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Post-reform China and the international economy

economic change and liberalisation under sovereign control

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Introduction

The changing relationship between Mainland China (China henceforward) and the international economy, since the onset of reform in the late 1970s, has been one of the most remarkable phenomena of modern economic history.¹ It is necessary to go beyond conventional economic analysis in order to underline the unusual features associated with it. The first, and most obvious, aspect is the rapid integration of an essentially centrally planned economy with the international economy, since such an outcome could not have been anticipated as an obvious likelihood. The second noteworthy attribute is the quantitative scale of this integration in terms of both trade and investment. But it is the institutional and political mechanisms associated with China's entry into the international economy, which are unique and merit fuller examination.

The argument put forward below is that China encountered unique conditions for its economic and political opening to the wider world. The contrast is with the CIS countries (former Soviet Union) in particular as well as the absence of such unique conditions in developing countries that have liberalised during the past decade or so. China was able to cushion and regulate its interaction with the world economy through an initial relationship with Chinese overseas investors, especially Hong Kong. This method of buffered entry into the international economy enabled China to deepen its ties with the wider world economy further, without becoming vulnerable to predatory market forces and associated political pressures.² Of course, post-reform domestic political conditions and specific economic policies, like sound financial management and the avoidance of short-term capital inflows also contributed to the relative stability of its internationalisation and economic success. For the present, the potential significance of China's path of international economic liberalisation for other underdeveloped agrarian countries might be noted. The conventional conclusions drawn from China's domestic reform and international liberalisation, some elements of which are implicitly urged upon other developing countries, are deemed incomplete.

China and the international economy

In the period after the catastrophe of the Great Leap Forward China's leadership remained divided about economic strategy. Although self-reliance was a shared aim, one group, that included Zhou Enlai and Deng Xiaping, sought to restore what was, in effect, an import substituting strategy that had brought important gains during the 1950s. This perspective would have been consistent with the developmental objective of modernisation through engagement with the international economy, although outside the framework of the market. Such a strategy would have involved importation of foreign technology and know-how to produce capital and intermediate goods (petrochemicals, steel, etc.) as well as consumer durables, instead of importing them. Other elites, including Mao Zedong himself and Lin Biao, were intent upon semi-autarchy with only very limited engagement with the capitalist world economy. Both groups considered the latter hostile and a dangerous adversary, but important differences of opinion obviously existed. It was the import-Substitution strategy that eventually prevailed, despite the setback of the period of the Cultural Revolution and the divisions following Mao's death. By the Third Plenum in 1978, many of China's elites had a keener appreciation of the limitations of inward economic orientation and sought to experiment with foreign economic policy.³

The reforms adopted by the leadership of the Chinese Communist Party after the Third

Plenum included export promotion policies, imports of foreign capital and technology and the creation of export processing zones. These policy initiatives had post-revolutionary antecedents and were restored with renewed vigour by 1979. The results can be seen in China's economic performance in the subsequent two decades. The goal of export promotion was formally adopted by in August 1979, by assigning top priority to fulfilling export contract obligations. Exports were identified as the principal method for acquiring foreign exchange for the modernisation of China's economy. Various price, tax and loan provisions as well technological upgrading were approved, freeing export production from the imperatives of planning for the domestic economy. As far as foreign investment was concerned, investment by overseas Chinese had been regarded by China's communists as somehow "genuine", indeed, local in terms of national loyalties.⁴ China also sought commercial borrowing, but entered the international market when the cost of borrowing was rising and this option was therefore abandoned. The new leadership therefore sought official and officially-supported sources of finance and credit, including the IMF and the World Bank. But it was three decades' experience of foreign investment from Hong Kong that had taught the leadership in Beijing of the impact and value of this relationship. In practice, it was this source that remained pre-eminent, highlighting an unusual degree of historical continuity. Finally, the potential of special export processing zones was recognised as a vehicle for isolating export production from the vagaries of the domestic economy. They were accorded special privileges, including banking facilities and the setting of wages.

The success of China's export efforts is evident in the rise of its trade GDP ratio. According to one estimate, China's trade GDP ratio rose from 10% in 1975-79 to 36% in 1990-94.⁵ In current US dollars the value of exports had risen from approximately \$ 16 billion in 1978 to \$ 138.4 billion in 1995. Export volumes, which had doubled between 1970-78, rose more than eight-fold between 1978 to 1997.⁶ However, as Angus Maddison notes, these figures exaggerate the importance of international trade to the Chinese economy.

Converting Chinese exports at PPP rather than the exchange rate indicates that they rose from 1.7% of GDP in 1978 to 4.3% in 1995.⁷ The low starting point hypothesis highlighted by Chengang Xu in the context of the dramatic productivity gains of China's township village enterprises, in the aftermath of reform, also applies to the rapid rise in China's exports.⁸ However, the catching-up process must nevertheless be recognised as rapid, although the starting point was unusually low in 1978 for an economy of the size of China's.

