

# Why China Works

**A look at bright spots in the recession begins with Beijing, where state control is looking smart.**

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China is the only major economy that is likely to show significant growth this year, because it is the only one that routinely breaks every rule in the economic textbook. There is no truly free market in China, where the state doctors statistics, manipulates the stock markets, fixes prices in key industries, owns many strategic industries outright, and staffs key bank posts with Communist Party members and tells them to whom they should lend, and in what they should invest. In fact, the main reason China is not slowing as fast as the other big five economies is its capacity for what economists ridicule, in normal times, as state meddling: it limited foreign investment in the banking sector and didn't embrace the exotic financial innovations that are the melting core of the global credit crisis.

Why does China's brand of command capitalism work? The question has long intrigued economists, who tend to cast the state as hopelessly stupid, the market as naturally brilliant. Now that the United States and Europe are moving toward state control—by nationalizing the banking and car industries, and imposing heavy new regulation on the financial industry—the question has a new urgency. China, the poorest and most chaotic big economy, looks like the one best positioned to navigate what may be the worst global downturn in seven decades.

In a time of crisis, China's bureaucrats can pick from traditional market tools, like their Western counterparts, and from the arsenal of command capitalism. Early last year, as the housing market was overheating, they simply ordered bankers to cut back on housing loans: then as home sales began to fall, they offered market incentives, like lower taxes on home purchases. In recent weeks they launched economic rescue efforts similar to those in the west, including a huge (\$600 billion) plan to ramp up government spending and big interest-rate cuts. But they've also issued orders that would be seen as improper "intervention" in the West—for example, calling last week on state industries, including steel and construction, to "actively increase" their roles in the economy by buying up new assets at home and abroad.

Once seen as the bad habit of an immature economy, China's state meddling is now seen as a bulwark of stability. "Government control of the most capital intensive sectors leaves me optimistic about China's prospects," says CLSA economist Andy Rothman. "The government can say to companies in these sectors, 'Continue to spend, don't defer your investment plans'." Despite the falls in its biggest export markets and its own stock markets, China's economy looks likely to grow more than 7 percent in 2009—down from the double-digit pace of recent years, but stronger than most. Corporate loan rates are actually up, as state banks loosen credit. In a nation where investment is "the backbone of sustainable growth," accounting for 40 percent of GDP, the state is once again ramping up investment to fight serious threats to growth, says Morgan Stanley Asia chief Stephen Roach. "What we're seeing is that the Chinese command-and-control system can actually work more effectively than other market based systems in times of economic stress," he says.

When the original capitalist roader, Deng Xiaoping, said "It doesn't matter if a cat is white or black, as long as it catches the mouse," he put economic growth above ideology purity. Now Chinese leaders quote Deng to defend the basic deal he offered the Chinese people: autocratic capitalism would provide economic growth, while the Communist Party would retain absolute political power. Many of these leaders now argue that a democratic China couldn't have survived—let alone

flourished—in a global recession. "China isn't ready for a democratic free-market system," says Fang Xinghai, the Western-trained director of the Shanghai Financial Services Office. "Think about what happened in the U.S. elections in 2000—if that had happened in China, there would be a war. The genius of Deng is that when he put China on the path to a market economy 30 years ago, he knew the country needed a stable political system [to withstand the changes of reform]. Whatever our system is, it is suitable for China."

China works because it is governed by a radical pragmatism that has focused on a slow but steady shift toward freer markets. Deng called it "crossing the river by feeling for the stones." The state still exerts a strong and stabilizing hand, but it has unleashed a private sector that now controls at least half the economy, and as much as 70 percent if you include state-owned companies that are in fact allowed to operate as private firms. That's up from around 17 percent in the early 1990s. Some 60 percent of GDP growth, and two thirds of new job creation now come from the private sector, according to CLSA.

