

## Lessons of China's Transition from a Planned Economy to a Market Economy

### I. INTRODUCTION

One of the most important events in the modern economic history is the socialist countries' transition from the Soviet-type planned economy to a market economy starting in the last two decades of the 20<sup>th</sup> Century. China's experience of transition has produced many interesting contrasts to the experiences of transition in Eastern Europe and Former Soviet Union (EEFSU). When the transition started in EEFSU, most economists in the West favoured a big bang approach, which included stabilization, price liberalization, and privatization. They considered these three reforms to be the necessary for a successful transition to a market economy and attempted to complete all these reforms simultaneously or in a short sequence (Blanchard et al 1991, Gomulka 1989, Kahn and Richardson 1991, Lipton and Sachs 1990). The big bang approach in essence is a version of the Washington Consensus, which is based on the basic principles of neoclassical economics for a well-functioning market economy and was recommended by the IMF/World Bank for market-oriented reforms in the developing countries. The proponents of big bang approach expected the transition in EEFSU to have a "J-curve" effect on economic growth; that is, they expected the GDP in a country that implemented the big bang approach to decline initially and to be followed by a strong recovery in a short period of time. Most countries in EEFSU followed this approach. The big bang approach, nevertheless, has resulted in an unexpected sharp and prolonged decline in GDP with extraordinarily high inflation rates and serious deterioration of other social indicators (World Bank 1996; 2002).<sup>1</sup>

China has adopted an alternative gradual, evolutionary approach to the transition since the reform started at the end of 1978. This approach is piecemeal, partial, incremental, often experimental, and especially without large-scale privatization.<sup>2</sup> The Chinese approach is not guided by a well-founded theory or followed a pre-determined blueprint. Some economists regard this approach to be fatally flawed and self-defeating,<sup>3</sup> while the big bang approach theoretically perfect and feasible (Sachs 1993; Murphy, Shleifer, and Vishny 1992). In the late 1980s, many observers predicted the reforms in China would lead to nowhere, and its experience provided a useful, negative lesson for the EEFSU (Prybyla 1990, p. 194). However, contrasting the economic collapse and social crisis in EEFSU, China has become the fastest growing country in the world ever since the transition started. China has also successfully controlled the inflation in an acceptable level.<sup>4</sup>

The success of China's approach to transition so far has produced many challenges to conventional wisdom in economic theory (Chow 1997; Perkins 2002). This approach violates almost all the basic propositions for a successful transition from a planned economy to a market economy that are identified by many economists advising the former socialist countries in the early phase of their transition.<sup>5</sup> The success has puzzled many economists (Nolan 1995). Some economists attribute the China's success to their unique initial conditions, namely, a large agricultural labor force, low subsidies to population, a rather decentralized economic system, and, large amount of rich overseas Chinese (Balcerowicz 1994; Woo 1993; Sachs and Woo 1994 and 1997; Qian and Xu 1994).<sup>6</sup> According to these economists, China's experience does not have general implications because China's initial conditions are unique. However, other economists suggest that

<sup>1</sup> The cumulative output decline in countries in Central and Southeastern Europe and the Baltics reached 22.6% and in countries in the Commonwealth of Independent States reached 50.5%. In 2000, Russia's GDP was only 64 % of what it had been in 1990, while in 2000 the GDP of Poland, the best performing countries in EEFSU, increased only 44 %, compared to that in 1990 (World Bank 2000). Certainly the collapse of international trade due to the demise of CMEA has also contributed to the decline of GNP in these countries. However, the big bang approach was undoubtedly a major cause of these downfalls (Brada and King 1991; Csaki 1994).

<sup>2</sup> To a large extent, the reform measures and sequencing adopted in Vietnam and Lao is very similar to those of China. There seems to be a common East Asian model of transition.

<sup>3</sup> In the words of Vaclav Klaus, former Finance Minister of Czechoslovakia, "Partial reform in a distorted economy is worse than no reform." (quoted in Wiles 1990, p. 56)

<sup>4</sup> China's annual GDP growth rate reached 9.4% in 1979-2002; whereas the inflation rate, measured by the retail price index, was 5.3% annually in the same period.