As far as foreign investment is concerned, aggregate figures show that by the end of 1996 China had approved 283,793 foreign enterprises involving \$ 466.8 billion of foreign investment capital. Of these more than 140,000, representing approximately received \$ 179 billion in foreign investment, had commenced operations. Much of this capital investment occurred between 1992-96, when China received \$ 151.5 billion.⁹ China became the second largest recipient of foreign capital in the world, after the US. Overseas Chinese investors from Hong Kong, Taiwan and Singapore accounted for over three-quarters of the foreign investment in China in 1996. The share of foreign investment in total national industrial output reached 13% in 1995 and its share in national export volume just below a third. Foreign investment also contributed 10% of tax revenues that year and constituted 18.3% of gross domestic investment in 1994.¹⁰

The role of special economic zones (SEZs) is more controversial because of their capacity to divert resources that might have otherwise gone elsewhere. They also became the conduits for the smuggling of consumer goods into the rest of the economy.¹¹ The SEZs were free-trade areas where imported inputs and exports were exempt from duty and new enterprises operating within them enjoyed prolonged tax exemptions. Four such SEZs, Shenzhen, Zhuhai, Shantou and Xiamen and Fukein, were created in 1980. Shenzhen grew rapidly to become a substantial agglomeration, from 23,000 in 1979 to its current population of over 3 million inhabitants. It became a part of the greater Hong Kong economy, which re-located most of its industry there to take advantage of its low wages and tax incentives. This nexus with Hong Kong enabled it to achieve booming exports.

A number of unusual features are evident in the evolution of the Chinese economy during the past twenty years. The first is the crucial importance of international economic relations for economic growth and its continuing role in the development of China's economy. China's comparative advantage in labour-intensive manufacturing is greater than would be expected for a country of its size because of poor endowment in land, which thus also predicts food imports.¹² The second is the fortuitous political environment that allowed international market access despite the lack of GATT membership, particularly the availability of MFN status on a bilateral basis with the USA - underlining the political calculations involved in international trade relations. The third is the extraordinary relationship with Chinese overseas investors, the conduit for inward foreign direct investment into China and the catalytic underpinning for China's export drive.

Conceptualising the political economy of Chinese overseas investment

The analysis might start with the significance of the relationship between China and Chinese overseas investors. A conceptual interpretation of the relationship suggests the counterpart of a merger between two firms, able to maximise the utilisation of each other's assets in a truly virtuous circle. One aspect of this merger has the characteristic of the advantage of increasing returns to scale. The combination of China's relatively well educated, disciplined and cheap labour force with the production, managerial, marketing experience and skills of Chinese overseas investors proved irresistible.

The economic rationale for the hierarchical integration of firms is partially consistent with the phenomenon described above. On the one hand, it combines the features of high volume production with mass marketing, but a number of the consumer goods involved in the transnational production relationship between China and overseas Chinese investors differs from the standard classification in the literature. The characteristic of product differentiation and barriers to entry in the standard analysis, promoting a strategy of hierarchical organisation, differs from the highly competitive and easily substitutable market for goods like clothing that China exports in substantial quantity.¹³ However, other goods produced transnationally in conjunction by China and overseas Chinese investors may have greater similarity with the types of products considered ideal for production by hierarchical organisation.

As a general point, high volume production in competitive markets has unusually strong quality control, packaging and marketing requirements. In this context, Chinese producers, who are new entrants to the market, benefit from the valuable experience of

their Hong Kong partners, who are, in addition, well suited to performing the more capital-intensive tasks further down the production chain. More pertinently, it might be borne in mind that transnational production involving China differs from the situation of a single firm. In the case of China and overseas Chinese foreign investors in particular, the distribution of specific skills between the transnational partners is also underpinned by comparative advantage, deriving from the geographical incidence of divergent national capital-labour ratios.

It might also be noted that China's protected domestic market constitutes a form of shelter for the backward integration of Chinese overseas investors' enterprise as well, although it might be objected that such protection imposes costs in the long run. The final outcome has been a rapid rise in Chinese overseas investors' trade/GDP ratio and a division of labour that has built on the comparative advantage of each.¹⁴ The rates of growth of different sectors of each partner's economy underline the degree of mutual interdependence that has come into being.

A conventional view would predict greater welfare gains for the smaller country than the larger one when economic integration takes place between them. The reason for such an outcome is due to the fact that the smaller country would experience a bigger reallocation of domestic resources in the aftermath of economic integration and its welfare gains would therefore be correspondingly higher. However, this view may not adequately capture the extent of benefits to the larger country when the smaller country has a significantly higher per capita income and is thus more advanced technologically and organisationally when economic integration takes place. The possibility of such an economic outcome also highlights an important political dynamic that comes into play in such a relationship and would be of interest to the larger, but less developed country.

