CARNEGIE ENDOWMENT FOR INTERNATIONAL PEACE

RETHINKING THE CHINESE ECONOMIC MIRACLE

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MINXIN PEI: Good morning. I'm Minxin Pei. I'm a senior associate at the Carnegie Endowment. Welcome to this event – Yasheng Huang's new book, "Capitalism with Chinese Characteristics." We have copies of the book on sale in the back of this room after the event. Yasheng will be very happy to autograph your purchases.

I'm very delighted to have my old friend Yasheng giving us this talk on his latest book, and I'm also very grateful to my good friend Eswar for agreeing to come here and serve as a discussant for this event. Yasheng teaches political economy at the Sloan School of Management at MIT. Previously he has taught at Harvard Business School and the University of Michigan. He is the author of three books, including this one. All of them are highly regarded and, I would say, many classics in their respective fields. I'm really envious of his productivity. I feel so unproductive compared to Yasheng and myself.

Eswar is the Tolani Senior Professor of Trade Policy at Cornell, and also a senior fellow at Brookings. Previously he has worked at IMF and served as the head of IMF's China division. He has written extensively on China's miracle economic policy and financial reforms and has published extensively in various prestigious academic journals.

Yasheng will start giving us the main argument of his new book and then Eswar will give us a short commentary on Yasheng's thought-provoking book. So I am now yielding the floor to Yasheng.

YASHENG HUANG: Thank you so much, Minxin, for organizing this event, and thank you, Eswar, for coming to comment on my presentation on my book. As many of you know, this is the 30th anniversary of economic reforms in China, and that provides an opportunity for academics and others to look back at the 30 years of reforms and reflect on what has worked and where are some areas where China may offer valuable lessons and experiences.

What I'm going to do today is – I hope this is okay in a fast-paced town such as Washington – to go back to the history a little bit. And when I talk about history, by business school standard I'm a historian because I chose to look at, in my book, 1980s in great detail. My own view is that it is very important to understand the evolution of the reforms and the success of the reforms and some of the challenges today by going back to the 1980s and then contrast the development in the 1980s with what happened in the 1990s.

So this is the way – more productive way to talk about and discuss, for example, some of the issues that have just come up, such as the stimulus package that the Chinese government has announced, the land reforms that they have tentatively planned to implement, and the healthcare reforms and educational reforms.

To understand why they were doing this, it is absolutely important to go back to the 1980s, so I hope this is okay. We have about an hour-and-a-half, so hopefully this is something that will be interesting to you.

When I talk about history I don't want to sort of talk about the historical details. My interest in history is trying to understand history to answer some big questions in social science and especially in economics. And one of the ideas – very influential ideas that has come out of social science research in China is that China has this very clever way of growing its economy without adopting conventional policies and conventional institutions. When we say "conventional," here we mean private entrepreneurship. China is viewed as a country that has grown fantastically without relying substantially on private ownership.

Financial liberalization – again, this is another idea that social scientists and some very eminent economists have come to, which is that, you know, you can grow the economy without adopting market-based Western financial institutions. Political reforms – you can achieve economic success without political reforms, and China typically is viewed as a poster child of what is known as a heterodox development strategy that doesn't rely on these conventional types of policies and institutions.

My argument in the book and my argument in my presentation is that details matter. If you look at the details – and this is why we need to go back to the 1980s – if you look at the details, the Chinese success, I would argue, is very much a convention success which says that it is a function of private entrepreneurship, private ownership. It is very much a function of financial reforms that were implemented very early on, and even political reforms, we could argue that China moved on to the reform path in part because the country implemented meaningful political reforms.

Much of the book is about getting the facts right, getting the details right. Let me begin with a story of Lenovo – I'm trying to look at whether this computer is Lenovo or not. This is IBM, okay, even better. (Laughter.) The PC manufacturing of a unit of IMB was acquired by Lenovo in 2005, and that acquisition was viewed as the arrival of globally competitive Chinese companies on the world stage. And Lenovo is very much used by many Western academics to underscore the point that you don't need private entrepreneurship. This is a state-owned enterprise. You don't need Western financial institutions. Lenovo grew up in China with a state-owned banking system. And what I'm trying to show here is that if you look at the details of this company, in fact the details show that Lenovo was very much a product of a private entrepreneurship – very much a product of Western finance.

And then I'm going to talk about the true China miracle. I would argue that much of the true China miracle happened – and there was a true China miracle in the following sentence, which is that the country was able to reduce poverty by a margin that is probably historically unprecedented, but the true China miracle, much of that happened in the 1980s. So this is another detailed look at the history, and in order to understand why so much of the poverty reduction happened in the 1980s, it is important to look at what the policies of institutions were in the 1980s.

And then I'm going to get to what I call a "tale of two decades," and this is a view that I put forward and I provided quite a bit of evidence in support of that view, and this is the popular view that is going to be controversial, which is that China, in the 1990s, reversed many of its very productive policies. And this is where the discussion of the challenges facing – economic challenges facing China are relevant. It is important to understand that reversal, to understand why the consumption in China is low relative to GDP, why the country has such a high level of income inequality, and why rural China, which pioneered economic reforms today, is in some degree of difficulties. So this is where the policy reversal is very, very important for us to understand what is going on today, and then I'm going to talk briefly about the policy challenges today. So roughly this is the agenda for today's discussion.

Let me go over quickly the conventional view on the part of Western academics of Chinese economic success. And this is loosely described as Beijing consensus, right? So there's Washington consensus and there's Beijing consensus. The Washington consensus and Beijing consensus are not exactly opposite to each other but there are substantial differences between the two.

The Beijing consensus emphasizes a productive role of the state. It emphasizes the productive role of the state in managing transition, in managing ownership, in managing finance, and the view there is very much private sector development is really as the result of economic growth. So if you look at China today it has a large private sector now, by some accounts, the account is between 68 to 70 percent of the GDP. But if you look at the early 1980s, China had a very small private sector. So the idea is that as the economy grew, you began to have a large private sector. You don't really need to have a large private sector on day one. So the private sector is really a function of the growth, a function of the reforms rather than as a condition for growth.

And there is a particular very interesting set of economic institutions that has attracted attention from academics. It is called TVEs. Terribly sorry if I spend time on these terms, but it is a very vital, important economic engine in growth in China in the 1980s and the early 1990s. And TVE stands for township and village enterprises. I would argue that without understanding TVEs, one would not be able to understand the Chinese success. And I will further argue – and maybe Eswar and I can exchange views on this – I would further argue that one of the biggest differences between China and India is that China had TVEs and India did not. The biggest differences, I would argue, between China and India has less to do with FDI infrastructures; it has very much to do with TVEs.

So TVEs powered Chinese economic growth in the 1980s and early 1990s. Financial reforms – again, Western academics would argue financial reforms, you don't really need substantial financial reforms. You can have other instruments of finance to help private-sector companies, and you can have government allocating financial resources in the way that promote economic growth. Much of my research shows that by looking at thousands of government documents and bank documents – my research is based on a very substantial, archival collection of data and documents. My research shows that financial reforms in China in – even some of them were in early 1980s – were very deep, were very substantial. The problem is in the 1990s many of these reforms were actually reversed.

Let's begin with Lenovo, right? In 2005 Lenovo acquired IMB, and Lenovo is often viewed as a classic example that a country with poor legal institutions, poor financial institutions can produce macroeconomic success stories such as Lenovo. In my book I detailed the funding of this company, and the argument there is that the devil is in the details. Lenovo was funded in 1984 and the parent company – it's not really a company, but the Lenovo was funded by CAS, Chinese Academy of Sciences. It is because of that connection many people argue that state-owned enterprise can achieve because CAS is a part of the Chinese government.

