

# **The Origins of Successful Economic Reform in China**

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**Paper presented at the Tenth Anniversary of the China Center for  
Economic Research, Peking University, Beijing, 16-17 September, 2004.**

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It is a great pleasure to be part of the 10<sup>th</sup> Anniversary celebration of China's pre-eminent academic institution for research and advanced education on the Chinese economy. I recall Justin Lin's articulation of his hopes in his visits as an Adjunct Professor to ANU in the years after 1989, for a new centre for economic research that would attract back to China a proportion of the best students who had traveled abroad to study economics and achieved at a high level. He was persuasive enough for me to include a recommendation on initial funding in my 1993 report to the Ford Foundation on Chinese research and graduate education in economics.

The China Center for Economic Research at Peking University is at once a product of the reforms that began a little over a quarter of a century ago, and a contributor to the continued progress and success of reform. CCER's early progress and success have exceeded our optimistic early expectations. Even greater achievements lie ahead.

The Australian National University, and especially the China Economy and Business programme, have valued greatly the exchanges of personnel and the active collaborative research with colleagues at CCER. This has extended the frontiers of our own research on the Chinese economy, most recently through our joint projects on the private sector and on privatization and restructuring of state-owned enterprises. We admire the excellent teaching of economics at CCER, and have benefited from it through recruitment into our PhD programmes. To mark the 10<sup>th</sup> Anniversary, and in acknowledgement of the academic excellence of the CCER's teaching, I am happy to announce the permanent allocation of one PhD scholarship in economics at The Australian National University to a graduate of the CCER economics programme.

The reform era has now occupied almost half of the life of the People's Republic. The past quarter century is the longest period of political order and coherent national

policy-making in China since the industrial revolution in Europe and North America began to exercise profound influence over Chinese life, from about 1840. The beginning of the era of Chinese disorder and incoherence that has recently receded into history is marked by the eclipse of China by the United Kingdom as the world's largest economy, and by the coincident First Opium War and colonization of Hong Kong. Its end is marked with even greater clarity by Deng Xiaoping's ascendancy at the third plenary meeting of the Chinese Communist Party's eleventh Central Committee, in December 1978.

The beginning and the end of China's period of disorder and economic underperformance are both linked to profound changes in China's relations with what are now the advanced economies. This reality is a reminder that the gains from deeper integration into an international community are not automatic. The gains depend on China's internal capacity to utilize international opportunity effectively. They are immense when the conditions are present for effective international integration.

The coherence and the order of the past quarter century, around increasingly ambitious economic reform and opening to the outside world, has had remarkable consequences. China is at peace with its neighbours, and trade and other economic exchange is expanding rapidly across the most complex and demanding, and, through much Chinese history, threatening, borders in the world. China is rapidly increasing its share of world trade, investment and production, with the 400 million people in its Coastal provinces moving swiftly towards the frontiers of global productivity and incomes. Chinese living standards have increased beyond recognition. While the remaining poverty is a problem requiring an early solution, China has moved from more people living in poverty than any other country, to by far the most people to have recently emerged from poverty. The volume of goods and services produced in China has increased by about six times, and the volume of international trade over ten times. From being one of the most closed economies in

the world, China moved in two decades to receiving the largest annual volumes of direct foreign investment ever to a single economy.

The changes in foreign trade are at the centre of the Chinese transformation. Deep integration into the international economy has removed what had been tight constraints of resources and technologies on Chinese economic development. China's abundant labour became an asset rather than a liability for economic growth when it could be traded for scarce capital-intensive and technology-intensive products. China's initial comparative advantage in labour-intensive goods at the beginning of reform ensured that the benefits of faster economic growth and deeper integration into the international economy were experienced to a considerable extent as increased demand for labour, thus spreading widely the benefits of growth and helping to entrench popular support for the new economic strategy.

The Chinese reform era is not only a transition from socialist central planning, as reform may seem to be in Russia or Poland. The change is deeper than that. The last quarter century is a time when China has linked itself productively and comfortably to the modern, global economy and society that began to force revolutionary change in all aspects of life in the North Atlantic two centuries ago.

Seen in this perspective, Chinese reform since 1978 is not mainly a retreat from a dead-end in economic strategy that began with central planning in the nineteen fifties. It is not mainly the unwinding of policies and institutions that were tried by the early People's Republic for a while and turned out to be mistakes. It is also and much more the expression of a new Chinese commitment to interaction with the modern world. It has emerged from the restoration of Chinese political order, alongside the transformation of many ancient Chinese institutions.

So what were the causes of this historic restoration and transformation?

It helps in the search for an answer if we stop thinking of sustained rapid growth as some sort of economic miracle. The departure from the natural order of global economic life was apparent more in Chinese underperformance for one and a half centuries than in the so far incomplete recovery of lost ground in the past quarter century. From this perspective, strong growth since 1978 is simply the beginnings of a natural catching up with economies that had for a while moved ahead.