Politics of international economic liberalisation

One of the issues that concern developing countries is the terms and conditions under which its access to foreign technology and capital occurs. There is anxiety that such access does not compromise its political autonomy either because of the nature of the terms on which access to foreign capital and technology is gained, or by virtue of the activities of foreign players within their domestic political system, once access has been granted. It may therefore be preferable to the country to access the international economy, the source of the desired capital technology, through an intermediary that shares some of its own political and economic objectives and over which it also has a degree of political influence. The relationship between Chinese overseas investors and China is an example of such a situation.

The economic role of Chinese overseas investors can be viewed, from Beijing's perspective, as the politically secure window that could act as a filter and conduit for the import of capital and technology. The fact that their ability to act in this capacity was already substantial when economic ties between them were growing, because of their level of economic development, enhanced the usefulness of Chinese overseas investors to China's economy and its policy makers. Chinese overseas investors were able to export capital to China that was not associated with the political baggage of originating from potentially, as well as in reality, in many cases, hostile countries. They were also able to transmit technology and entrepreneurial knowledge, including modern business management and marketing techniques and experience without posing a threat to the

prerogatives of policy makers in Beijing. Nor do Chinese overseas investors bring with them the possibility of recourse to powerful home governments, sensitive to their responsibilities towards their own economic agents operating in other jurisdictions.

As compared to signing inter-governmental international treaties like the WTO and articles of association with international organisations, as a prelude to economic openness, such bilateral relations, with suitably endowed but politically weak economic entities, would be more beneficial from the perspective of any government. In the former case, formal equality is underpinned by the realities of the power capabilities of signatories as well as the likelihood of claims being pursued and rights enforced and legal obligations being upheld, in the event of disagreement. By contrast, investors originating in politically weak entities, who supply physical or intellectual capital, subject to bilateral, and often, informal understandings, are likely to be willing to reach accommodation in the event of disagreement rather than seek to enforce their legal rights. In the case of investors from Hong Kong, their political vulnerability was especially acute given the impending transfer of power, a perception that should have become more unambiguous with the approach of the scheduled date of transfer and the certain knowledge that it would occur. The position of Taiwanese investors was even less promising for a debate on their economic rights.

Economic relations between China and Hong Kong, the principal source of Chinese overseas investment since 1978, can be conceptualised as a form of economic integration in which its political implications for policy makers in Beijing were submerged under the scheduled hand-over of Hong Kong's political sovereignty to the Government in Beijing. Thus, the possibility of increasing Hong Kong economic influence over China could be deemed an internal issue, balanced by the political preponderance of decision-makers in Beijing. The fact that Hong Kong was also much smaller as an entity would merely reinforce the conviction that its direct political impact would be circumscribed to the manageable level implied by its relative size.

This relationship might also offer a model for other developing countries by suggesting possibilities that are absent in current thinking, on foreign economic policy options. It is of course to be recognised that the relationship between Chinese overseas investors and China, that led to what may be regarded as the fortuitous circumstance identified above, cannot be replicated exactly since it was the product of particular circumstances and a long process of evolution. It involved the prior developmental trajectory of Chinese overseas investors in the independent jurisdiction of their own country of domicile, politically separate from China. However, the relationship does offer insights about the possibility of achieving an enhanced degree of control over the process of accessing the international economy. Contemporary international economic commitments like WTO obligations have made similar policy options more difficult to pursue, but the issues involved in the relationship between Chinese overseas investors and China are worth examining nevertheless.

Overseas Chinese economic activity in China

The economic integration between countries in which Chinese overseas investors reside and China has taken place at the level of trade and investment, with associated transfers of managerial know-how and technology. China's low wage work force has provided the basis for Chinese overseas firms to persist in productive activities in which their own

home country had lost comparative advantage. In the usual course of events, firms from countries that lost comparative advantage would have also shed market share to firms operating from other countries, lower down the specialisation rung, that possessed the appropriate capital labour ratio for the goods in question. Instead, by investing in China, overseas Chinese firms remained in their pre-existing production activities by internationalising production and establishing a new division of labour. Labour intensive processes and production have generally moved to China while more capital intensive and knowledge intensive parts of the production process are located elsewhere in the more advanced economies of the region - mainly Hong Kong and some parts of Southeast Asia.

The critical issues for growth in market share in these labour intensive goods is the degree of protection that is encountered in the export market, the income elasticity of demand for the products as well as competition from other developing countries. The latter is unlikely to be a major issue for Chinese overseas investors who have organised their productive activities within the region in accordance with the comparative advantage enjoyed by each country. By comparison, there are cost disadvantages for countries that cannot locate different parts of the production process in accordance with the appropriate capital labour ratios for that segment of the production chain. As far as trade protectionism is concerned, China, which is a major participant in this new international division of labour in Asia, has the political clout to argue its case and, as a corollary, defend the interests of other countries who are participating in it as well. At the same time, the new provisions of the WTO treaty offer greater opportunities for light industrial goods, including leather and apparel.