CAS provided $50,000 of funding capital, all right, so original capital. That's according to the official history of the firm. If you look at these details deeper, it turns out that from the very beginning there is a dispute whether or not $50,000 was debt capital or equity capital. And what's very interesting is that according to a very detailed account of the funding history of this firm, the funders of Lenovo took out a personal loan from the Chinese bank. They loaned the money to

Academy of Sciences and the Academy of Sciences loaned the money to Lenovo as the startup capital. The loan was paid up within two years.

So I think, you know, this is a relatively straightforward concept is it's the equity capital that establishes the ownership; the debt capital does not. From the very beginning, this company was really funded by three or four scientists from CAS and it was really their own money – not their own money; it was a loan that they took out against their personal assets, and the reason why there was this convoluted funding history of the company was that in 1984, although there were substantial reforms in rural China, in urban China the economy was completely state-owned. So you couldn't really register the company as a straight-forward private sector company. Then you had to use these very elaborate, very convoluted instruments to start a company such as Lenovo. So from the very beginning there is an issue whether or not Lenovo actually belonged to CAS or not because of that, but there's more about this company that is fascinating.

It is very important for us to understand why Lenovo succeeded by understanding its connection to Hong Kong. In 1988, Lenovo formed a joint venture in Hong Kong. The joint venture investment was financed by a company called China Patent Technology, a Hong Kong-based company. And then in 1993 Lenovo issued IPO shares on the Hong Kong stock exchange to the tune of roughly $12 million U.S. dollars. That $12 million U.S. dollars was instrumental for the company to venture into computer manufacturing, for them to acquire computer manufacturing assets, for them to establish factories in China.

So we may say, you know, these details are interesting but why should we talk about these details? Think about this: Hong Kong is the world's most laissez faire economy in the world. If you believe – and I think there's a lot of facts to believe – that success of Lenovo had a lot to do with Hong Kong, then the story of why Lenovo succeeded is a story about Western financial and legal institutions. Hong Kong has those institutions – is the most laissez faire economy in the world. If you believe that Lenovo was a pure local play rooted in China, then those people who argue for or on behalf of basic consensus have a point, right? You have state-owned financial institutions, you have state ownership, then you have the success of Lenovo, right? Clearly that fits with the Beijing consensus view of the economic development.

But if you get the facts right, at least Lenovo is a function, I would argue, of two things. One is it's a function of purely Western legal institutions, purely market-based financial institutions based in Hong Kong. The other is that it is a function of expending and growth of Chinese economic and business opportunities, right? That does – I hope that in Washington, D.C., people will pay attention to this because it does have very important policy implications. There are many people now who advocate the China model to Africa and to other countries on the basis of the success stories such as Lenovo. Whenever I hear that argument I will always ask whether or not those countries have Hong Kong. (Laughter.) And the answer is always no.

It is, in my own view, that the Chinese entrepreneurial success has a lot to do with Hong Kong – Hong Kong being a place that provides security of the assets. Hong Kong provides Western financial institutions, and China is actually quite unique in the sense that the country itself doesn't have those Western, market-based financial institutions but it has access to Western legal institutions and market-based finance. And this is a very unique situation that is very difficult to replicate in other countries. I would argue that many of the analysts have not appropriately understood the vital importance of Hong Kong. Most people think about Hong Kong as a place that provides management know-how, capital to China. I would argue the most important function of Hong Kong is to provide a substitute for China's poor institutions.

TVEs, why is this important? TVEs powered growth in China in the 1980s and the early 1990s. There is a prevailing view among Western economists and Western social scientists that TVEs were owned by local governments, okay? And I can cite to eminent names here, both winners of a Nobel Prize in economics – Joseph Stiglitz, a name familiar in Washington, D.C. He argued that the most important function of TVEs is TVEs prevented private stealing of public assets. Okay, so the TVEs were owned by the local governments. And the view that Stiglitz has about economic transition is that the most difficult challenge during economic transition is to prevent private entrepreneurs, private investors from stealing assets of the government. Okay, so that's his view. It's a respectable view – wrong but respectable. (Laughter.)

Douglass North, sort of the grandfather of – one of the grandfathers of the institution of economics, he would argue that TVEs don't fit with standard forms of economics. What is very interesting about Stiglitz' view of TVEs is that there are numerous documented cases where the TVEs did exactly the opposite, which is that the government used TVEs to appropriate private assets. It's exactly the opposite from what he believed. But let me get one fact straight: Are TVEs owned by local governments or not? This is where the detailed research of government documents is very, very helpful. I go through hundreds of these documents and many of these – it's really remarkable; I read some of these documents that will have the number of the copies printed, and some of them have like 24 copies printed and I was reading one of them. So it's quite a reach.

I go by the number – the famous number four document issued in 1984 by the Politburo, and this is the definition that established TVEs. And I go through many, many other documents to see if this definition is consistent, and the answer is that it is consistent with other government and legal documents. Let me read it to you: "TVEs include enterprises sponsored by townships and villages." These are the locally owned local government enterprises that Stiglitz was talking about, okay? But it goes on. "The alliance enterprises formed by peasants, other alliance enterprises and individual enterprises" – let me explain individual enterprises as a way to explain alliance enterprises.

Individual enterprises are essentially mom and pop shops, so single proprietorships. So essentially you have one or two shareholders who are related with each other. They don't have many employees. The difference between the individual enterprise and the alliance enterprise is that the alliance enterprise has multiple shareholders unrelated with each other and they have more employees. Usually the technical cutoff is that if you have more than eight employees, then you are an alliance enterprise. If you have less than eight you are an individual enterprise.

The alliance enterprise and individual enterprise are straightforward private enterprises, completely private. Then the next logical question is to ask, how many of the TVEs were private enterprises and how many were locally owned enterprises? This is a very complicated table. You don't need to look at all the numbers. But let me just point to two of them.

In 1985 there were 12 million TVEs. Of 12 million TVEs, 10 million of them were completely private. Ten (million) out of 12 million, from the very beginning of the reform era were completely private. I would argue if we get the facts right about TVEs, TVEs are probably – maybe I'm overstating it – TVEs are probably the history's most impressive private sector development story ever. You know, within four years of reforms, five years of reforms you have 10 million completely private enterprises.

Okay, let me skip a few slides, but to emphasize why TVEs were important. One thing about private TVEs, private enterprises in rural areas, is that most of them were located in the poorest provinces of China. And this is a very important point because as development economists, as social scientists concerned about economic development, we want to know how poor regions grow rather than how rich countries, rich regions stay rich. So the most important policy question here for China and to understand China, why this country was able to reduce poverty at such an impressive rate, I would argue one of the most important points here is to understand that completely private entrepreneurship play the instrumental role in reducing poverty because they started in the poorest provinces in China.

I rank the share of the private TVEs in the total output value of the TVEs by provinces. Those provinces higher on the table are poor provinces and they have the largest shares of the private TVEs. Look at the province or region at the very bottom of that table, Shanghai – Shanghai being the richest region in China, and the share of private TVEs in the rural – and that's your upper value – was only 6 percent. I'm going to come back through Shanghai later on. I have a whole chapter with the title, "What's Wrong with Shanghai?" And this provides a preview of that argument. It has a very small private sector development. And that's not the only thing that's wrong. The other thing that's wrong is that for much of the 1990s, Shanghai became politically dominant, and that's even a bigger problem. So the Guizhou then and now is the poorest province in China. Because of private entrepreneurship, this is why China was able to reduce poverty at such a dramatic pace.

Let me skip the political reform, but if there are questions about political reforms I will be happy to come back because I want to finish, to give time to Eswar to comment on my presentation.

