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China at the crossroads

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ABSTRACT

This essay joins in the international controversy about the nature and sustainability of the economic system in China. While official ideology continues to stick to the concept of 'socialist market economy,' albeit with changing contents, international observers are split. One group considers China as a *de facto* market economy, which is in line with the top-down tradition of ruling in the region. Others consider it as a *sui generis* system. And a third line takes it as yet another case of *hybrid regime* which proliferated globally in the new millennium. I try to create a link between these readings and the empirics of Chinese growth. This may help interpret the slowdown, exacerbated by the COVID-19 epidemics on Chinese output.

KEYWORDS

hybrid regimes, growth deceleration, socialist market economy, informalism, comparative economic systems, property rights, party control

JEL CLASSIFICATION INDICES

P11, P16, P21, P27, P52

China has always been something of a puzzle for outsiders owing to its impressively distinct ancient culture, vast size, large number of complex characters in its writing, and peculiar mindset, very dissimilar to the Euro–American way of thinking. China has remained a mystery even for the China watchers in several disciplines, including economics.

China is known to be one of the uncontested growth successes in the past four decades. The gradual implementation of the sweeping reforms of command planning, introduced under the authority of Deng Xiaoping, taking sometimes formal, sometimes informal, though no less decisive positions of rule (Pantsov – Levine 2015: 407–427) has brought about an unprecedented long period of uninterrupted growth. Libraries have been produced on this (Kwong 2019;

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Piketty et al. 2019; Gang et al. 2019), since this is one of the major explanatory factor of the fact how the number of persons living under absolute poverty – currently defined by the World Bank as being below 1.95 USD a day – has come down by 1 billion, or halved in the 2000 to 2015 period of the Millennium Development Goals of the UN. GNI per head grew between 3.9 and 9.8% per annum prior to the collapse triggered by the Covid-19 pandemics, whose total impact is yet to be assessed at the time of writing (April 2020). Poverty rates, still at 40.7% in 1999 declined to 10.2% by 2014 and 1.7% by 2019 according to the official data.[1]

1. THE SYSTEM BEHIND THE NUMBERS

In the present paper, I attempt to understand the economic system that allowed for this stellar growth performance, which – unlike in the US and Sub-Saharan Africa – did trickle down. True, the main driver of growth in the first two decades of the current millennium continued to be the exorbitant rate of fixed capital formation, accounting to 41–49% of GDP by the year. While this is indicative of a generally low level of efficiency in resource allocation (if we compare it to the OECD average of about 20%), China is definitely not a Soviet-style centrally planned economy. The impressive development of many cities, especially in the coastal areas, the continuous expansion of export industries, the wide use of information and communications technologies render China to be one of the shop-windows of the Asian Century. Particularly the latter, the broad and aggressive use of artificial intelligence renders the challenge of Chinese state capitalism to a much more formidable challenge to the US capitalism than the Soviet Union could ever marshal (Lee 2019).

Chinese economic system is hard to describe, especially in the positive (that is avoiding the conventional methodological fallacy of telling what it is NOT). Libraries have been produced inside and about China, both in theoretical and in comparative and policy terms, using abstract and applied models alike. Still, we are short of empirically-based, systematic overviews on the macroeconomic realities. Most of the papers are constrained not only in time, but in space and sector alike. What may hold for one region, sector or time span may not be relevant at all in a different setting in different times or in other sectors.

There are no over-arching, nation-wide empirical descriptions of such important areas as banking, corporate behaviour, fiscal transactions or party-firm relationships, while we do possess accounts on each of these by the region. Studies on the role of the formal versus informal institutions tend to be more speculative than empirically based. While descriptions of the sectoral and regional evidence abound, these invariably point out the limits to their generalisation. Namely, what is allowed in one province or in one time, may be prohibited or even persecuted in another region or time period. Chinese regions are proverbially attached to experimentation that allows, despite the one-party system, for a rich diversity of competing approaches, a next-to-Hayekian competition of regulation. And this diversity dates back to millennia, not being a product of the post-Mao decades.