The income elasticity of demand issue becomes less of a constraint as the producers concerned begin to diversify into higher value added items within the same general range of output; for example, designer clothes rather than standard items and higher specification electronic goods as well as more complex ones. The very fact that the range of per capita incomes in these countries, joined together in the transnational production chain, diverges widely produces an attractive combination of production possibilities, underpinned by the non economic, but important, variable of a shared political ethos, common business culture and linguistic homogeneity. The underpinning of this regional division of labour by a dominant China and its growing market, absorbing a significant proportion of the same output, suggests grounds for successful co-operation between the various parties involved in the economic relationship.

The economic relationship between Chinese overseas investors and China involves an interdependent association between foreign direct investment and international trade flows. Basically, overseas Chinese foreign investors are largely in the export sector of China's economy.¹⁵ A significant proportion of these exports from China is also imports into the overseas investor's country of origin for further processing, particularly in the case of Hong Kong. Hong Kong itself exports 200% of its GDP, most of which originates in China. There are thus four inter-related facets to the economic relationship between China and overseas Chinese investment: the first pertains to the export of capital in the form of foreign direct investment into China; the second concerns exports primarily from China to the rest of the world; the third element of the triangle is the import of a proportion of these exports as semi-finished goods for further processing in the economy

of the Chinese foreign investor; finally, there are the exports from the investor's home country to China.¹⁶

Trade and investment

The rise in China's exports has been both spectacular and remarkable since the beginning of reform in 1978. Chinese overseas investors have played a major role in China's export success through foreign direct investment. The compound annual growth rate of China's exports exceeded that of all countries during the post-war period, except Korea. The base against which Korean export volumes grew is of course much lower than China's and the absolute levels that the world economy absorbed from China correspondingly higher; in constant prices, \$ 51 m in 1952 for Korea, against over \$ 16 billion in 1978 for China, at the start of the reform process.¹⁷

The scale and importance of China's exports are exaggerated by conversion at the official exchange rate and when measured against official estimates of GDP. Maddison, as highlighted above, has questioned the unrealistic 36% trade/GDP ratio that this method of calculation suggests. However, the importance of international trade for China's economic growth and reform programme is not reflected by the arithmetic of trade/GDP ratios, especially the lower adjusted one indicated by Maddison. In fact, China's international trade is more significant in relation to industry and manufacturing, even allowing for the contribution of township-village enterprises to total output.

A conventional interpretation of the contribution of China's international trade to economic growth would correlate exports with domestic economic growth. However, such a method of evaluation does not unambiguously establish the direction of causation in the relationship between domestic economic growth and exports, since the latter could be an epiphenomenon of the former. But in China it is more certain that trade liberalisation did anticipate wider changes in economic organisation within China.

International trade was also of greater qualitative importance. For instance the export sector was a catalyst for the advance of legal and institutional changes necessary for the domestic reform that occurred subsequently. It also had a positive impact on resource allocation and the introduction of competitive behaviour into China's economy, in addition to the direct benefits of specialisation itself. International trade is also the source of critical technologies as well as the vehicle for participation in developments in the wider world economy. The fact that approximately a third of the contribution to economic growth, in the post-reform period, was because of increases in total factor productivity underlines the importance of improved resource allocation.¹⁸

Capital exports to China from the rest of the world began to rise with the onset of pro-market reforms in the late 1970s. Hong Kong remains the largest single home country for capital exports to China. And the bulk of foreign direct investment into China is from firms of overseas Chinese origin, with 60% of recent flows from Hong Kong alone; this figure rises to almost 70% when Taiwan is included. By 1995 it was privately estimated that 25,000 Hong Kong firms, directly employing between 4-5 million workers were operating in China.¹⁹ By 1998 Taiwanese investment in China was estimated to have reached \$ 38 billion, employing 2 million migrant workers and 25,000 managers from Taiwan itself.²⁰ These industries included clothing, telecommunications and sound and

recording equipment, footwear and textile yarn and fabrics.²¹ Hong and Taiwan therefore remain pre-eminent during the 1990s.

Restrictions on portfolio capital also bias ownership of foreign investment in favour of overseas Chinese investors, who enjoy political and cultural advantages, although recent policy changes with regard to the bond market, suggest a shift in government perceptions.²² The share of portfolio capital remained under 1% of GDP in 1993-94, compared to around 6.5% for FDI during the period 1993-95.²³

A proportion of the capital exports routed through Hong Kong is owned by nationals of third countries like Taiwan and elsewhere, for reasons of political prudence as well as the advantage of expert Hong Kong intermediation for operations in China. A further element is estimated to be the product of 'round-tripping' that arises because investors from within China register ownership abroad to take advantage of tax concessions to foreign investors - estimated at up to 20% of total inflows in recent years.²⁴