Let me talk about the true China miracle in the 1980s. I'm using a very simple metric and I'm using the Chinese definition of poverty. You can use different poverty definitions. They all come out about the same. The specific numbers differ but they come out about the same, which is that the most impressive error when China was able to reduce its poverty was in the 1980s. Remember in the 1980s China didn't have what many economies now believe to be the quintessential hallmarks of China development model. FDI, foreign direct investment – huge infrastructure investments. China had none of those in the 1980s and yet the poverty reduction was substantial, mainly because of the TVEs, I would argue. Poverty had declined by 154 million – this is just in rural China – by the rural Chinese poverty line.

In the second decade of the reforms, from 1989 to 1999, the poverty head count only declined by 62 million. Let me emphasize that the 62 million reduction does not take into account that in the 1990s the Chinese government lowered the poverty threshold three times to make it – I don't know; I'm not talking about the intention, but the fact is that it became easier to be lifted above poverty in the 1990s in the statistical sense than it was in the 1980s. And the other thing about the statistical definition is that if you control for inflation, the Chinese poverty line in the 1990s, even in the late 1990s, never exceeded that in 1988. So essentially you have 10 percent of the GDP growth every year. In terms of the real value of the poverty line, it was never increased. In nominal terms it was actually lowered.

And this is where I have more hope for the current leadership. I'm going to talk about that later on. They pay attention to this issue. They actually raised the poverty line substantially since 2003. Even by the raised standard they have been able to reduce poverty. My view is that the current leadership implicitly is returning to a version of the 1980s, the development model. Whether or not they can succeed is a separate issue, but at least in terms of the policy design this is what they are doing.

This is another thing, the last bullet point. Many of you probably know that China today has one of the highest income inequality levels in the world, probably next to Latin America, but few people probably know the following, which is that in the 1980s China was actually improving its income distribution in the 1980s. It was improving its income distribution. Much of the deterioration of income distribution came about in the 1990s, associated, I would argue, with the development model of the 1990s rather than with the development model of the 1980s.

My own view is that in the 1980s, China was moving broadly in a similar direction as the rest of East Asia. So you had rural entrepreneurship, you have improving social performance, very impressive reduction of poverty. There are some questions about whether or not the investments in education and healthcare were adequate, but at least there was – at least I don't see any data that show that the education performance and health performance deteriorated in the 1980s, and I would argue that the country was moving incrementally toward a more political reforms and political liberalism. So in 1980s the country was really moving broadly as the rest of East Asia, as Taiwan, as Korea. In the 1990s, I would argue that the development model in the 1990s is closer to that of Latin America, and this is where you have lots of these problems today.

Let me skip this slide, but the point of this slide is the rural household income. So I pay attention to two measures more than the measure that journalists and many other people talk about. I pay more attention to household income growth and poverty than I do to GDP, and I'm going to show you why the GDP performance – I'm not talking about the statistical issues – and a lot of other people will talk about statistical issues; I'm not talking about those. My point here is that in the 1980s you had fast GDP growth, you also had fast household income growth, so the two things were moving together. You also had improvement in the social performance, okay? In the 1990s the GDP growth continued at a very high level, and this is the top line that most people look at, but as a proportion to the GDP, the household income declined dramatically.

And then we also have other issues such as income inequality, and also there are lots of issues now in rural China about education and health – access to education and access to basic health services. None of those problems was of a severe magnitude in the 1980s. None of those social problems was of a severe magnitude in the 1980s.

Let me talk about, very quickly, the financial reforms. Let me just show you maybe two slides to underscore what happened in the 1980s. I have to say I was surprised by doing this research. I didn't know that China implemented many of these financial reforms in the 1980s. In the 1980s the financial reforms were of two types. One was lending very substantially to private sector. And this is in rural China. And the other is a tacit permission to allow private providers of capital to enter into the financial service industry – again, in rural China, not in urban China, okay? And what is very interesting about the shift in financial policy in favor of the private sector, and to allow private providers of capital to come to play a meaningful role in financial intermediation service – what is very interesting about that is not so much that those things happened. What's very interesting about that was how these financial reforms were engineered by top government officials, top bank managers and officials. Let me show you some quotes.

This is the president of Bank of China. So we're not talking about a low-level branch manager; we're talking about the CEO of one of the major banks in China, Bank of China. Nineteen-eighty-four – it is a long quote. Basically what he said is, people ask me – he actually said some comrades asked me, and so I called this area of financial reforms as a financial engineering by comrades. None of those people had any exposure to Western financial economics and business school, thank god. (Laughter.) What he was talking about is that if private-sector companies qualify for a loan, definitely, you know, you should make a loan to them. There's none of this collateral requirements, checking on their history and things like posting upfront the assets, making a huge deposit in a bank in order to take out the loan – the size of the loan sometimes smaller than the deposit. So there's none of that in the 1980s.

Let me show you a quote from Madame Chen Muhua – and I have to say, when I was in China in the 1980s, Madame Chen Muhua never impressed me, and I thought she was a colorless central-planning bureaucrat. She was the president of People's Bank of China, basically the chairwoman of the central bank. She went to visit, in 1987, Wenzhou – you know, many of you probably know Wenzhou, the most capitalistic, most entrepreneurial region in China. She talked about how it is productive to have non-state financial institutions to compete side by side with state-owned institutions. She actually used the functions and the vibrancy of the private sector finance as an illustration of her argument that state-owned financial institutions were not doing their job, okay?

So this is in 1986, 1987 – very progressive view of market finance. You allow private sector finance to come in to compete with state-owned finance. She didn't like the fact that the private entrepreneurs were charging very high interest rates, but her view is that competition over the long run is going to reduce the high interest rate and then is going to prompt the state-owned financial institutions to service the private sector better.

And this is – you know, I found numerous quotes from her to make that argument. This is another one. This is where we enter into the decade of the 1990s. I will argue, beginning in 1993 the People's Bank of China reversed its course, especially in rural areas, and we can talk about why, but two of the things they did were – one was increasing substantially the qualifications, the conditions for the private sector businesses to qualify for a loan. And there's another subtle change in the financial policy, which was that in the 1980s the Chinese financial institutions were making loans to farmers for them to transition out of agriculture. So they were supporting the farmers to engage in commerce and industry.

In the 1990s, the emphasis of the policy was to support the farmers to stay in agriculture. So essentially if you grow more rice I gave you a loan, but if you start a small business to do commerce and industry, then the loan qualifications became extremely difficult.

The other big change was that there was a substantial crackdown on private providers of capital. It was not a clean wipeout of the private finance. In a country the size of China you couldn't cleanly wipe out the entire informal finance. It drove much of the informal finance even more informal, even more underground, which had the effect of raising the interest rates, which had the effect of creating all these loan sharks in the 1990s. They criminalized the conduct and the practices of the informal and private financiers. Several people who engaged in private finance went to jail. The famous one was Sun Dawu, a poor farmer in Hebei Province. He was sent to jail. In the 1980s, if you did that, it wouldn't have been a problem.

I would argue that many of the problems today that – that the policy leaders today have to deal with in China – are a result of the 1990s model. And that model, as compared with the 1980s, put emphasis on technology, so technocratic goals became paramount. A lot of emphasis on foreign direct investment as opposed to indigenous private entrepreneurship. In fact, there is a connection between the technocratic goals and the FDI, because FDI was viewed as bringing high-tech advanced technology.

There's nothing wrong with emphasizing FDI except for the way that sometimes this emphasis was implemented. Think about how China – and this is where I disagree with many mainstream economists when they look at the FDI issue. The emphasis on FDI in China is not the result of FDI liberalization; it is the result of subsidy. That subsidy has to be financed by somebody else, and that subsidy is financed by mainly two players: indigenous private entrepreneurs and peasants. So think about how China attracted FDI in the 1990s – built huge industrial parks, huge special economic zones, and then the government – local governments in most cases – gave the land to foreign investors, sometimes free of charge, sometimes charge them very little money. So the costs of business are very low for foreign investors, right? So many foreign investors like China because the business costs are very, very low. If you have, you know, 30,000 people living there, next week I come back nobody lives there; they've been relocated.