The diversity highlighted above applies to all walks of life, such as the role of private, non-state, non-private and public property; central, provincial and local management and the inter-relationships among these levels; the role of foreign investment, particularly direct investment;

[1]Normalised by and cited from www.databank.worldbank.org, unless otherwise indicated.

the presence of overseas Chinese businesses and people, the relevance allotted to ideology and central deliberations. In short, China is eminently non-Soviet, and the clichés in comparative economic systems' research, anchored in the Russian and the East European experience, do not seem to hold.

First and foremost, the direct micro-management of economic and social affairs by the Communist Party is not anymore an all-prevailing and automatic feature. It is there in some cases and much less so in others. Analysts often forget the five millennia in the Chinese experience of decentral rule of a diverse Middle Empire.[2] Likewise, the tradition of the merit-ocratic administration, which is the heritage of antiquity, seems to be often forgotten. This is understandable, as diversity limits generalisations at the level of social science theory. Thus, while we do have empirically based interesting insights, presenting a model at the level of comparative economic systems' theory remains largely a speculative endeavour.

No wonder that studies generalising the experience of coastal areas and especially of Special Economic Zones paint a picture of full-scale capitalism (Naughton 2017). Meanwhile, local observers, mindful of the practices of the internal, northern and backward western provinces (Zhang 2014) underscore the surviving command of economy features, such as administered prices and state-fixed, non-equilibrium rates of exchange, political subordination of management and arbitrary/non-controlled decisions on major investments.

Needless to elaborate: if, and to what degree, the system is responsible for achievements and shortcomings is a relevant question in more than one respect. First, it is important on its own right, from the point of view of area studies. Second, depending on the reading, one may enter into speculation on the superiority of the 'Beijing Consensus' (Bird et al. 2012) over the more traditionally known Washington Consensus on global development. Third, it is a much-debated issue if China has developed a new variant of hybrid regime (Kornai 2016) that constitutes a full-fledged alternative to the two ideal types, command and market economy. Finally, we may also ask if this option is sustainable or not? If we just consider that the fundamental criticism of state socialism by Ludwig von Mises and Friedrich August von Hayek from the 20s and 30s actually holds, still the Soviet system existed for over 70 years, this final question is also becoming more than of abstract academic interest.

2. COMPETING INTERPRETATIONS OF IDENTICAL EVIDENCE

One of the many reasons which may arouse interest in the somewhat speculative readings of the Chinese evidence is its extreme diversity (as I described above). Even allowing for the usual disagreements in the social sciences, which are in part value based, and in part methodologically informed, the dissimilarities in interpretation are striking, indeed.

Firstly, the official ideology has been speaking of the 'socialist market economy model' ever since 1978. Evidence marshalled in the literature that I cite below seems to agree on one point. Namely that across those decades China experienced various periods of centralisation and de-centralisation, more marketisation and enhanced state control, all under the same banner. As we

[2]The English translation of 'Zhongguo' as the Middle Kingdom (or Middle Empire or Central Kingdom) in European languages in the 16th century and became popular in the mid-19th century. The Chinese were not unique in thinking of their country as central, although China was the only culture to use the concept for their name (Editor's note).

may also know from the experience of Central and Eastern Europe, the term is flexible and broad enough to be interpreted in either way. The concept implies a few uncontestable items, while leaving sufficient place for policy interpretation both at the national and local levels. It means a clear delineation both against a 'market economy without adjective,' as advocated – though not practiced – in the Central European transition, and against any attempt to regress into a version of the Soviet-type command and control methods, which used to be short lived in China anyway (Csaba 1996). Allowing for some arbitrariness and simplification of complex realities on the ground, this concept may and does imply at least the following basic features:

1. Public property, which includes what Chinese authors refer to as 'non-state' in its bulk, prevails over open, full-fledged private property. Land in particular, may be leased, but not accumulated or freely traded.
2. State decisions are dominant, in the field of investment, price setting, foreign trade and income distribution.
3. Currency is *de jure* and *de facto* inconvertible, there is no talk about capital account convertibility.
4. Income and wealth distribution, including inheritance, is state managed.
5. Selection of top managers, both in the economy and other fields of public activity, is controlled tightly by the Communist Party.
6. Foreign investment is tightly controlled by the state, mostly regional, but on occasion of the central apparatuses. There is no free turnover of companies, and traditional joint venture form, which allows control by the locals, predominates. Full-fledged foreign ownership exists only in Hong Kong, Macau, and the Special Economic Zones.

In short, such a draft model is broad enough to cover such varying cases as Bukharin's New Economic Policy in Russia (1921–1929), the Yugoslav self-managing model or the Hungarian New Economic mechanism (1968–1988). But it would definitely exclude anything resembling to any of the experiments in Central Europe and the Baltics in the 1990–2010 period. West Germany, France or Italy between 1950 and 1970, usually considered to be statist, especially from today's economic historians' perspective, also should not qualify, despite strong state interventionism or the large share of publicly owned assets in overall national wealth.

Secondly, a considerable part of the literature, by contrast, as exemplified by the above cited article of Naughton (2017) and equally unambiguously by Roland (2019) among the major comparative economists, both consider China to be beyond the limits of any version of socialism. Many travellers and business executives also share this point, since the flourishing of the coastal cities, or the numbers in Chinese foreign trade statistics are truly impressive. 90 plus per cent of manufacturing and 50 plus per cent of high-tech in the exports are anything but the industrial museum that the Soviet Union exhibited even in its final years of existence. China today is what Britain was in the 19th century: the workshop of the globe. China is a major player in global tourism, finance and transport, it has an impressive high-tech industry and a focus on ICT.

Subscribing to all these features one may still observe, what is a platitude in social science, from Max Weber to Karl Polanyi, namely that profiteering, greed and even being industrious is not the same as capitalism. The latter is a special interrelationship between the economy and social sphere, a *modus operandi* which goes beyond the features listed above. Unless we misread the Chinese realities entirely in the six-point draft above, what we observe are features of a market, without fundamentals of capitalism. The very fact that stocks can be traded either by locals or foreigners on two separate markets with no room for arbitrage, or the central fixation of the exchange rate of the renminbi, are clear evidence of markets being possible and workable outside a normal capitalist frame, as has been in China in the past few decades. Kornai (2008) has spared no effort in elaborating this point in detail, and the collection of papers cited above is just one easily accessible example of it.

Thirdly, Kolodko (2020) and Nuti (2019) have gone perhaps the farthest in characterising the Chinese experience as a *sui generis* model, that cannot and should not be confused with any of the ideal types we know from traditional comparative economics. As someone particularly seasoned and knowledgeable in theory and practice, both authors have a point in underscoring the difference we should note between the Chinese and the Soviet-style economic system.

The basic point of debate may be the following. Had not the Soviet-style economies also been different among themselves? Could one compare say, East German centralisation with Yugoslav decentralization? In the case of Hungary there emerged a decade long ideological and academic debate, if and why the country under Imre Nagy and János Kádár evolved into an alternative model to the Soviet Union or just a mutant of the same species? A lot depends on how we define a model in general and in concrete.

Once we stick to our highly pragmatic and descriptive six item definition of the Chinese model, it is hard not to agree with the official protagonists (Lin 2012) underscoring the continued presence of the socialist ideology-driven fundamentals. This holds for property, for state-economy, relationship, the nature of political rule, the functionally closed nature of the system and central conduct of major investment decisions, combined with the lack of rule of law. While these have not led to similar decline as in Russia, the usual answer is twofold: a) Commercial spirit survived the truly oppressive period of 1958–1978, a mere two decades against millennium of traditions; and b) the tradition of decentral imperial rule has allowed for much more diversity, thus much fewer implosive powers as in the Russian Empire. Thus, China – also in this respect – has remained different from any other culture in Asia or Europe. But the official talk about 'socialism with Chinese characteristics' is truly more than sheer lip service, as recent developments have amply demonstrated (see below).