Much of the activity of Chinese overseas investors has been concentrated regionally. Twelve coastal provinces and municipalities have absorbed 90% of foreign direct investment. The principal recipients of inward flows are Guangdong, Shanghai, Fujian and Jiangsu. The investment was mainly in export activities and real estate and gradually diversified from light industries to electronics, telecommunications and transport. It created a buoyant intra-Asian economy that embraced the twelve provinces, Hong Kong and Southeast Asia. This growth was made possible by ancestral links of overseas Chinese to villages as well as the matching of comparative advantages with different stages of processing in different national locations.²⁵

Aspects of overseas Chinese economic activity

The other noteworthy feature of overseas Chinese foreign direct investment in China is the shift from labour-intensive to capital-intensive sectors in the 1990s. The initial emphasis on labour-intensive assembly operations for re-export, in which Asian Chinese firms had a stronger presence owing to pre-existing local comparative advantage in their home country, is now supplemented by growing involvement in more capital-intensive sectors. According to evidence collected by Ampalavanar-Brown, the number of US and Japanese firms rose while Asian Chinese firms declined among the top 100 foreign firms in all sectors in China during 1991-93. This phenomenon was accentuated by government policy favouring technology-intensive industries, while overseas Chinese investment was more concentrated in labour-intensive industries. Nevertheless, 45 of the largest foreign firms in China were still owned by overseas Chinese business.

The strategy of overseas Chinese business for moving into capital- and research and development-intensive industries may also be judged more beneficial to the local economy. It is achieved through joint ventures with the Chinese State as well as other foreign enterprise, allowing for the possibility of greater spill-over and technology- as well as know-how transfer. The contemporary diversified portfolio of activity includes investments in power generation, telecommunications, automobiles and aerospace, responding to the Chinese State's purchasing policies and attendant budgetary constraints. It also demonstrates a capacity to deliver technology-intensive products through sub-contracting arrangements. Chinese overseas business was thus willing to adopt greater flexibility than possible under the preferred conventional arms-length mode

of operation of Western companies. Chinese overseas investors, however, fulfilled fewer contracts because of their involvement in riskier ventures.²⁶ However, losses incurred by foreign investors in higher risk ventures suggest that more potential business opportunities are being explored and China remains a beneficiary of such investment, despite the losses borne by the foreign investor.

One cognate aspect for appraising the impact of Chinese overseas investment on China's economy is its indirect catalytic role in stimulating more investment because it helped to bolster post-reform economic growth in China. As the 'firstcomers' they also smoothed the path for the 'latecomers', especially Western and Japanese investors, because it enabled the Chinese authorities to gain experience of how to deal with foreign investment and recognise its contribution to the economy. It also instigated the development of infrastructural and other facilities that made it possible for foreign investors to operate with greater ease in China.

Ultimately, it is the qualitative impact of international economic relations that has to be taken into account, contrary to the narrower quantitative view taken by some researchers.²⁷ The very idea of 'catch-up' already embodies this qualitative relationship even if the resultant sectoral shifts and mobilisation of domestic resources, in the form of capital and labour, are its quantifiable visible expression. Thus, the contribution of international trade and investment to growth is under-emphasised by standard growth accounting.

Hong Kong and China

The importance of China's relationship with Hong Kong stands out in any assessment of its international economic relations in the post-reform period. It may even be argued that the subsequent diversification of China's international economic relations was facilitated by the economic, political and administrative changes that came about because of its sustained interaction with Hong Kong. This relationship is central to the argument put forward that Hong Kong acted as the principal conduit which eased the opening of China's economy to international trade and inward investment. It offered relatively secure, but high quality intermediation of the inflow of goods, capital, services, technology, know-how as well as administrative facilities into China. In the words of one researcher:

“Because of its strategic location: its modern facilities in banking, finance, insurance, transportation and other services: and its credible and enforceable legal framework, Kong Kong remains Mainland China's main gateway to the West, while the West continues to view Hong Kong as the main entrance to Mainland China. In large part, Hong Kong's role in Mainland China's trade is to act as Middleman, a role not dissimilar to that of a giant trading company”²⁸

The geographic distribution of China's exports underlines the importance of Hong Kong once again. Throughout the period beginning in 1970s, up to 1996, Hong Kong absorbed a little under a quarter to a fifth of China's exports. This is remarkable because during

this period, beginning with the onset of reform in 1978 to 1995, the value of China's exports rose from \$ 16, 076 million to \$ 138,388 million, just under nine times, in constant prices. Hong Kong continues to absorb a higher percentage of China's exports than Japan or the US, who are in second and third places, respectively. An added dimension to the trade relationship between Hong Kong and China is re-exports of goods that originate in either of the two economies and then have value added to them in the other, before being exported to a third country. The scale of this trade between the two economies is substantial, much of it in the form of re-exports. In 1995 over 55% of China's exports and almost 38% of its imports were re-exports. China is the principal source of Hong Kong's re-exports as well, amounting to 57% and HK \$636 billion. In fact, the extent of the economic integration of China and Hong Kong is underlined by the fact that 92% of all Hong Kong re-exports to the world occur because of trade with China, including re-exports to China and re-exports that originate there.²⁹

The relationship was possible because the government of Beijing did not regard overseas Chinese investors as "foreigners" and had long experience of dealings with them. In the case of Hong Kong, the most important relationship with the capitalist world economy, the impending transfer of sovereignty created an asymmetry of political power in favour of China.