But think about this transaction. I as a foreign investor have lo operating costs. That means somebody else – the cost to me is the income to somebody else in the economy. That means somebody else in the economy is deriving very little income by the fact I'm operating my factory there. And the biggest problem of that methodology, of that method of attracting FDI is that the peasants who previously occupied the land never derived the appreciation of the rising value associated with the land as a result of industrialization and urbanization. If you have 900 million peasants deriving relatively little from industrialization, from FDI, from urbanization, it also means that you have 900 million peasants who have relatively small purchasing power.

But then you have all these FDI, you have all these factories, which means that you have a huge production capacity and you have a relatively low and depressed consumption base. The difference has to be exported, and this is exactly where China is in today, right, and the current leadership is worried about the fact that with the financial crisis in the United States, how they can improve the rural income quickly to offset the consumption decline in the United States, and this is why they announced the land reforms. A piece of that reform is trying to – I'm not sure it's going to succeed but at least the policy intention is to try to get peasants to be able to derive the upside from industrialization and urbanization by allowing them to participate in the land transaction process. And I would say that reform was delayed for 20 years. There were a lot of discussions in the 1980s about that type of reforms in the 1980s, and that reform was delayed by 20 years. Had China implemented that reform in the early 1990s and late 1980s, I think China would not have been so vulnerable to the U.S. economy today.

Let me – I can talk about Shanghai but some people may say I'm biased because I was born in Beijing – (laughter) – but that's okay. I mean, the basic story of Shanghai is – let me just show you two graphs. The basic story of Shanghai is that the city – this is the three graphs of Shanghai.

The yellow line represents the GDP growth. GDP growth of the city was very impressive. Let me say I don't talk about Shanghai out of my courtesy to Minxin. Minxin was from Shanghai.

(Laughter.)

MR. PEI: I'm not a masochist.

(Laughter.)

MR. HUANG: The two other lines represent household income growth. So essentially the city had a phenomenal GDP growth in the 1990s. The household income growth on the part of the average Shanghainese remained pretty much flat relative to the rest of the country. If you do it formally, if you calculate the statistical correlations of these lines, actually the coefficient is negative, which means that when the GDP growth was fast in the city, the income growth was slower, and when the GDP growth was actually slower in the 1980s, the income growth was actually faster.

Contrast Shanghai with the most entrepreneurial province in China – Zhejinag Province. And this is the same picture that you see for Zhejiang Province, the most entrepreneurial, most laissez faire, private entrepreneurship, rural entrepreneurship province. I love Zhejiang Province and I have papers about the province. The three lines move roughly together, so essentially this is the difference between what I call an entrepreneurial economy and state-led economy. The difference is not so much GDP growth. You can have fast GDP growth under both sets of economic policies. The difference is the growth that really matters to average Chinese differs substantially between the entrepreneurial economy and state-led economy. For Zhejiang, much of the growth actually benefits the average residence in Zhejiang.

ALBERT KEIDEL: (Off mike) – and the scale is a bit different too.

MR. HUANG: What do you mean, scale? It's the direction, right? One is moving up and the other is moving down.

MR. KEIDEL: (Off mike.)

MR. HUANG: Well, this is – yeah, actually the level – no, Bert is absolutely right. Shanghai is still today the richest city in China. I don't dispute that. It's just, relative to the rest of the country, it's the growth – it's the trend that differs systematically between Shanghai and Zhejiang. Zhejiang today is still not the richest – it's actually ranked number three – but what is interesting about Zhejiang is that Shanghai was rich – Shanghai is rich today because Shanghai has always been rich. Zhejiang was ranked roughly 13th in the country in 1978. Today it is – if you actually don't include Shanghai, Beijing and Tianjin, Zhejiang is ranked number one. If you include Shanghai, Beijing and Tianjin, it is ranked number four.

So for Zhejiang it's a catch-up story. For Shanghai it is basically – Shanghai is rich because Shanghai is rich, and so there's not much to say about that. But in terms of the direction of the movement, the direction of the movement in Zhejiang is that you have all these three lines moving together, whereas in Shanghai they move in different directions.

Q: (Off mike.)

MR. PEI: Let's just finish this and –

MR. HUANG: No, that's a good – (inaudible, cross talk) – yeah, that's a good thought. Yeah, so I can come back to that later.

Let me conclude by talking about the policy reforms and the policy challenges today. I think the current leadership – they probably don't say this explicitly, but by their policies, my interpretation is that they are trying to return to the model of the 1980s with a lot of political baggage and with lots of issues. They have done many, many things that I believe to be in the right direction. They abolished the rural taxation. They reduced education fees and health fees. And this is another thing I didn't get to when I was talking about the 1990s. If you look at the 1990s, the taxation on peasants was high. The government was also increasing fees for provision of education and health. So the current leadership is trying to reduce the educational fees and health fees. They are trying to revise rural finance, and this is one of the biggest developments in the 1990s.

If you look at the branches, the number of branches of the rural credit co-ops in the 1980s, in 1985 there were about 400,000 of those branches in rural China. Basically rural credit co-ops were savings and loan institutions servicing sort of micro-loans, that kind of function. In the late 1990s, the number was reduced to less than 100,000. Now they are trying to revise that rural finance and with some good effects. Some land reforms that I talked about and the current stimulus package – a part of the package was designed to improve the rural income. If they could implement that, that would be a good development.

My question is whether all these measures were too little and too late, and especially now we have a global recession. I think the policy design is good. Implementation I'm not quite sure because today's Chinese bureaucracy is quite different from the bureaucracy in the 1980s. Roughly the size of the Chinese bureaucracy has doubled in the 1990s, so you have so many more bureaucrats to worry about than you did in the 1980s. So that's one big difference. I worry about implementation. The policy design is good; I worry about implementation.

The other worry that I have is the country being caught in this very uncomfortable position. The income growth is going to – if the policies succeed, the income growth is going to happen sometime in the future, but the external demand from all the data that we know of from the United States is going to decline probably faster than the speed at which the rural income is going to increase, right? So it would have been better to implement all these measures back in the late 1990s and early 2000s. Now you have a global recession. My worry is that whether or not these policies are going to produce a desirable effect in time to completely counteract the negative effect of a global recession.

Let me end there and let –

MR. PEI: Thanks. This is a beautiful segue into Eswar's comments.

ESWAR PRASAD: Thank you. So Yasheng is one of the premier researchers on China. In fact, although he's a political economist, he forces even us economists to take him seriously, and economists don't take too many people seriously. (Laughter.) So that already is a very significant achievement.

But Yasheng reminds us that perspective is really important, and being in Washington we tend to take the perspective that everything that the Chinese do, that the rest of the world does, is somehow driven by forces in Washington. It takes a person from Boston to remind us that Washington is not quite the center of the world. But this is an important issue, trying to think about what are the forces that are driving the policymakers in China, from what political and economic perspectives?

Now, there is an additional complication as one starts getting into China. At least when I initially started trying to understand China – and I'm far from understanding China yet – one realizes that this notion that there is a centralized mode of control with orders coming down from Beijing and essentially being followed down the line all the way to the provinces is not quite right. The provincial leaders are masters of their own domains, and it goes all the way up.

So there is this very delicate political dynamic where what Beijing hands down is not necessarily followed through unless the incentives are set to the right level. So thinking about the incentives not just from the point of view of the leadership, the state council, but also thinking about the incentives at the provincial level or even at the township or village level, towns start to be very important. And this is where Yasheng really brings some very important research to bear because in China, again, the data are never the full story. There are the data and then there are stories behind the data.