In 1995, China began a revolutionary dismantling of state-run industry, laying off 46 million state workers—the equivalent of the entire workforce of France and Italy—over the next six years alone. In the years following, the streamlining has continued, sharply raising profitability at state-run firms (it was up 38 percent between 2004 and 2005, for example), and the private sector was allowed to play an increasingly important role in the economy. Rothman calls it "radical change, but over an extended time period." During this period numerous books on Russia's transition to capitalism were translated into Chinese. Above all, the Chinese wanted to avoid the chaos that followed Russia's "big-bang reforms" of the early '90s, which created a corrupt, Kremlin-sponsored economic oligarchy that still haunts Russia today.

China's crackdowns on political dissent have obscured the daring risks it takes on economic reform, even in crises. China opened to Western investment at an earlier stage of development than either Japan or South Korea—in the early 1980s, when its average yearly income was only 760rmb (\$500), because Deng recognized that global trade was the way out of national poverty. He also freed peasants to seek jobs in cities, a risky move in a nation with a long history of mobile peasant rebellions. Even after the Tiananmen massacre of 1989, Deng continued to push economic reform. During the Asian financial crisis of the late 1990s, China joined the World Trade Organization, committing itself to a wider opening of its domestic markets. Around the same time, the government allowed laid-off workers to start businesses and buy up state-owned housing for a song, founding an ownership society almost overnight, and setting the stage for a middle-class society, in what Rothman calls "the biggest one-time transfer of wealth in the history of the world."

Now, as a worse crisis gains momentum, Beijing continues to push market reforms in key sectors, even as it reasserts control in others. Banks are one main target of reform. "Capital markets are still dominated by bank lending. We have too few products and we need to get more institutional investors into the market," says Fang Xinghai. To that end, China is boldly moving beyond stocks into new types of complex securities, including stock index funds, corporate bonds and other debt products, and even options and futures trading—albeit simple oil futures, rather than the complex credit derivatives that tanked Western markets. The fact that Chinese leaders understand even in the midst of the credit crisis that more sophisticated forms of securitization can play a stabilizing role is a sign of strategic thinking, and great skill at learning from others' mistakes. Asked what he admires most in Western counterparts, Jiang Jianqing, chairman of China's largest state bank, ICBC, says, "Innovation. Americans have an endless passion for it. Perhaps in the past, it hasn't been so well regulated, but you can't stop it. It's one of the most important ways to push enterprise forward."

Even more farsighted is the new, landmark land-reform program, which would make it possible for Chinese peasants to rent or lease their land to outsiders (including corporations). Simply figuring out who owns which properties can be a Byzantine task in China, so land reform could take decades—but the idea is already generating excitement. In November, real-estate consulting firm Jones Lang LaSalle estimated that land reform could unlock rural property worth as much as \$2.5 trillion. "Land reform will be Hu Jintao's lasting legacy," says JLL national research director Michael Klibaner. Turning peasants into land-owning consumers could go a long way toward creating a consumer society, reducing China's dependence on exports, and rebalancing the world economy.

Once Chinese leaders signal a new direction, they rarely waver, says Rothman. Witness the political battle over American charges that China is deliberately holding down the value of the yuan to boost its exports, a charge that ignores the gradual 21.5 percent rise in the yuan that had already taken place between the summer of 2005 and 2008. While the yuan did fall a bit in recent months, most economists believe Beijing will continue to allow a modest appreciation, weighing its

need for export competitiveness against the world's need for more balanced trade flows.

This balance between free and managed markets can also be seen in China's approach to price fixing and state control in key sectors like financial services, telecoms, utilities and energy. Some of these industries are partially privatized—in telecoms, equipment markets are open to foreigners, because they bring capital and expertise that eventually trickles down to local firms, like the now internationally competitive Huawei. But the more lucrative services market is still run by authorities, who set prices on mobile-phone calls. "China does control prices, it's true," says Fang. "But it moves one step behind the market. The market is always the baseline."

Recently, for example, China has been cutting fuel subsidies to bring prices closer to international norms. It's part of a 15-year process, that, according to CLSA's Rothman, has taken the percentage of total consumer prices fixed by the state from 95 percent to as low as 5 percent. The slow easing was designed to avoid the 1,000 percent burst of inflation that hit Russia from 1991 to 1992 after Moscow deregulated prices. "The Chinese don't want shock therapy, which has proven to be all shock, and no therapy," says Cheng Li, a senior fellow at the Brookings Institute.