Autonomous economic zones and backward and forward linkages

The economic relationship between Chinese overseas investors and China represents an unusual historical conjuncture. Developing countries seeking to join the world economy, that is comprised of politically and economically more advanced countries, may, rightly, regard the available options for access too demanding. While participation in world economy undoubtedly offers major economic and political advantages for such countries, it also entails political and social sacrifices that they might wish to mitigate. In so far as the terms and conditions for access to the world economy, as represented by existing treaties, and economic relationships between weak and strong players, are unavoidably asymmetric, rapid economic liberalisation is not the only possible option for access to the world economy that might be considered. The path adopted by China signals a politico-economic option for accessing the international economy that confronts this difficulty.

This issue of the method of entry and economic integration has been a particularly important for the former socialist economies that had previously planned their economies. The transition of planned economies to the market presented distinctive problems, because their previous isolation from the international economy and the fact that most resource allocation had been planned according to non-economic criteria, created the likelihood of greater disruption, as resource-use came to reflect international prices. The size of the country and the historical length of its association with central economic planning constituted a proxy for the extent of the adjustment necessary and the likely scale of the social disruption that would attend it. In this context, the choices faced by different transition economies differ and for, Russia, the largest of them, it entailed especially painful choices.³⁰ Basically, the issue is one of the speed at which price changes and corresponding resource allocation shifts can occur during the transition and the impediments it will encounter, prolonging the associated social dislocation accompanying the transition.

In principle, smaller countries are likely to perform better than bigger ones because the necessary policy responses that need to accompany it can be more coherent and better focused and the outside assistance proportionately larger in relation to the needs of the economy concerned. A formerly planned developing country in which the penetration of market forces is impeded because of its low level of development, will also be in a better position to resist the disruption of its pre-existing structure of exchange entitlement, that was designed to achieve particular distributional objectives, prior to the transition. However, the extent to which the economy is dominated by agriculture and its condition will be relevant to this outcome. In a sense, a large developing economy is the best placed to cope with the costs of transition because most of its agricultural economy will remain relatively isolated, again, by virtue of its very backwardness. In the case of China, the reform of agriculture was the pre-condition for a less disruptive transition as most recognise. The particular path of calibration of Chinese internationalisation also provided further stability by regulating its impact.

The comparison between China's transition and that of Russia illustrates this problem acutely. The former managed to protect its political structures and prevented disruption to both its economy and society by ensuring a separation between the fast growing foreign sector and state-owned industry, which shrank in size, though remaining a fiscal burden.³¹ As far as the industrial economy was concerned, the weak state sector was sheltered, with township village enterprises (TVEs) occupying an intermediate staging post in the process of reform, beginning to gradually supplant the state sector through their explosive growth and labour absorption.³² It was not merely that the reform policies of China and Russia diverged, they were also geographically delimited and restricted to some types of economic enterprise in China, in order to prevent social disruption. Paradoxically, by restricting economic reform and change geographically (SEZs) and negotiating its entry politically the leadership in China was able to embark on more radical reform. By contrast, Russia got bogged down precisely because the political leadership was unable to control the effects of economic change that impacted vertically as well as horizontally, creating resistance that succeeded in prolonging that very disruption. Ironically, it led to calls for more vigorous implementation of market reform, without taking into account the fact that the extended scale of the form in which the reform was introduced, in the first place, provoked the opposition to reform. However, China managed to avoid the depth and scale of the interconnected political instability and economic dislocation that has engulfed Russia, in particular.

Conclusion

The experience of China re-affirms the critical qualitative role of internationalisation for economic change and growth. But it also highlights the unusual path of internationalisation that China was able to adopt. The circumstances in which such a path of internationalisation became possible were unique. However, they offer lessons that might be considered by other countries that are internationalising their economies, despite the need to adapt China's example to different historical circumstances.

The reform policies embarked upon by the leadership in China, restricting its geographical scope, sectoral extent as well as policy type, were fortuitous. In effect, a number of coastal provinces led the transition to the market, despite the associated negative regional distributional consequences of the policy incentives designed to achieve it. The exemption of uncompetitive and weak state-owned industries from the forces of

change is much lamented, but it is only possible to guess at the social and political disruption that a simplistic economic reform might have precipitated, to the detriment of the reform process itself.

