Lessons learned from China

By Rachel Oliver

One can often take for granted the fact that China is now the world's biggest market opportunity. It's just been accepted universally as a fact. Few questions, however, how China came to be – and so quickly. Why did China grow so fast? How did it do it and what can others learn from it?

This was the key question at the center of a high-level conference, "Capitalizing China", held jointly by The Institute of Economics and Finance, chaired by **Professor Joseph Fan**, Co-Director of the Institute, and the U.S. National Bureau of Economic Research (NBER).

Held on December 15-16, 2009, the Conference brought together world class experts to study the accumulation and allocation of capital in the rapidly growing Chinese economy. Conference papers are in process of being published as an NBER book under the title "Capitalizing China".

China is growing rapidly but displaying increasingly evident growing pains. The accumulation and allocation of capital is unquestionably central to that growth, and inefficiencies in the raising and uses of capital are key impediments to fuller and smoother growth. The Conference explores these problems by commissioning leading experts on China's financial development, corporate finance, and public finance. How is capital raised and allocated among China's various sectors, including those producing public goods? How functional are the country's banking system and capital markets, and how can their functional efficiency be augmented? Or can growth race on regardless? How important is global integration to China's rise? What role does household accumulation of real estate play? How do China's capital markets and institutions bode for future macroeconomic stability?

The reason these questions are so intriguing, says Professor Fan, because China appears to have capitalized itself successfully without adhering to some commonly accepted rules. And that is, it has appeared to lift itself out of poverty, create millions of jobs, open up to international trade and establish itself as the market every MNC on earth wants to work with without going down the path of a free market system – or a democratic one, for that matter.

In some ways, says Professor Fan, it was the very fact that it didn't follow either free market theory or democratic beliefs that China was able to bring itself up so quickly. And the recent financial crisis has shown that yet again China has been able to react faster than many 'developed' nations have been able to for those very reasons.

"Before the financial crisis, few would question free markets as the best way to allocate resources," says Professor Fan. "But after the crisis, everyone needs to be curious about how it did it. China has markets but they are by no means free.

"It heavily intervenes in the markets. China is a mixed economy. Everything is subject to approval by the government, taxes, kickbacks, interventions. Nothing is free. But this model, this mixed model has turned out to be successful. The central government can immediately inject RMB4 trillion. Financial crisis? No problem. We will just pump this money into cities, provinces, counties and villages. Immediately the whole country is flooded with cash. Go and spend it! What financial crisis?"

"In a 'free' country like the U.S. or U.K. you can't do that. In China, you just do it."

'Just doing it' was how China's rise began, moving from a country completely shut off from the rest of the world to one that was open to it – although only by a little bit at first. But that's all it took, says Professor Fan. "China started from a very low point," he explains. "Originally the country shut its doors, no free market, central planning. Then Deng Xiaopeng opened the doors to give a little bit of freedom and a great leap was made."

China's very first private entrepreneur was a street hawker, selling pumpkin seeds from a cart. Professor Fan sees this fact as very symbolic. "China started low and the story of the first private sector entrepreneur selling pumpkin seeds on the street showcased it is much easier to grow an economy from a very low point," he says. "So if you are desperate, you have had the cultural revolution, any small change in policy can lead to big developments."

"Anything you do is better than nothing."

The exploitation of resources also clearly drove China's fast economic development, but something else also helped China along that couldn't have happened in the West.

"Local governments have high incentives to prop up local economies. Local entrepreneurs, local property developers, working together - like Hong Kong government works together with property tycoons controlling the local economy, making growth a lot more possible than in the U.S. or the U.K."

"China has already started to worry about social stability. Lots of poor people in the countryside. How China deals with these social issues will also offer valuable lessons to the rest of the world, he says, on how to capitalize sustainably.

"They need to take care of the poor people. Otherwise they will rebel. They will demonstrate. You don't want that. Is there any way better than to send troops to police them like in Bangkok? There is a better way. You provide health benefits and housing so low-class people have a house to rest in and doctors to see. This is what China will do."

In fact China is doing it already, says Professor Fan. "In some cities they are already offering low cost housing to people," he says.

In order to ensure social stability, China will need to develop new forms of public governance, he says. "The government can provide promotion incentives – very powerful incentives to support central government policy."

He adds, "All bureaucrats, now their tables are full of cash. Will they put it in their pockets? The answer is they will calculate. Young bureaucrats at grassroots level will think 'I will use the money to prop up the economy. If I keep it I will be caught for corruption'. So many bureaucrats will invest for the long term."

Professor Fan sees the central government's increasing focus on social stability as indirectly setting the stage for future corporate governance initiatives in China.

"The central government needs to factor in some performance indicators into promoting the formula so they don't have to monitor [local bureaucrats] every day," he says.

"This is public governance. If there is no public governance there will be no corporate governance. The key is public governance. If this incentive system works very well and we can contain corruption at low levels then it will work for corporate governance."

Overall, the main conclusions drawn at the conference were that China's unique way of pulling itself up was a success in many ways.

"The conclusions were that the bureaucrat allocation system actually worked. It was a force for development in tangible economic ways," Professor Fan says.

"But we see slower development in high level human capital. One reason is that for the smartest people in China, where do they get their jobs? Becoming a top bureaucrat would be a priority. This would cause a brain drain as the best people go to the government sector, not the business sector."

China's system has slowed down many intangibles, he says, "The quality of social welfare, the growth of hospital beds, areas of green space, the quality of air, pensions, these indicators are lagging behind.

"It doesn't pay them to invest in these intangible assets - [bureaucrats] get promoted by building a great big dam. So there is a risk of dichotomy in economic development. So the conclusion, the future of sustainable growth is we have to pay attention to investment in intangibles like welfare, environment.

But what lessons will the rest of the world take from China? Professor Fan believes that countries such as the U.S. will find it hard to follow down the same path as China, such as its own strong belief in free markets.

"Every economy is entrenched in its own past," he says. "In the U.S.A., even after the financial crisis, they will not go as far as believing China as they believe in free markets. They will not learn from China."