Fourthly, China is also often presented as an ideal type of hybrid systems. Here the expression denotes a peculiar 'third way' between the western democratic market and eastern despotic, autocratic non-market models. The possibility of combining illiberal, authoritarian policy with pro-market policies, first attempted in Chile in 1973–1988, has long been in the focus of attention of political scientists (Diamond 2002), economists (Kornai 2016) and sociologists (Magyar – Madlovics 2020). Building on those extensive preliminaries, China has also been shown to be a place of a new type of *rent-seeking society*, where state regulation creates room for private economic benefits (Mihályi – Szelényi 2019: 87–101).

'Hybridology' has developed already a separate field of inquiry. What I find relevant from the investigation, limited to a single country case, is the current open question of sustainability. Yes, we do observe this combination performing quite well in China in 2010–2019. But: will it go on like this? We do know that epidemics come and go, but will China continue to be the growth champion of its league? And if yes, for how long? In the following, therefore, we shall speculate on the growth potential (not of potential rate of growth) of the Middle Kingdom.

3. POLICIES, INSTITUTIONS AND GROWTH

No economic theory, not even old and new schools of institutionalism, would attribute economic performance to systemic factors only or predominantly. In turn, mainstream or close to mainstream growth accounting would not be published without introducing at least one institutional factor besides or on top of the policy variables and customary factors of growth (typically L and K). While the nuts and bolts of how to introduce the institutional variable and what weight is to be attributed to it, when say, we put a number on allocational efficiency or technological change, which is beyond the scope of the present paper. What I claim here is a modest and universally accepted claim: institutions matter.

In the case of China one of the few consensus points in the literature is the pre-eminent role of informal institutions and spontaneous, bottom-up development, trial and error. The official version, 'cross the river by feeling the stones,'[3] implies the benefit of step by step and experimental approach over various grand designs and other forms of social constructivism. Putting it in more conventional terms (Xu 2015), this implies the paramount role of informalism, including informal institutions, relationships to overseas Chinese community and *quanxi*, literally contacts with persons of the same village (which may go as far as enforcing contract by arms).

Due to the peculiarities of Chinese culture, informalism is often seen as a plus, allowing for sectoral, regional and ideological diversity. This held obviously in the first two or even three decades of incremental change after 1978. Allowing for initiatives for the small scale may become harbinger of larger scale rearrangements by the way of social learning and/or gradual liberalisation. But gradualism has its inherent limits. As managers in the late socialist period tended to joke, if all passenger cars drive on the right side of the road, but some trucks remain on the left side, that is bound to cause a trouble. Today few analysts would doubt the point elaborated in Cunningham – Diboglu (2020), namely that at a certain point a qualitative change, i.e. formalisation is required, else the system explodes or regresses into a version of command system. The novelty of their insight is, that this age-old experience from Eastern Europe has become topical for China, not least because of the implementation of marketizing reforms in the preceding decades.

Which are the cornerstones of 'socialist market economy' which seem to have come to be obstacles to a further move to the market? Gang Fan et al. (2019) underscore overregulation of pricing, non-transparent governmental action, competition-distorting favouritism in public procurement and in the allocation of investment. Even if they do not mention property and party control to the point of micro-management, it is clear that these features are indeed constitutive for any model which deserve the name of socialist. Similarly, monopoly positions of power, including licencing and limitations of heritage and of capital accumulation in the form of acquiring firms, are at the root of corruption as a systemic element under Chinese socialism (Yi et al. 2018).