The decision not to privatise state industry is but one further aspect of this policy. The contrary prescription, to proceed through a “big bang”, has been one reason for the dismal outcome in Russia as well as the cause of its very abortion due to political resistance. The economic costs of political and social dislocation do not register in the calculus of efficient resource allocation once that has already been paid, but they form the new base line against which, paradoxically, the subsequent tranche of growth performance is evaluated. It is possible that a higher long term rate of economic growth can be achieved by avoiding the disruption in the first place, even factoring in the economic cost of allowing resources to remain misallocated for a prolonged period.

The policies choices enumerated above were more feasible in China because of the fact that its economy was organised geographically, shielding individual regions from the negative consequences of change in other parts of China. By contrast, the thorough integration of the Russian economy, on virtually continental proportions, within the wider economy of Russia as well as the former Soviet Union, allowed fewer opportunities for sequential geographical advance. Change in one sector was transmitted throughout the economy, disrupting other segments and requiring them to change as well, in order for the original initiative to proceed. It may be argued that more careful planning, that did not primarily rely on market signals to force change across the economy, was required in Russia. More thought was also needed to distribute the economic and associated social dislocation with greater concern for economic sectors that would impact on the greatest number of people.

The experience of China is of particular interest to the thesis being proposed that China found itself in a fortuitously unique situation. The existence of advanced elements in what is now the greater Chinese economy, particularly in the form of neighbouring Hong Kong, created a buffer for China. This buffer inadvertently protects China from international market volatility and foreign political pressures, because the greater Chinese economy operates in a context of political and cultural ties that mitigate their potential harshness. Economists have noted the quantitative dimensions of this phenomenon, as outlined earlier in the paper, but like good economists, failed to appreciate its significance. The government of China was able to regulate its economic ties with the outside world much more effectively, by calibrating its policies in a sequence that, at least, allowed the possibility of retrenchment in the event of threatened serious internal disruption.

In this nexus, the Chinese overseas community engaged in a profitable economic relationship in China, but one that is also moulded by unique cultural and political factors specific to their relationship with China, as overseas Chinese. Thus, Hong Kong’s labour shortages and skills may have complemented the economic conditions that China provided, but China’s sovereignty over Hong Kong was pending. The latter circumstance alone altered the notion of purely market-driven relations and the possibility of Hong Kong withdrawing from commitments in China, should conditions become unpleasant. This was a marriage without the possibility of divorce, the one certainty prior to the

nuptials, that predicated mutual accommodation and the probability of success because the rational calculus would have internalised this absolute constraint!

As far as developing countries are concerned, none have a comparable situation, of more economically advanced, neighbouring kith and kin offering such a powerful catalyst for change. However, an interesting insight suggests itself from a political perspective, especially if political disruption caused by attempted economic liberalisation is likely to thwart economic reform itself. The idea of an advanced region within a country becoming a gateway to the international economy might lead to a fundamental re-appraisal of the limited experiments with free trade zones as a potential buffer, of the kind the Chinese overseas investor in general and Hong Kong in particular provided for China. Such a free trade zone would then be a major strategic choice for the developing economy. It also offers the additional advantage of permitting a form of legal discrimination between the free trade zone and the country, which might be helpful for providing temporary relief from international competition. In addition, the political spin-off of international liberalisation is subjected to a kind of quarantine that might be deemed useful for policy-makers, unable to withstand the scale and complexity of unrestricted foreign entry. This is a problem that is already evident in a different form for developing countries because of the demands that are being made and strains experienced by administrative systems, following accession to the WTO, owing to the need for domestic legislation required as a counterpart to WTO provisions. The analogy is not exact because the creation of a buffer in the form of a substantial free trade zone, primarily concerns economic forces that bring in train associated political and other demands. Thus, a country that does not wish to liberalise its economy rapidly in entirety might wish to establish a substantial area, on a different scale from the small-scale free trade zones that have been in operation since the 1960s. This option may be especially suitable for larger economies that fear excessive dislocation if international liberalisation occurs too rapidly and if they are large enough to bifurcate themselves on a meaningful scale.

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¹ See for example the summary of The World Bank, China 2020 Washington D.C.1997 and Nicholas Lardy "The role of Foreign Trade and Investment in China's' Economic Transformation", The China Quarterly, December 1995.

² The history of China during the latter part of the 19th and early 20th centuries was one of humiliations and imposed commercial treaties of which China's elites remain acutely conscious. See, for example, J. Gernet, A History of Chinese Civilisation, 2nd edition. Cambridge University Press, Cambridge 1996, pp. 576-589.

³ Lawrence C. Reardon, "Learning How to Open the Door: A Reassessment of China's 'Opening' Strategy", The China Quarterly, September 1998, Number 155, pp. 479-511.

⁴ Chinese authorities viewed foreign investors with suspicion, but did not consider overseas Chinese investors as foreign, except during the period of the Cultural Revolution. See Lawrence C. Reardon, op. cit. footnote 78, p. 494.