But there was nothing inevitable about the catching up. For several decades after the Meiji restoration in Japan, when China's large neighbour to the East found and applied successfully a formula for rapid absorption of superior economic methods from the North Atlantic, innovative Chinese tried to emulate that achievement in their own country. They were defeated by the weight of institutions that were deeply resistant to necessary change, and which retained legitimacy from a time when they were successful beyond any others on earth. There were elements of success in applying the productive new ways of the West in the decades after the destruction of the imperial order in 1911. These remained isolated efforts as their extension outside the treaty ports was overwhelmed by political disorder, civil war and then war with Japan. The Chinese Communist party after its success in 1949 contained a large modernizing element, whose efforts were distorted by adoption of a model from the modern West, the Soviet Union's embodiment of a Marxist-Leninist ideal in central planning, that was later to be recognised as a failure in the countries from which China had drawn inspiration.

What was different about the new efforts in modernization under the Deng ascendancy from 1978?

The political order under the reformist leadership of the Chinese Communist Party stands out amongst the important things that were different. But after the continued dislocation of the first 29 years of the People's Republic—the Great Leap Forward, the Cultural Revolution, and the destabilizing shifts of strategy before and between--this itself seems to have required an element of good fortune. It depended first of all

on the surviving status of old leaders who had played major roles in the times of war and revolution that could create heroes, and at once on the disillusionment of these grand leaders with the outcomes of the early decades of Communist Party rule. The Communist Party judgement on Mao Zedong's historical contribution was that he had been 70% right. The successful launching of reform depended on the historical legacy of order under the Communist Party, and just as much on the clear identification of the "30%" that was wrong.

The ascendancy of the reformers, like the Duke of Wellington's description of the victory over Napoleon in the Battle of Waterloo, was a "close-run thing". It followed several years of what Deng Xiaoping once described to me as "indecisive policy", after the death of Mao in 1976. It seemed an inevitability only in retrospect.

The ascendancy of a new leadership was only the first of several demanding necessary conditions. China was in the right place at the right time to launch a new approach to economic development. And its leaders stumbled upon a combination of reform policies that were able to accelerate growth for a while, and so establish a base for the identification of the more complex policies that could maintain growth momentum.

East Asia at the time of maturation of Japan's postwar expansion and the height of internationally-oriented growth of what were called the newly industrialized economies was the right place and the right time.

It was the right place, because geography matters to trade and investment flows and to the international transmission of ideas about economic development strategy and policy. Throughout the period of deepening integration with the international economy, transactions with East Asia have been disproportionately large. With the exception only of 1997 and 1998, the years of the Asian financial crisis, trade and investment have expanded more rapidly with East Asia than with the rest of the world. It has helped that these have been times of strong expansion in the rest of

East Asia's international trade and investment, especially with the structural adjustment out of labour-intensive exports in Japan from the early 1970s and the newly industrialized economies from the mid-eighties. The easing of political tensions with Taiwan and Korea expanded China's East Asian trade and investment world from the late 1980s. Structural change continued to generate reasonably strong growth in imports into and outward direct investment from Japan even through the Japanese macro-economic stagnation after the early 1990s.

It was the right place and time because a prosperous Chinese business community in East Asia outside the People's Republic was ready to respond on an immense scale to the new opportunities in China's opening to the international community. The proximity of the Chinese business diaspora in Hong Kong, Taiwan and Southeast Asia facilitated the response.

It was the right time as well because smaller East Asian economies had pushed their way as exporters of labour-intensive exports to the rest of the developed world. Japan, Hong Kong, Taiwan, Korea and the first of the Southeast Asian economies had done this at a time when Cold War strategic imperatives helped to contain protectionist reactions to the rise of newly competitive suppliers. Over the first decade of China's open policies, Japan and the NIEs' economic success was causing them to vacate international markets for newly competitive suppliers, with China first amongst them. The expansion of China's labour-intensive exports could therefore proceed mainly by taking over the shares of other East Asian suppliers. Without the geo-strategic support that had accompanied the rise of Japan and the NIEs, it would have been difficult for China to force its way as a pioneer large-scale exporter of labour-intensive goods.

It was the right time for all of these reasons, and also because China was open to new approaches to economic strategy at a time when success of internationally-oriented policies elsewhere in East Asia had become evident for all to see. The contrast between the economic dynamism of Japan and the NIEs and economic

instability and underperformance in China generated pressure for change in China. More importantly, the success of internationally-oriented growth elsewhere in East Asia provided a model for development that was at once broadly appropriate and demonstrably practical.

I can say with some confidence that Chinese leaders “stumbled” upon a successful growth strategy, because that is more or less what they said themselves. There was no “blueprint” for China’s economic reform and internationalization—even less than there had been in Taiwan and Korea at the beginning of their sustained economic growth one and a half decades earlier.