It goes without saying that a regular and sizable surplus on the current account, as has been the case in China in the past decades, ranging between 2 and 7% of GDP by the year, is not typical and not justified in a developing or emerging country position. Development theory

[3]A saying, attributed to Deng Xiaoping, describing the China's approach towards internal reforms and opening.

generally rejects this type of mercantilism, since the major source of welfare enhancement is known to be imports, especially in the catching up countries.

Thus, the regular surplus on Chinese account is anything but a natural phenomenon. It is certainly understandable on the grounds of history: China spent much of the 19th and 20th century to avoid colonisation, thus the fear of debt/external dependence is formative of political thinking. But this psychological factor cannot be taken as a justification. Rather, if anybody doubted, it is a proof of strong state management of foreign trade operations (despite WTO membership since 2002). The more one believes in the role of competition, especially from abroad, being formative for innovation and competitive behaviour of firms, the less one is inclined to accept systemic/functional closedness as a minor shortcoming of the Chinese market order.

Chinese growth is known to have been driven by two major factors. One is the relocation of people from low productivity farming to high productivity industry, the classical Domar-effect of structural change. The second is the record high rate of fixed capital formation, peaking with 49%, then declining in recent years to 41%, or the double of the OECD average. Despite these efforts, multiplied by an expansive fiscal and lax monetary stance for several years, growth has been on the decline. In official numbers growth peaked by 14.2% in 2007 declining to 10.6% in 2010, 7.3% in 2014, 6.6% in 2018 and 6.1% in 2019. Even if we accept the forecasts that consider the Covid-19 impact as a one-off shock in 2020, the decline is a clear trend.

One of the more sensible ways of counter-acting this trend would be to improve the efficiency of resource allocation, by reforming banking, the capital markets and the entire system of investments, that currently penalises the private sector and provides considerable preferences to the priority investments of the government. This point, acknowledged by several of our Chinese sources cited above, is where the issue becomes a matter of power: who controls the button? Without pretending to have a quick fix, we may note that no easy solution is in the pipeline. There are at least two insights of the received wisdom, which warn against any quick fix. First, as it is known from the classical Solow model and its extensions, investment-based growth is inevitably ebbing out, saves for major technological breakthroughs. While China is by no means stagnant technologically, this factor alone is unlikely to bring back the expansion of the best years. Much of the Chinese innovation is based on foreign inputs, another factor of decelerating relevance with catching up. Second, fiscal and monetary policy are useful tools to manage cyclical slowdown, but much less useful in counteracting secular, structural decline. As I illustrated above, pre-virus growth rates were halved in a decade, and that despite the ongoing joint fiscal and monetary stimulus ever since the Great Recession.

4. HOW SUSTAINABLE IS THE CHINESE MODEL?

This is a non-trivial question. All the less so because the Chinese model was under continuous change in the past four decades. While Deng seems to set very clear limits to how far changes may and may not go, especially with crushing the pro-democracy movement in 1989 and more recently, by his successors' putting down the like-minded protest in Hong Kong, China today is most unlike China used to be in 1978. Not only in terms of level of development and lifestyles, but also in terms of economic realities on the ground.

Insightful analysts (Zhang 2014; Kwong 2019) have elaborated in detail that a further radicalisation of market reforms is both conceivable and desirable from the point of view of economic advancement. They also warn, however, of drawing the premature conclusion, that if this is logical, then it must also happen, the only question being when. And the political economy of policy reform across the globe has indeed shown such a variety in terms of success and failure, that nobody should present his/her vision as a foregone conclusion (cf. also Xu 2019).

The empirical literature that I cited (Gang et al. 2019; Zhang 2014; Xu 2015) documented on the grounds of different source material as a common thread. And this is a slowdown of reform, dating back to the period prior to the adjustment to the Great Recession in 2008/2009. Following the deeper systemic logic observed in other Communist-led countries, the role of party officials has been strengthened. Central control of investments was enhanced, large industrial associations were formed, state management of prices, interest rate and the exchange rate became stronger. While regional differences sustain, the centralizing trend has become a new tide, not just a cyclical wave, as documented in detail in Lardy (2019).