The leadership's faith in its own ability to mold markets may derive from the fact that most are engineers, trained to build from a plan. Eight out of the nine top party officials come from engineering backgrounds, and the practicality of their profession may also help explain why they didn't buy into risky and Western financial innovation. At a recent Chinese business conference in Barcelona, Xu Kuangdi, vice chairman of the advisory body to China's Parliament, and President of the Chinese Academy of Engineering, mocked the "virtual" products sold over the last decade by Western bankers: "They had Ph.D.s in physics inventing tools that the banks themselves couldn't understand or regulate. Investors listened to their stories and were told how wonderful all this would be, how much better it was than producing real goods. Everyone was working in a dream."

A command-and-control system run by relatively skilled technocrats allows China to get things done, quickly. "I'm always struck by the ability of the Chinese state to move in a coherent manner and to marshal its people and the resources of the country to a common target," noted David Murphy, head of CLSA's China Reality research division, in a recent report on the country's efforts to bolster growth. Contrast this to Russia, where thuggish autocracy has created an "anything goes" environment in which neither investors nor most officials have any idea what might happen from one moment to the next.

The ruling engineers preside over a system that is highly process-oriented and obsessed with performance metrics. One economist who works closely with top government officials notes that many of them serve the same brand of Chateau Lafite Bordeaux at their dinner parties because of its exceptional rating by the Wine Spectator's Robert Parker. Ambassador Wu Jianmin of the Chinese foreign ministry recalls a recent meeting with a deputy mayor from the city of Wuxi who could compare in detail his own local economy with that of the United States in the 1970s. The official was concerned about why his service sector hadn't grown larger, given the respective per capita income growth (the town's party secretary has since been dispatched to America to hunt for service-sector talent).

Leaders who don't meet internal performance standards are, more often than not, held accountable, and do get sacked, which is still unusual in many developing economies. For instance, the scandal in which at least six Chinese kids died and 300,000 fell ill from toxic milk mixed with melamine to give a falsely high protein level led to the swift sacking in September of six city officials—including the mayor and party secretary—in the hometown of milk-powder maker Sanlu. China's top food safety inspector also stepped down and the company's chairwoman has gone to trial. Such moves seldom fully satisfy public anger but they do rattle officials.

Clear performance targets are part of an efficiency ethos that the Chinese also tend to admire in Americans. Four out of five high-ranking officials now train for some period of time at major universities in the United States (the Kennedy School at Harvard has been nicknamed "the fourth Communist Party school"). What the Chinese people still want at this stage is prosperity, and stability, which they are pursuing with a pragmatic, capitalist zeal that arguably surpasses even that of Americans. Huang Ming, who teaches at both Cornell in New York and the Cheung Kong Graduate School of Business in Beijing, jokes that while he can command respect in the United States simply by telling people he's a tenured professor at an Ivy League university, Chinese people say, "OK, that's good, but how much money do you make?"

Of course, the increase in Chinese prosperity has also created more opportunities for corruption, yet steady progress is visible even when it comes to graft. In just under a decade, China has fallen

from 52nd most corrupt country to the 72nd, according to Transparency International's ranking of the world's most corrupt regimes. While Chinese and Western business people don't like to be quoted by name on the subject, they seem to agree that corruption in China tends to be of the soft, "wheel-greasing" variety, rather than the violent and disruptive type. "You don't have to worry about someone coming to your door with a bulge under their arm," laughs one British businessman working in Shanghai. One chairman of a large European firm, who has worked in a number of developing markets, makes this comparison: "In Russia, if there's \$100 in the bridge-building pot, the official takes \$90. In China, they take \$30, and at least you know the bridge will eventually get built."