And what Yasheng has done is truly a monumental effort in terms of going back and looking at archival material. And he has put together I think a very comprehensive and interesting story. And it is provocative in many dimensions, as Yasheng has already pointed out, and it's very important in the context of the present debate, especially in terms of growth, because the question is whether China sui generis – whether there is something very special about the mix of institutions, politics and everything else in China that makes China very special, or if there is something that we can all take away from China's growth experience that can be applied to other countries. So in that sense as well this research is very important.

And Yasheng has a number of provocative things that he puts on the table. He's already given you a very nice overview of those things, and a couple of those especially stand out. One is the notion that reforms in the 1980s, especially in the rural sector, were especially important in terms of getting growth started, and he points out that in fact the private sector and entrepreneurship were very important, even back in the 1980s, and perhaps a misclassification or mis-thinking about the labels applied to certain enterprises like TVEs may have misguide some of us researchers.

And he makes a number of other provocative issues. I mean, most of us, we go to Shanghai, we admire Shanghai, and Yasheng correctly asked the question, what's wrong with Shanghai? It still seems to me there are quite a few things right with Shanghai, including the fact that it sent us people like Minxin, but nevertheless – (laughter) – the issue is that we need to think very hard about broad experiences of provinces and China as a whole from a much more critical perspective, which is exactly what Yasheng affords us. And this is very important because ultimately, when you think about criteria like GDP growth, which is the bottom line that we tend to focus on, again there is a lot behind it that tends to get hidden, and Yasheng nicely points this out in the context of thinking about the welfare implications of growth.

And there are a couple of dimensions in which Chinese growth has not exactly delivered the sort of welfare you would like to see in terms of increases in household income growth or in terms of employment growth, both of which are stated objectives of the policymakers, but clearly they've been able to deliver GDP growth but not quite implements in these other dimensions.

This book can be situated in the broader context of the debate about what it is that sparks growth. Economists who study growth try to think about their favorite reasons why growth gets going. Everybody has their favorite explanations. One of my favorite explanations is the financial system. Now, at times growth economists go out and do growth regressions. If I believe that finance is really important, my regressions turn out to show that finance is really important. (Laughter.) And people who think that institutions are really important go out and run regressions, the same regressions; institutions turn out to be really important. If you believe that it's trade that is really important, you find that trade is very important.

But ultimately we don't have a good sense of what mechanisms really generate growth, and the problem with thinking about growth, especially in a cross-country context, essentially there is a lot of endogeny floating around. What that basically means is that perhaps countries get more openness to trade, get better financial systems, better institutions, more capital, more of the right types of capital if somehow they grow. And here the book provides a very interesting and provocative thesis that perhaps what sparked growth in China was not what we see today in terms of relative dynamism and the export sector, but perhaps the rural sector, maybe this is what created the spark that then begat more growth and begat better things going on in China.

But let's step back a little bit and think about the research method. Now, I spoke about incentives in terms of producing data, in terms of reporting data and so on, and the archival material are clearly a very good way of getting around some of these problems. But one does wonder whether, despite all the effort that Yasheng has put in, what the incentives are of the people who are producing these documents in the first place, and what exactly the documents mean in themselves. Again, we saw the statement about what exactly the TVEs mean to the party leadership or the bureaucrats, but we don't really have a sense on the ground what TVEs actually ended up meaning; how did the provincial officials actually end up dealing with the TVEs in terms of whether they were private sector enterprises or quasi public sector enterprises?

So these questions are hinted at in the book, and ultimately we need to tie this picture together – not just the archival material but also what we see in terms of what has been happening on the ground. But I think this sort of research, trying to dig in at a very low level – and by low I mean at the micro level. It's really important in terms of us being able to make progress.

And important issue that is brought up in the book is the notion that formal finance is not really important and that somehow an informal financial system can deliver the same sort of growth may not quite be right. And here the thesis of the book is that Mainland China had this very convenient satellite, Hong Kong, which effectively acted as an efficient center of financial intermediation. I believe there is some truth to that. I think Hong Kong's presence has really been very important for China, but my skepticism arises from the question about whether it was really Hong Kong that was providing finance for what is emphasized in this book; that is, the rural part of China, especially the TVEs, in rural enterprises.

I think it is a fair characterization that when one thinks about the larger enterprises – and Lenovo is indeed a very good example. Lenovo might have had access to Hong Kong, but did the average TVE or did the average small enterprise have access to Hong Kong? And ultimately when you think about the relative sizes of the Hong Kong economy and the Chinese economy and how much intermediation takes place through the formal financial system in China itself, one wonders if these components, like FBI or Hong Kong, can really explain a lot of what happened, because if you think about the amount of finance that is intermediately through the domestic banking system – I mean, Chinese savings rates in the last few years have been on the order of 40 to 50 percent of GDP. So that's a lot of money being pushed through the domestic financial system.

So whether Hong Kong or FDI, which accounts for basically two to 3 percent of GDP in the best years, can really provide that spark is an interesting issue. But, again, you don't really need much more than a spark, so perhaps there is something here that Hong Kong, or just the presence of Hong Kong itself provides a spark, which makes domestic financial institutions work better.

An interesting thesis of the book, one among the many, is that it was really the 1980s that were the go-go years for China, and the 1990s when things are beginning to fall apart. Now here Yasheng is in a slightly complex position which reminds one of this famous line from a Groucho Marx movie – in fact, it was not Groucho Marx but Chico Marks dressed at Groucho Marx – (laughter) – who, when caught in this compromising position says, who are you going to believe, your eyes or me? (Laughter.) Your eyes or what I tell you is a precise quote. And now we see China booming.

We see China having a lot of dynamism in terms of the industrial sector, and although Yasheng makes the point in his paper that perhaps PFP growth has slowed down, and cites a few studies suggesting this, my reading of the evidence, in fact, is that if you look at the rates of growth in the Chinese economy as a whole, and especially in the industrial sector, it does look like the PFP growth is doing pretty well, because after all, if you put together relatively low employment growth, even though investment growth has been very high, there's still a fair amount left over that residual which we call PFP growth.

So something is going on in China which we don't fully understand, and although I take his point that in the 1990s you may have had certain reforms that were reversed relative to the 1980s, it does seem to me that we don't have the full story. And I'm also not sure that the counterpoint that this paper has to the notion that in the 1980s certain reforms were put in place, in the 1990s they were reversed and now although China is delivering high GDP growth in all other dimensions, it's going to hell in a hand basket may not quite be true because it seems to me that these theses can coexist, that you had a certain set of reforms in the 1980s which were not very well appreciated – and I think that is the real strength of the book – but there were other reforms that took place in the 1990s.

If you think about the trade liberalization that dates back to the 1970s – but accession to the WTO, for instance, was a really important spark, in my view, in terms of getting Chinese growth going, again, not just in terms of how much it contributed to trade expansion, but, again, the competitive forces that it unleashed in the domestic economy were very important. Likewise, when you think about the commitments that China made to financial system reform under the WTO commitments, again, they had no illusion and we had no illusion that the Chinese financial system was going to be completely opened up to foreign competitors or that foreign competitors would rush in and be viable competitors, but it served as a very effective deadline to get the Chinese banks to start moving. And of course when they didn't start moving, then the Chinese authorities brought in foreign strategic investors in order to get things moving a little better.

So in fact, I think there is still a fair amount of enlightened policymaking. It's not fully enlightened. I think there are severe repressed parts of the system, especially the financial system, which create certain delicate balances and risks in the Chinese economy. And here, in fact, I agree completely with Yasheng that the points he's made about how GDP growth is not to be equated with overall welfare growth is exactly the right one.

In research of this sort it's very difficult to set up a falsifiable hypothesis that one can then argue can be overturned by data because it is a very particular way of looking at the data, and given the quantity of material that Yasheng brings to bear and the analytical perspectives that he has, I think we are forced to take him very seriously. But, again, I don't think it's really necessary that taking Yasheng seriously implies that we need to downplay the reforms of the 1990s or the problems that still exist and the roots of those problems.