This U-turn is relevant in more than one respect. First, we are talking about the second largest economy of the globe and about one sixth of the mankind. Second, it is an interesting issue, if and to what degree China may qualify as a version of the Asian developmental state, an issue outside the scope of the present analysis. Third, and closely related to our immediate topic, it is an interesting contribution to the debate over the viability and sustainability of the hybrid regimes across the globe, where China tends to be the prime example. A lot depends, of course, on the ability to generate well-being, including environmental sustainability in cities, not just quantitative expansion of output, with material advancement having taken the role of ideological convictions – nationalist or Communist – of the previous periods.

The two competing major reading of Chinse events were the theory of hybrids and Chinese exceptionalism. The former literature argues – including the major contributions cited above – that a combination of authoritarianism with truly market order is realistic, and China is the case for success. Kurlantzik (2016) for one forecasted this to be the dominant trend, that of illiberalism for the decade to come. The competing reading draws on China being traditionally different from any other country or culture, not lending itself to any broader generalisations. Joining this line, Önis – Kutlay (2020) forecasted the further weakening of the liberal international order under the influence of successful hybrid regimes, rendering the illiberal turn of the 2010 into a lasting turn.

Being amidst an open-ended story, it is risky to run into speculations about the future. Still, on the grounds of the Central and East European experience one may doubt, if a system built on mostly or exclusively materialistic legitimation would not tremble under the social and economic impacts of ebbing out growth. China is no longer the global growth champion, and this is a problem only if we accept: it is primarily material advancement rather than addiction to any ideology which is currently the petrol in the engine. It is next to impossible to visualise a situation, where competing interests – even if these are not formally aggregated in parties or lobbies – would not clash over a diminishing pie. If we accept – on the grounds of data provided above – that the Chinese system is not very efficient in the allocation of resources, trouble may emerge earlier than the official nominal numbers would suggest.

Also, if one looks into the details of the more recent centralisation drive, strengthening micro-management of both society and economy by party officials, it is just the use of Internet which may seem defining difference from the established Communist practices. In terms of outcomes it sounds reasonable to conclude (Düben 2020) that this step backward implies the abolition of precisely that informal consensual decision-making, which allowed for accommodating competing interests and factionalism within a single party framework. Furthermore, this is likely to exacerbate well researched problems of over-centralisation of economic decisions (Xu 2019), which used to be the 'exceptionalist' solution of limited and informal pluralism. Life-long service for the top leader, strengthening ideological alertness, fighting political opposition and ethnic autonomy initiatives, and many other show towards a rather well-known non hybrid socialist market economy model.

China has undoubtedly entered a road crossing. One option is to radicalise the market features of its model, even at the cost of softening the political grip. This implies clearly more democracatic and more market oriented than Deng would have been happy with. Russia today, despite all shortcomings, is indeed a far cry from what Gorbachev's perestroika delivered, and nobody doubts its fundamental credentials as a market economy, even under strong state intervention. Russia, thus, is a different quality from any brand of market socialism. Should something comparable evolve in China, it would indeed put to test the theories of a hybrid regime, which are currently in a rather abstract form of elaboration. Should this be the case, that would raise weighty theoretical and moral concerns, as voiced by Kornai (2019).

The other option is to follow the traditional ways of the 'politics in command' as Lenin, Mao and Deng equally practiced. In the latter case, sustaining Party control dominates economic considerations. As indicated by the East European experience, this solution can also be more lasting, than pure theory would imply it. But it also has a price to be paid for the time gained, in terms of growth, efficiency, competitiveness and innovation. The more we are aware of the fact, shown by many polls, that following a century of shocks, a majority of Chinese may value stability more than individual liberties, the more we may see the potential in the second option too. But one should not pretend that there would be no price to be paid in terms of social strain and economic decline, first in relative, later in absolute terms.

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