<sup>5</sup> The basic propositions, according to Nolan (1995, pp. 401-2). include: 1) 'market socialism' cannot work; 2) institutional reform cannot be successful unless there is macroeconomic stability; 3) enterprises' attempts to make profits will not produce socially desirable outcomes unless prices are determined by market forces; 4) economic progress will be greatly inhibited unless the economy is fully integrated into the world economy; 5) the pace of the transition from central planning needs to be rapid; 6) and democratic political institutions are a necessary condition of success with economic reform.

<sup>6</sup> However, the initial conditions are not necessarily to the net advantage of China's transition. See the insightful discussion by Chang and Nolan (1995).

China's success poses a challenge to the wisdom of Washington Consensus which considers stabilization, market liberalization, and privatization as necessary components to a successful transition, and the Chinese experience demonstrates the superiority of evolutionary, experimental, and bottom-up reforms over the comprehensive and top-down big bang approach (Chen et al. 1992; Harrold 1992; Jefferson and Rawski 1995; McKinnon 1994; McMillan and Naughton 1992; Murrell 1991, 1992; Perkins 1992; Rana 1995; Rawski 1995; Singh 1991).

When the transition started in EEFSU, the socialist ideology has bankrupted there. In addition to the fact that there was no theory supporting a gradual switch of system (Aslund 1990, p. 37), a new ideology of capitalist triumphalism prevailed.<sup>7</sup> Therefore, the countries in the EEFSU intended to have a rapid and comprehensive change and expected to jump to a market economy in a short period of time.<sup>8</sup> However, as reviewed by the 1996 World Development Report, the experience in Poland and other countries shows that stabilization and liberalization can be implemented quickly, privatization may take a number of years to accomplish, the development of market supporting institutions, such as legal and financial systems, will take years, even decades.<sup>9</sup> Therefore, no matter what approach is adopted, the transition from a centrally planned system to a market system in any country, in fact, will necessarily be a gradual process. During the process of a gradual transition, the effectiveness of any individual institutional arrangement cannot be ascertained *a priori* because the function of an individual institutional arrangement depends on the functions of other institutional arrangements in the institutional structure (Lin and Nugent 1995). Even the market system is accepted as the final goal of transition and what makes a market system work are known to the economists and policy makers, the goal and knowledge do not provide much guidance for a smooth transition. Therefore, it is desirable to have a better understanding about China's experiences, how China's transitions could have been accompanied by rapid and stable economic growth, whether the Chinese approach has any generalizable lessons for other economies in transition.

China and EEFSU all had a Soviet-type planned economic system before the transition. In Section II, I will argue that the logic origin of this planned economic system and many economic problems before and after the transitions in China and EEFSU can be traced back to the adoption of a comparative advantage-defying (CAD) heavy-industry-oriented development strategy. In section III, I will provide a review of the process of reforms in China. Some lessons from the Chinese experience are presented in Section IV. It is followed by some concluding remarks in Section V.

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<sup>7</sup> The capitalist triumphalism, as defined by Wiles (1995, p. 48), is "Thatcherism plus optimism: i.e. monetarism plus privatization plus dogmatism, but also irresponsible (i.e., not Thatcherie) versions of easy success."

<sup>8</sup> The instruction to Jeffrey Sachs, when he was invited to advise the reform programs by Solidarity leadership in Poland in July 1989, reflected the general mood: "Give us the outline that you see fit. But make it a program of rapid and comprehensive change. And please, start the outline with the words, 'With this program, Poland will jump to the market economy.' We want to move quickly; that is the only way that this will make sense to our society, that it will make sense politically, and --as we understand from experts-- the only way it will make sense economically as well." (Sachs 1993, p. 43-4).

<sup>9</sup> Even Jeffrey Sachs, the most famous proponent of big bang approach, changed his position on the speed of privatization. In the 1991 World Bank Annual Conference on Development Economics, he proposed to accelerate the privatization in Poland and argued that, otherwise, the entire process of transition would be stalled for years to come (Sachs 1991). In his later writings, he only argues that the government of a transition economy to have a commitment to privatization (Sachs and Woo 1997).