So TVEs are very critical for China. And then in an interesting part of the book which Yasheng didn't get around to talking that much about, he provides a contrast with India, arguing that perhaps what is really different between China and India was the fact that China was able to get these TVEs going and then, bless his heart, me being an Indian, he states that India has, in fact, got this fundamental strength, like the financial system and various other parts of the economy that will get India growing faster. The India story is a little shakier these days than it was even last year.

Fundamentally, I think he's right. I think the real difference in the long term is going to be the financial system. On the other hand, my views of the Chinese authorities do have a very strong sense that the financial system is what would hold back growth in their economy. The problem is they live in a very second-best world where they're trying to deal with a number of policy reforms at the same time and they just don't have the courage, again, to move forward on all these fronts at the same time. Therefore, when they prioritize financial system reform, while at the same time keeping the exchanges relatively stable, they're sort of trying to undertake financial system reform with one hand tied behind their back. Why? Because even though they have capital controls, they're becoming less effective over time.

So if you have a stable exchange rate objective, ultimately you're going to end up not having an independent monetary policy. And my view at least is that that is a critical component of financial system reform. But this very basic question is still on the table, whether a formal financial system is absolutely crucial, especially an efficiently functioning formal financial system. In a couple of papers cited in the book, and Bert Keidel has also argued that perhaps China's financial system is just right for its stage of development. And, again, given the very second-best world that China is in, perhaps trying to move on to a more formal and efficient financial system is not quite the right approach.

The key value of this book, again, is that it puts these questions on the table. I don't think it has completely satisfactorily answered all these questions, but that is a very high standard to set for a book of this sort, which is really bringing some new perspectives to bear to the discussion, and there I think is its real value. As Yasheng pointed out, many of these reforms are taken by what he calls the comrades in China. In fact, these days, given where things are in the U.S., I think if you think about what Chairman Bernanke and "Comrade" Paulson – (laughter) – have been doing in terms of the U.S. system, I think Yasheng's next book in fact should be looking at the U.S. system. In fact, I already have a title for him. It's capitalism with American characteristics.

Thanks.

MR. PEI: Thank you. Yasheng, do you want to respond quickly or do you want to open up?

MR. HUANG: Maybe we should open it up and I'll respond to –

MR. PEI: Okay, well – yeah, I'll save you some time. Let's now open up. Please tell us who you are and I will call on you individually. I will give the floor to Bert first.

MR. KEIDEL: Yeah, I'm Bert Keidel, Carnegie Endowment. Yasheng, congratulations on producing the book. It's very interesting and stimulating. I have a few questions. The first one is kind of basic, about the different decades. I'm not sure whether you're saying that the first decade was faster-paced than subsequent decades or whether the level of liberalization and the level of sort of a friendly environment for private sector and profit-seeking activities was stronger in the 1980s than it is now. There seems to be a general confusion in the book, and you actually almost answered one time in parentheses where you say, actually, by this measure the 2000s is more liberal than the 1980s.

But I also want to ask about financial reforms having been reversed in the 1990s because this doesn't really accord with my working experience there in rural areas in the 1980s and in the overall economy in the 1990s and since. You had a stock market that opened up. You had negotiable Treasury bills in the 1990s. You had a banking law that set up the independence to a certain degree, or at least separated the functions of the central bank from the commercial banks. New regulatory bodies. You had international capital flows beginning on a regulated basis.

And so there's – whereas the 1980s was really a pathetic period financially, you did have a lot of these private, unregulated financial institutions that ended up, many of them, going belly up and many of them disappointing their depositors with no guarantees. And so there were a lot of very serious failings for the informal financial sector. And so in the 1990s they regulated it, which is something we're now looking at doing for some of our failed institutions. And so this is a natural progress, but not necessarily a condemnation of the 1990s for regulating what had become in many ways, in a lot of dimensions, the dysfunctional informal financial sector.

And in terms of corporate governance, you know, in the 1990s they introduced a corporation law that allowed standardized boards of governors and appointments of management. So that comparison with the 1980s, when all the municipalities that I was working, all the companies were just owned and managed by these boards, these municipal boards. And they introduced some factory managers' responsibility system, but they really didn't run the place. It was only in the latter 1990s when they sold off; they sold all medium- and small-sized state-owned enterprises.

So it seems to me that the pace of reform in the 1990s in creating a competitive environment – and you also saw reward for educational status, which was nonexistent in the 1980s. So the incentive structure for true entrepreneurial and also worker productivity came and blossomed. And so the pace was fast in the 1980s but from a very low base. The breakup of the communes, I would argue, more than TVEs, really raised rural income until 1985 when inequality kind of declined after that.

And finally, the empirical basis in your book – my fourth question – measures fixed asset investment and shows how that was really growing faster in the non-so-called private sector, but that's exactly the one you would think would grow fast in those sectors that are heavily state-owned – the petrochemicals, the steel and so forth that, in all countries in Asia, were very slow to privatize. And I wondered if you looked at, also, employment levels, for example, in private and non-private, and what the pace is. But I just have to say that the picture of us having gone backwards in the 1990s, when you look at all that was accomplished, including WTO accession, doesn't quite fit the thesis of sort of nostalgia for the great free-market heyday of the 1980s compared to the environment now, which offers so much opportunity to seek profit.

MR. HUANG: To address Bert's question, one part of the observation that Eswar made is actually very straight-forward, very easy. I was talking about the reversal in rural China and the part of China that affects – the poorest people – as to the largest number of the people in China. In my book I explicitly said several times that urban China in the 1980s was completely dominated by the state. There were no financial reforms whatsoever. In the 1990s, I guess my reading of the urban China is more – how should I put it – okay, so it has two perspectives. One is that there were reforms such as WTO and some of the reforms that you mentioned. The other is that there were also clear reversals.

Okay, so you talk about stock market opening in the early 1990s. In 1995 or 1994, the Chinese government closed down regional stock markets that were actively servicing private sector companies at that time to concentrate the resources on the SOEs, who were the only ones that could access the counter markets in Zhejiang and Shanghai. The downsizing of the state sector was implemented when they also created huge state-owned monopolies that today are – you could argue about corporate governance, whether they are better sort of governed as compared with straightforward traditionalism. Probably there is some marginal improvement there. But now they have become – and the Chinese talk about this openly – now they have become both an economic drag as well as a political obstacle to further reforms. All of that also happened in the 1990s.

So essentially this is my view: There were meaningful reforms in urban China in the 1990s. There is no question about it and my book acknowledges those reforms. But there were also reversals, and the reversal was especially substantial in rural part of the country where the welfare of the majority of the Chinese is the most relevant issue.

And there's sort of a second issue, which is not addressed empirically – it cannot be addressed empirically. We can have an argument about which China is more important, right, rural China or urban China? And, you know, clearly in the 1980s urban China was still state-controlled. Rural China was much less, and the direction of the reforms was progressive and liberal. In the 1990s you kind of have a reverse of the fortunes between urban China and rural China.

Then we have an issue of which part of the country that you think is more important than the other part, right? So let me offer two defenses for why I laid out my argument the way that I laid out. One is that, just numerically, one part of China is more important than the other China, and also, I think as an opposing matter, I care more about poor people than about rich people. But that's not the most important – that's just one difference. The other difference is that – and we can have a debate – I think rural China is always more market-driven than urban China. Even during the Cultural Revolution you had a residual element of market economy, private entrepreneurship in rural China.

So to the extent that the policy emphasis was placed on rural China in the 1980s, you essentially placed more emphasis on the part of the economy that was more market-driven, okay? So in the 1990s you have a – you have some substantial reforms, non-trivial reforms in urban China, but you also concentrated resources on urban China. This is where Eswar's observation absolutely came in. Even though you go to China, you observe this incredible growth in the part of China that is urban, then you deemphasize rural China and you deemphasize the part of China that is most market-driven, sort of most entrepreneurially driven. There's more entrepreneurship – politically independent entrepreneurship.

