger generations, eventually found himself giving speeches about the virtues of socialist stock markets. By the end of the 1980s, the real conservatives were mostly confined to the propaganda organs, and they are no longer safe there. Among prospective leaders in younger generations, there are those who would move forward more slowly and those who would move forward more quickly on market-oriented reforms. But there are none who would move backward or stand still.

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In contrast, Mr. Gorbachev quickly lost the support of virtually all important social groups for economic reform. Farmers remained neglected and alienated. Workers faced stern demands for harder work as their real wages collapsed and their vodka was cut back. The managerial class found its power and perks curtailed while its real income fell and the overall strategy of industrial revival failed. The Communist Party leadership was told to run for election after three generations of alienating the population. The military lost much of its budget and access to new technology just as all the country's major allies were revolting and aligning with the West. All these groups had reasons to resist further reform.

Another difference is that China emphasized gradual, carefully sequenced reform whereas the former Soviet Union and Eastern Europe, goaded by Western professors, have been more attracted by spasmodic approaches, most notably Poland's Big Bang: precipitous liberalization of prices and privatization of enterprises. Sudden liberalization risks unacceptable inflation and currency collapse.

China decided that price liberalization had to be gradual so as not to cause panic that results in hyperinflation, currency collapse and political disillusionment. Sudden liberation of prices in the context of the severe shortages of supply typical of socialism leads directly to hyperinflation. Poland's sudden liberation of prices produced inflation rates in excess of 2,000% during the last four months of 1989. The Soviet Union experienced 91% inflation in 1991 and a multiple of that level this year, while suffering a potentially catastrophic collapse of its currency. The social consequences of such developments are hard to overstate.

Severe inflation also frightens away both domestic and foreign investment, thereby destroying the country's potential for economic growth. Inflation itself can be the cause of widespread unnecessary bankruptcies. Such problems throughout Eastern Europe and the former Soviet Union led to widespread political disillusionment by early 1992.

China has liberalized prices gradually, and has been careful to ensure that the price of rice is not allowed to become too volatile. During the process of liberalization, China has built the institutions that will enable it to control inflation, namely credit controls and bond markets. The result has been rapid growth with a manageable inflation cycle that never exceeded 20%.

China has been particularly cautious about privatization. If one privatizes before price reforms have taken full effect, then many firms are bankrupted – not because they were inefficient but because their product prices were set below market. For instance, it is not unusual in some socialist countries for prices of a commodity like coal to be set at only 5% to 10% of market levels; having to sell so far below market prices will quickly bankrupt the coal company if it suddenly loses subsidies and has to pay market prices for inputs. Moreover, this problem is not really solved by Big Bang price liberalization, because an effectively liberalized price system does not just mean instant freeing of prices but also a network of institutions that can receive price signals, analyze trends and take appropriate action. If one privatizes rapidly at a time when inflation is high and growth low, as is typical in the early phases of spasmodic liberalization, then one creates mass unemployment at just the time when the economy is least able to absorb extra workers.

Hence China has delayed privatization until it has successfully liberalized prices, created a national pension system, undertaken major banking reforms and created working stock markets. It is characteristic that it has moved its currency to near-market levels and opened its stock markets to foreigners in a much earlier phase of reform than South Korea and Taiwan but has been much more determined than East Europeans to create the institutions necessary to make markets work properly before undertaking widespread changes of ownership.

Evolving Markets

Financial reform has been essential to China's success in the real economy. It gradually moved its official exchange rates to near-market levels and opened limited free markets in each major city. In so doing, it avoided any local analogue of the collapse of the Russian ruble. China has publicly committed itself to the goal of a convertible currency and is already within striking distance of that goal.

China is also moving quickly to develop its still-diminutive stock markets and futures markets. Stock markets will mobilize the country's savings for productive use and allocate those funds competitively. They will also provide a method for smoothly mixing foreign and local capital, for merging firms, and eventually for privatizing a substantial part of state enterprise. Futures markets will facilitate price stability, price predictability and knowledge of the direction in which the prices of price-controlled commodities should be steered.

In all of this, China's leaders have shown remarkable insight into the institutional requirements of market systems and have thoughtfully constructed sequences of liberalization that build the necessary institutions while avoiding fatal damage to price stability, social welfare or political support. The Chinese experience has shown that a socialist economic system can indeed be transformed into a market system without an intervening social catastrophe – a conclusion that would be very much in doubt if the world had only experienced the Soviet and East European approaches.

Mr. Overholt is author of "The Rise of China," (W.W. Norton, forthcoming) from which this is adapted.