Many point to the current insider-trading case involving the detention of China's richest man, Huang Guangyu (the founder of electronics retailer Gome), as proof that the government is also getting more serious about prosecuting corruption. Independent economist Andy Xie (formerly of Morgan Stanley) says that the more important point is that Gome, the company, will most likely survive regardless of what happens to Huang—a sign that Chinese markets are maturing. Xie also notes that recent legal changes in stock-ownership law have made markets more liquid, putting them farther out of the control of state authorities. That's one reason authorities have tried since August to revive the stock market by scrapping the stamp tax on share purchases but in vain. The market is getting too free for the state to control.

That said, there's no doubt the state's hand in the economy will grow in this downturn. Much of the new stimulus package will flow through state-controlled sectors like transport and power and construction, which can spend it quickly. Beijing has also chosen this moment to issue new 3G mobile licenses, which will further funnel money through the state telecoms sector. And in Hong Kong, there's evidence that investors are moving money from commercial to state banks, because of the implicit promise of state support.

Perhaps the most intriguing evolution in China's hybrid markets is in the way leaders are tracking public sentiment, including political sentiment. Beijing is sending out consultants to teach local officials American-style public-relations tactics, part of a new "openness" campaign designed to quiet public protests triggered by economic tensions. Last November in Chongqing, China's largest municipality, party secretary Bo Xilai went out in the street to talk down thousands of striking taxi drivers, an almost unprecedented move for a senior party official. Bo later brought together a meeting between government officials, drivers and citizens' representatives to hammer out a deal that included lower management fees, increased fuel subsidies and approval for the drivers to form a union. "The government is learning from the mistakes of the past," says Wang Shuo, managing editor of the Beijing-based economic magazine *Caijing*. "There has been a lot of social unrest in the last decade, but they are handling things much better—no blood, and no major repercussions. They understand that is a life or death issue for them."

Savvy management of public opinion may prove crucial as economic conditions head south. The Chinese love the idea of choice—reality TV shows similar to "American Idol," which allows viewers to vote on the winner, are hugely popular. While they can't vote on their political leaders, in many places they can now post their views about local government on city-run Web sites, and local leaders are required to answer individual complaints within three days. Public rankings of various city departments are posted based on the number of positive and negative comments.

It's part of a government strategy to use the Internet and public opinion to put pressure on provincial officials, as well as to influence policy decisions. Victor Yuan, chairman of Horizon, a Beijing market-research firm, conducted public polls to help the government set Olympic ticket rates and figure out what to charge for natural-gas upgrades in remote areas, in order to avoid public outrage over too high prices. Next year, he'll be launching a poll-based ranking of 10,000 middle- and upper-level Chinese officials, and Yuan believes it's possible such a poll might be extended to include the very top officials, perhaps by 2014. "This is very much a performance-oriented administration, and they need to understand what the people want in order to avoid trouble," says Yuan. "Since Deng, leaders are no longer supermen. They need legitimization, and the approval of the people."

It's getting tougher even for radical pragmatists to deliver on Deng's promise. Thirty years ago, there were 963 million people in China, and 30 percent of them were hungry. Today, there are 1.3 billion, and 97 percent of them have a full stomach, but the step up to the middle class (in which only 6 percent of Chinese live today) is harder. Ruchir Sharma of Morgan Stanley has pointed out that China's per capita GDP recently hit \$3,000—the level at which Japan's miracle economy began to slow to a more mature pace.

China's successful use of command capitalism also carries, at most, limited lessons for the United

States or Europe. It's much easier to boost growth by ordering engineers working in an autocratic system to build roads where there are none, as in parts in China, than to stimulate growth in a developed nation like the U.S. Still, the fact that an increasingly rich China still works so well is worth studying, not least because the credit crisis is provoking a wider questioning of free-market orthodoxy. "It is worth remembering that China is the only major nation that is experiencing neither a credit crisis, nor a crisis of confidence," notes Rothman. "Its still safe to say that nobody worries about the Chinese government's ability to get things done." As Wen Jiabao has said, "confidence is worth more than gold," and the Chinese people still believe in their system—at least for now.

*With Melinda Liu and Mary Hennock in Beijing and Duncan Hewitt in Shanghai*

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