We can have a debate about the weight that I assign to rural China. I assign more weight to rural China than I do to urban China. We can have a debate. But it's not fair to say that my book didn't talk about or didn't acknowledge some of the – I didn't have a laundry list of all these things, but my book explicitly talks about WTO and some of those – the SOE reforms and those things. The issue is the matter of weight – you know, how much weight you assign to rural China, how much weight you assign to urban China. And, you know, I put out my view explicitly, which is I assign more weight to rural China. Maybe that's because of the methodology that Eswar criticized, because he would start with a prior that rural China is more important and you end up with that conclusion.

But let's talk about whether or not that assignment of the weight is a defensible or not, and rather than – I think it's quite an unfair criticism of my book that I didn't talk about those reforms. I explicitly – I actually held up Shanghai as a pioneer of those reforms that you have just laid out, and that's – I don't think that's an empirically accurate criticism. But there is – let me put out – there is a debatable issue. You know, maybe now urban China is more important and we care more about reforms in urban China. Maybe urban China is more globalized. And so you can have all sorts of arguments against my assignment of weight, but I don't think that that particular empirical criticism of my book is fair.

In terms of the policy liberalism, comparing 1980s and 1990s, I was not talking about the growth rate of the fixed-asset investments that were in the private sector. I was talking about share. I was talking about share. And there is no question that the share of the fixed asset investments by the most politically independent private sector declined throughout the 1990s. Now it is beginning to rise. Actually, what I find very interesting in the data is that how recent the vibrancy of the domestic private sector is in China, I would date sort of the surge of the domestic private sector to maybe 2002, 2003 rather than to 1993 or 1994. And if you look at the data, there was an initial surge and then it stayed this way, and then there was another surge since 2002 and 2003.

The point I was making about the output share that Bert pointed out, there is no question that the output share of the private sector in the GDP is much higher today, or in the late 1990s as compared with the 1980s. So there I feel very uncomfortable with some of the journalists who reviewed my book with the title, China today is less capitalistic than it was 20 years ago; China is more communist than it was. Clearly that is not what my book was all about. There is no question that China today is more capitalistic than it was in the 1980s, but what is very interesting is that the kind of capitalism that China had in the 1980s was sort of more political independence, more scale. I would say that kind of capitalism promoted welfare more as compared with the state-connected, politically connected capitalism, which we also see in Latin America, in the Philippines.

So I think the difference is not whether or not one era was more capitalistic than the other. The difference between the two eras is in the 1980s you had what I call a virtuous kind of capitalism and in the 1990s you have a different kind of capitalism.

In terms of output share, I would argue – and then we can have a debate about this – this is the wrong way of measuring policy, essentially because the output share, as well as employment share, has two dynamics. One is the policy dynamic and the other is the firm efficiency. And we don't really know whether the rising share is driven by policy evolution or by firm-level efficiency. So let me put out an illustration to make that point.

When you have state-owned firms that are massively inefficient, even when you gave the private sector a very limited scope of operation, that share can rise without further policy reforms. This is exactly what happened in 1989, 1990 and 1991. In those three years, nobody would dispute that there was a crackdown on the private sector, and yet that share rose. That share rose. So in my book I used a different measure. When you use fixed-asset investment allocation, then I think the evidence is fairly clear that the, I would argue, capital allocation is a more accurate representation of the preferences of the government. By that measure I would rank the 1990s as less liberal as compared with the 1980s. Especially you see in rural China a collapse of private TVEs and many of those firms – in the 1990s.

MR. PEI: Joan.

Q: Joan Nelson, Wilson Center. In your presentation you remarked that part of your framework was political, but that you were skipping it.

MR. HUANG: Yeah.

Q: You made a number of references that are clearly political, and you've indicated a concern about implementation of some current strategies. But I wondered if we could have just a few more sentences on that to round out the framework.

MR. HUANG: Minxin, what do you think is the best – should we collect a few –

MR. PEI: Yeah, let's collect a few because we're running short of time and –

MR. HUANG: Then I can be more disciplined.

MR. PEI: Okay, let's take two more. Yes?

Q: Zhi Wang from U.S. International Trade Commission. So I listened to all your presentation and I think you both gave an important contribution to understand the China's miracle. And my question here is – you mentioned about – you contrast the '80s and the '90s. Especially you say because the earlier reform basically started from the rural area. So that's basically, you say – basically distribute the land to the farmers. So that is a – (unintelligible) – reform. So that's – you say that raises the rural income, so you will have a lower Gini coefficient at that time. Then you say you go to '90s, you go to the urban sector reform, go to the industrial sector reform.

So almost in the – you say – in the later '80s was the starting for the urban reform. So mostly in the '80s is basically – in the early '80s is rural reform. But then you reduced the income distribution because the major difference is the rural and the urban division in China driving the Gini coefficient up.

So today I think you – so that is not quite sure. You say – your version is the reversal of the policies. I think it is the state of the environment. You say China – I hope – because you didn't measure anything, adjusting in – I don't know if you agree with him or not, but I think that at least he provides another perspective of the Chinese miracles because basically you say – in the '80s, you say, the Chinese go back to their comparative advantage, to labor-intensive industries, not the TVEs. Then go to '90s. The Chinese government is trying to promote the technological progress, so they implement the FDI in favor of foreign investment, in favor of presenting trade, in favor of a special – (unintelligible). Those are the incentives that create some success, but they bring big problems, like you mentioned. But I think you simply can't exactly compare them, maybe not exactly capture China's development.

Another question – you mentioned the capital allocation. I believe that is the better way to characterize the influence of the state sector. But I don't know; you're using the data of the equity allocation because you say in Chinese data if you go to the China data online they will have the data for each industry sector: how much the original capital allocated, how much capital from state sector, how much capital from FDI, the difference in the FDI to Hong Kong, Taiwan – (unintelligible) – and the other foreigns.

So like those things, you will see in the '90s the state capital is – our share is quite high – (unintelligible) – SOEs. The reason is the state is starting to citing those SOE capitals, gave it to foreign investment. What are they trying to do is trying to increase the efficiency of the state capital because when the state capital started with the – (unintelligible) – and the foreign capital, our capital efficiency increased.

So the final question is regarding the use of the GDP index. The GDP, you said, basically is any forms produced in China, like GM or Intel have effect in China, will be part of China's GDP. But the GNP will be a very different concept because that's very close with your household income. So that's basically my comments. Thank you.

MR. PEI: Eswar has to go back to Brookings to meet – to have a meeting, so he sends his apologies.

Let me just collect one more. Yes?

Q: I'm Steve Dunaway with the IMF. Just a simple question. What was very interesting is the charts that you show of the difference in growth between GDP and household income. And I guess that begs the question about who got the money?

MR. HUANG: Okay. Okay, so let me get to the who got the money first because I want to know too. (Laughter.) I mean, as you know, we can decompose GDP in two ways: expenditure and income. Typically the data are presented in the income – sorry, in the expenditure approach, but if we look at the Chinese data by income approach, the biggest gainer in the 1990s is the government, so essentially the government crowded out the households. In Shanghai and Zhejiang I do actually have those data. You see the difference between Shanghai and Zhejiang mainly in the share by the government. So basically in Zhejiang Province, the government is about 14, 15 percent poorer than the government in Shanghai, but the households, in terms of the percentage of share of the GDP, are about 13, 14 percent richer.

The corporate share is about identical between Zhejiang and Shanghai, but what is very interesting about Zhejiang and Shanghai is that because Zhejiang relied on a sort of indigenous local entrepreneurship approach, when you go to Zhejiang you see the dense distribution of local suppliers. They are just as successful in export production, if not more, than foreign investors. And this will get to the hypothesis by Justin Lin because there's a view, unfounded by facts and evidence, that you need FDI to produce export production. If that view is truly correct, we wouldn't see Japan today as a successful export economy – Korea, Taiwan, even Hong Kong.