⁵ See World Bank, China Engaged, Washington, D.C. 1997, p. 6.

⁶ Angus Maddison Chinese Economic Performance in the Long Run, OECD, Paris, 1998, pp. 87-88.

⁷ Angus Maddison, *ibid.* provides figures for the relevant period.

⁸ Chenggang Xu, A Different Transition Path, Garland Publishing, Inc., New York, 1995.

⁹ Maddison, op. cit. pp. 87-88.

¹⁰ Yadong Luo, International Investment Strategies in the People's Republic of China, Ashgate, Vermont, USA, 1998, pp. 7-8.

¹¹ World Bank 1994(a) China: Foreign Trade Reform, Washington, D.C. considers tariff evasion to be serious (as well as ad hoc exemptions) and one reason for generating little revenue compared to other developing countries

¹² The World Bank, China Engaged, op. cit. pp. 13-16, esp.

¹³ See, Herman Daems, "The Rise of the Modern Industrial Enterprise, A New Perspective" in Alfred D. Chandler, Jr. And Herman Daems in Managerial Hierarchies, Comparative Perspectives on the Rise of Modern Industrial Enterprise, pp. 203-224 and 211-216, esp. Harvard University Press, Cambridge, Mass. 1980.

¹⁴ This is a phenomenon that has also been noticed by other researchers. See, for example, Paul Krugman, "Growing World Trade: Causes and Consequences," Brookings Papers on Economic Activity 1. Brookings Institution, Washington, D.C. 1995.

¹⁵ By contrast, Western investors invested to supply the local market. See Rajeswary Ampalavanar-Brown 1998, "Overseas Chinese Investments in China - Patterns of Growth Diversification and Finance: The Case of Charoen Pokphand," The China Quarterly, September 1998 number 155, pp. 612-613.

¹⁶ See L.C. Fung, Trade and Investment Mainland China, Hong Kong and Taiwan, City University of Hong Kong Press, Hong Kong 1997.

¹⁷ (see p. 85 Maddison)

¹⁸ China Engaged op.cit. Also see page 16 for the relationship between trade and industrial output under different assumptions. Maddison, op. cit. P. 61 and pp. 65-68 on productivity growth and its sources reiterate this point.

¹⁹ China Engaged, op. cit. p. 22. Also see Aasim M. Husain, "Hong Kong, China in Transition", Finance and Development Volume 34 Number 3 September 1997, p. 1.

²⁰ Economist Survey of Taiwan, November 7-13th 1998, p. 16.

²¹ L.C. Fung, op. cit. p. 16.

²² On the subject of China's borrowing preferences see Edward M. Graham and Ligang Liu, "Opening China's Bond Market - Catalyst to further Reform and a Jumpstart to the Stalled Wto Accession Negotiations", Journal of World Trade, Volume 32 Number 4, August 1998, pp. 5-21.

²³ China Engaged, op. cit. pp. 8-9.

²⁴ UNCTAD, World Investment Report 1995, Geneva.

²⁵ China Engaged, op. cit. p. 22; Rajeswary Ampalavanar-Brown, op. cit. p.617-8; also Angus Maddison, op. cit. pp. 86-89.

²⁶ Rajeswary Ampalavanar-Brown, op. cit. p. 613.

²⁷ L.C. Fung, op. cit. esp. pp. 113-15 and A. Maddison, *passim*.

²⁸ L.C. Fung, op. cit. pp. 14-15; also see Aasim M. Husain, op. cit. pp. 2-3.

²⁹ (For a detailed examination of the data see L.C. Fung, op. cit. p. 15)

³⁰ There are basically five types of transition economies: small advanced (East and central Europe) small developing (central Asia, Vietnam) large advanced (Russia) large developing (China). The small advanced are the best

candidates for speedy reform and rapid integration into the world economy, especially if special assistance is forthcoming in the form of loans and market access. In their case, slow adjustment may be a worse choice because ownership and price changes can occur quickly and slower pace and scale of adjustment might undermine reformist policies applied only partially. By contrast, the developing small transition countries will also face the additional burden of development itself, which really means human, social and fixed capital accumulation, but it is shielded by the dominance of agriculture and the very smallness of planned industry during the transition itself. The problems and options faced by Russia cannot be deduced mechanically from the successes of some small advanced transition countries, as much analysis has apparently both implicitly and explicitly suggested (IMF, Economic Outlook, 1997). It is this issue that will be considered briefly in the main argument of the text and the lessons offered by China, the large developing transition economy, considered as a counterpoint. Also see Anders Aslund, How Russia Became a Market Economy, 1995.

³¹ Geng Xiao, "What is Special about China's Reforms", Socialist Economies Reform Unit, Research Paper Series, The World Bank, October 1991. Also Angus Maddison, op. cit. p. 83.

³² See Chenggang Xu, A Different Transition Path, op. cit.; Angus Maddison op. cit. makes a similar observation in a different context.