But after the 1978 Plenum, there was acceptance that domestic and international exchange through markets was a necessary and acceptable component of a national development strategy. There was pragmatic acceptance that institutions and policies that raised national economic output had a legitimate place in China—summed up in Deng’s rehabilitation of an earlier Maoist exhortation to seek truth from facts. These strands were drawn together in the 1987 Party Congress’ acceptance of General Secretary Zhao Ziyang’s definition of China as a backward country in the “primary stage of socialism”, in which the first national objective had to be the strengthening of the national economy.

After 1978, foreign trade, direct foreign investment and the utilization of external technology and capital in all forms became acceptable components of national policy. Local experiments with new forms of agricultural production were given legitimacy, leading within a few years to the virtually complete replacement of the people’s communes with the immensely more productive household responsibility system. Markets became important for exchange for the rapidly expanding agricultural output.

The absence of a comprehensive reform strategy, the eclecticism of economic policy and the gradualism of change have been criticized by foreign observers from time to



time over the past quarter century. But the absence of a blueprint was an inevitability of China's circumstances, and in practice a virtue.

It was an inevitability because in 1978 there was no conceptual basis for a market economy in China. A few leaders, and a few intellectuals around the edges of policy, had absorbed some of the elements of internationally-oriented growth elsewhere in East Asia. The main understanding grew out of the new patterns of development themselves, supported at crucial times by insights from the wider East Asian experience.

The absence of a model was a virtue, because any theoretical model of reform of the centrally planned economy in China after 1978 would have been deeply flawed. The rapid unwinding of the institutions of a centrally planned economy, dominated by state-owned enterprises in the cities and communes in the countryside, is fraught with risk. We understand this reality more clearly since the unhappy experience in the former Soviet Union a decade or so after the commencement of Chinese reform. Some of the great strengths of the Chinese economy in the era of reform came as surprises to Chinese and foreign observers alike, and would have been given an inadequate place in a programme built upon received theory and the experience of others as it appeared in 1978. After the initial success of the household responsibility system, first amongst the surprises was the extraordinary dynamism of industrial production in the township and village enterprises that grew out of the disintegrating people's communes.

The surprises in institutional transformation have continued over the past five years with the extraordinary pace of development of private businesses, including through swift movement of most small and medium-sized state-owned firms and township and village enterprises into private ownership. The designers of a reform blueprint would have held up progress dangerously if they had seen the imperfections of the township and village enterprises as barriers that had to be corrected by planned privatization at an early stage of reform.

So China's reform succeeded partly because leaders who had confidence in some general directions of movement were bold enough to make a start before many features of the path ahead were clear. Chinese reform required transformations in ideology, in ideas about economic development strategy and policy, in law and regulatory systems, and in economic institutions. Above all, it required the accumulation of new knowledge and wisdom in a billion Chinese minds, as the Chinese people learned to do new things in an economic and social world that was changing fundamentally.

These transformations in ideology, ideas, strategy, policy, law, institutions, knowledge and experience occurred alongside each other, reinforcing each other. The further the changes went, the closer they took the emerging Chinese reality to that of advanced economies and societies and of China's East Asian neighbours which had lived for longer in an internationally-oriented society and economy. The further the changes have gone, the more immediately relevant have been the insights from modern economics in the advanced industrial economies.

While the emergence of a market economy in China renders insights from economics more directly applicable to policy, there is danger in simple application of formulae developed for other economies. The way economic variables relate to each other depends on cultural and institutional factors that have their origins in history.

It is therefore important for each economy and society to develop its own economics and its own economists. They will not be good economics and economists unless they have absorbed thoroughly the wisdom of the international profession. But neither will they be good advisers on policy in their own countries unless they understand how economic relationships are shaped by the institutions of their own societies. This is important in countries from within the Western cultural tradition. It

is crucial to the success of economic policy in a country with cultural traditions and institutions from other historical backgrounds.

China has many challenges ahead as it treads the path towards the high productivity and living standards of today's advanced economies. It will need economists deeply steeped in the international economics profession's wisdom, and also in the institutions and history of China, to overcome the challenges of an over-regulated agriculture, a flawed financial system, periodic macro-economic instability, and of rising interpersonal and inter-regional inequality.

There is not much chance now that failure to meet any of these economic challenges will bring the productive processes unleashed in December 1978 to a halt. But good economics and economists will reduce the time wasted over each hurdle. They will reduce the pain and trauma that is inevitably associated with sustained, rapid economic growth. They can improve the trade-off between equitable distribution and high rates of growth. And they reduce the chance that periods of poorer economic performance will encourage such serious questioning of the growth strategy that the growth process itself is thrown off course.

These are amongst the reasons why we are so glad to celebrate the achievements of the China Center for Economic Research. It is a major asset in China's reform and growth. We congratulate the people at the Center who have achieved so much in ten years.