Hong Kong, if you look at historical data, the share of FDI was actually very small. And Zhejiang – so if you look at the corporate sector, much of the corporate sector in Zhejiang is owned by the Chinese, whereas in Shanghai much of the corporate sector is owned by the foreigners. So of the part of the GDP that goes to the corporate sector, the Chinese get the most of it in Zhejiang as compared with the ones in Shanghai, right?

So that's the basic difference both in terms of the time – what's very interesting about the 1980s is that the household income, as percentage of GDP, was rising throughout the 1980s. In 2002, the last year we had the income approach the GDP, in 2002 the household share or the employee share or labor share of the GDP, is exactly identical as the labor share of the GDP in 1978. We went all the way back to 1978, and the main difference is the government.

Going to the question about politics, there is no question that this is a political story. The issue there – the reason I emphasize the economic story is that I have to say I have a hypothesis but I don't really have a lot of data to say which political story I believe, right? So one political story is that in the 1990s, because of Tiananmen, which was an urban riot, the leadership came in to implement policies that would satisfy the urban middle class. I don't really quite buy that story, but another person's guess is just as good as mine. My own view is that it is a technocratic story.

If you look at the leaders in the 1980s, the economic decision-makers, each one of them first built up their career in an agricultural province. So Zhejiang was one. And then there's another person who is less known in the West but who was very important – Tin Jiuan (ph). They came from Anhui Province. They came from Sichuan Province. If you look at the top economic decision-makers in the 1990s, many of them came from my favorite city, Shanghai. What is very interesting is – I don't have the graph here – the leaders in 1990s – the national leaders in 1990s were respectively the mayor and the party secretary of Shanghai in the second half of the 1980s. So basically they ruled Shanghai from '85 to about 1990, 1989.

As soon as they came in there was an immediate decline of the fixed-asset share by the individual enterprises, small-scale enterprises. There was an immediate decline. So essentially I would argue – although this is a hypothesis – that the Shanghai model preceded the decade of 1990s by about five years. And then you had Tiananmen, which really had this effect of undermining the political fortunes of those leaders who were rooted in a rural area. Either by accident or by design, they boosted the leaders who were rooted in the least reformed city in China, which is Shanghai.

So that's my hypothesis. I don't really have any facts to back it up, but if you look at the objective differences between the leaders in 1990s and leaders in the 1980s, this is one objective factual difference that I can tell. What is very interesting about today's leadership is that at least some of them came from poor rural provinces. Hu Jintao came from Guizhou and from Tibet, although there, there are some complications.

So it is interesting – I mean, it's really, I think – you know, I have been a professor for many years. When I talk to my students, those of my students who have been to rural China, who have worked in rural China, almost intuitively understand market economy and they don't even have to study Western economics textbook. They intuitively – because they understand the value of residual claims; they understand the value of property rights.

Going back to the very – some very good questions about income distribution. My reading of the data is similar to Justin Lin except probably his view is there's nothing wrong with this, whereas my view is there is something wrong with that. So that's the only difference, right? So he emphasizes technology; I always emphasize technology. In fact, if you look at Latin America, the countries that have very high income inequality in the 1960s and '70s, you also had leadership who emphasized technology and the technocratic – I will say that there is a similarity.

The difference I guess I have with Justin, whom I deeply respect – the difference I have with him is that he somehow views this as a natural stage, natural evolution. If this is true, then you don't see that in Zhejiang whatsoever. Zhejiang has the best income distribution. It has the least of these social performance problems as the rest of China. And it is moving directionally – we can talk about the speed, level – it's moving directionally toward high-tech, and by an incremental approach, natural selection, evolution approach. I would argue that you have – if you look at Taiwan and South Korea, both economies evolved from low tech. In 1985, the largest item in Korean export production to the United States, as late as 1985, was fake hair – or maybe real hair – hair. That was the largest item –

MR. PEI: Wigs. Wigs.

MR. HUANG: Oh, wigs. That's right, wigs. I was – I didn't need that so I don't know that word very well.

MR. PEI: I need that.

(Laughter.)

MR. HUANG: This is an economy that evolved from producing wigs in 1985 to now producing very high-tech products. You don't see this deterioration of the Gini coefficient in Korea. You don't see this deterioration in Taiwan. And you see abysmal failures in Latin America, which didn't move from low tech to high tech with a very high level of a Gini coefficient. You see Philippines, you see Indonesia – so I don't really see the rising Gini coefficient as a necessary – somehow as a necessary prize that you pay for moving from low tech to high tech. Zhejiang definitely doesn't fit with that pattern. I see that as a result of government policy that systematically had an effect, if not by intention, depriving the poorest people of their claims to one source of income that would rise very fast during urbanization and industrialization, which is the title to the land. So if you – you know, I have to profess I haven't studied this issue systematically, although I want to.

Taiwan – the first generation of the well-to-do Taiwanese were basically small-scale farmers, and then they got rich as result of industrialization, as a result of urbanization. So property rights really matter. The land property – so I go back to de Soto. Although de Soto there is really talking about whether or not you have a certificate to prove that you have the land, here the issue is more about if the government owns the land, then you have one pattern of development, right? I will argue that's sort of Latin America, sort of Southeast Asia. If the private farmers have the land, then they can participate in the urbanization, industrialization; then you don't necessarily – you may lose the agriculture income but then you gain on the asset income. Then there is no logic that the rural-urban income gap has to increase, right? So the only thing that has changed is really the sources of the income. Before it was the labor income; now it is the asset income.

The citing of the – this is going back to Bert's comments about the citing of the SOEs and things like that. Again, this is a debatable point, but I make a distinction between private – evolution of private economy by FDI and evolution of private economy by indigenous entrepreneurship. In the 1990s – you are absolutely right, and Bert is absolutely right that you see a huge rise of the foreign claims on industrial assets in China. And then if you count that as private, definitely there is a big rise of the private economy. In my book I actually stripped down this question into several levels. I took out the foreign claims and I looked at indigenous claims. I was surprised by how small the indigenously private claims on industrial assets – using against the same dataset that you were talking about – using exactly the same dataset.

As of 1998 – you know, 20 years after the reforms – the indigenous claimed industrial assets – again, so I don't go by indigenous points, but we're talking about less than 7 percent, something like that, whereas the foreign claims we're talking about 20 percent, triple the indigenous claims. Much of the increase of the indigenous claim on industrial assets actually happened after 2002 – after 2002. So there was clearly some suppression of the indigenous private entrepreneurship on 2002 and 2003. We know what happened in 2002 and 2003, and this is the point that I put forward in my previous book, "Selling China," which is that in the 1990s China globalized its economy by suppressing indigenous entrepreneurship, by courting and subsidizing FDI.

In 2002 and 2003 they began to address that imbalance. They began to neutralize the tax differences between foreign firms and domestic firms. They began to adopt legal measures that would elevate the property rights of the indigenous firms all the way to the foreign enterprises. So, as a result, you begin to see some of the change in the data.

GDP and GNP, I'm not sure GNP captures the household income. I mean, the difference between GDP and GNP is that, you know, Zhejiang may have firms outside of Zhejiang and GDP doesn't quite include those firms, but GNP includes those firms. I have not looked at the difference between GDP and GNP yet. I'm not sure at the provincial level you can actually get GNP data province by province, year by year.

MR. PEI: Okay, I'm afraid we have to end here. I want to leave some time so that those of you who want to get Yasheng's book and have his autograph on the books can do so. Please join me in thanking Yasheng for giving us such a splendid talk. (Applause.) As I said, the books are on sale at the back of the room.

(END)