7-1-2002

The Chinese Market: An Enigma Unraveled

Stephen F. Diamond
Santa Clara University School of Law, sdiamond@scu.edu

Follow this and additional works at: http://digitalcommons.law.scu.edu/facpubs

Part of the Law Commons

Recommended Citation
The Chinese Market: An Enigma Unraveled

THE CHINA DREAM: THE QUEST FOR THE LAST GREAT UNTAPPED MARKET ON EARTH
by Joe Studwell
Atlantic Monthly Press, 2002 256 pp $22

INEQUALITY AND POVERTY IN CHINA IN THE AGE OF GLOBALIZATION
by Azizur Rahman Khan and Carl Riskin
Oxford University Press, 2001 240 pp $45

Stephen F. Diamond

This spring, workers pushed out of China’s state-owned enterprises (SOEs) unleashed a wave of protests that began in the famed Daqing oilfields of northwest China, now owned by the partially privatized PetroChina Company. They staged massive, though largely peaceful, demonstrations against the meager severance payments and health care benefits they were left with in the wake of widespread layoffs.

The job cuts are the price paid by workers as part of a restructuring of the oil industry engineered by the Chinese communist regime with the guidance of an army of Western consultants that includes PricewaterhouseCoopers, Goldman Sachs, and McKinsey and Co.

The oil workers’ protests were soon followed by others in several industrial districts in China and included small but unprecedented demonstrations inside Beijing itself. The situation has been brewing for some time, with similar demonstrations occurring with greater frequency in the past few years. University of Michigan sociologist Ching Lee describes these events as a “veritable labor insurgency.” Whether or not this wave of unrest will lead to a final reckoning with the communist regime or whether that regime will be able to manage a secure transition to some new form of authoritarian capitalism is an open question.

Joe Studwell’s The China Dream draws on his decade of firsthand experience writing for the international financial press from China. Studwell edits the China Economic Quarterly, an independent and reliable source of information about China’s economy. The value of his book is that it helps the reader move away from the traditional framework that the outside world usually applies to China. There is no question that the movement for civil liberties evidenced by the battle of the Falun Gong for religious freedom, the Tibetans for national liberation, or the Chinese working class for jobs and independent unions are critical social struggles. But Studwell asks the reader to focus on the impact that important changes to that country’s economic and financial structure can have on political change, a relationship that has been misunderstood in the past.

It is instructive to look at what happened in Eastern Europe. When I visited Poland during the martial law period of the late 1980s, I had a lengthy and intense discussion—animated, perhaps inevitably, by a good deal of vodka—with several underground Solidarity activists in the textile district of Lodz. Their near fanatical adherence to the free market ideology of Friedrich von Hayek and Milton Friedman was truly unsettling. But the emergence of this ideology in Solidarity was all but ignored by Western activists backing the campaign of workers to democratize communist Poland.

Sure enough, the new postcommunist regime led by former Solidarity activists implemented a brutal form of shock therapy, attempting to impose a free market economy overnight. This helped the labor union side of Solidarity reemerge to lead a strike wave that threw out the government, which was replaced by former communists! Ever since, there has been in Poland a kind of socio-economic im-
passe, with a significant private sector in consumer goods, light industry, agriculture, and small shops, but state ownership maintained in many large industrial plants (at least those that have not been shut down completely).

Studwell describes a similar phenomenon in China, but this time the regime has implemented the Polish program without losing power. In the early eighties, it partially freed up prices in the agricultural sector and allowed farmers to retain a portion of their profits. This, in turn, unleashed pent-up demand for consumer goods, and so the regime went one step further, endorsing the new light industry and consumer goods businesses that began to emerge in the rural townships and villages. These Township and Village Enterprises (TVEs) provided the bulk of the alleged Chinese miracle.

The results in this “golden age” were truly astounding. Studwell describes the emergence of an “extraordinary virtuous circle” whereby higher prices for food stimulated demand for basic consumer products like bicycles, televisions, and refrigerators and, increasingly, for light industrial goods such as tractors. This process sustained growth rates averaging 9 percent for most of the 1980s. Studwell notes that non-farm employment tripled from thirty million to ninety-three million people in that decade alone, with some sixteen million new businesses established. These new entities are seen by Western Sinophiles as evidence of the emergence of a new private entrepreneurial class in China that will allow the country, in the words of mainstream economist Barry Naughton, to “grow out of the Plan.”

But many of the TVEs were formed with local state and party official endorsement and participation. They have become a new competing power center in Chinese society, absorbing scarce financial resources. They are also the source of huge new income inequalities. In their articulate and thorough study Inequality and Poverty in China, economists Azizur Rahman Khan and Carl Riskin look at the impact of market reforms and find disturbing results. Communist Party reformer Deng Xiaoping had declared “let some get rich first,” and the lucky few have done so with a vengeance. Although the country has indeed registered huge gains in national income during the last twenty years, the gains have not been equally reflected in the personal income of ordinary Chinese households. Khan and Riskin note that “between 1988 and 1995 inequality in the distribution of income in China increased sharply [as] China [became] one of the more unequal of the Asian developing countries.” In rural China, the TVEs have actually worsened income inequality as the enterprises offer higher wages but to only a small portion of the workforce, most of whom survive at or below the poverty line on whatever their backyard plots of land can produce.

The new so-called private sector has nowhere near the resources to take on the huge industrial needs of Chinese society. The single largest fully private entity in China has annual revenues of six hundred million dollars, half the turnover of the lowest-ranked company on the Fortune 1000 list. Even today this sector contributes only one-eighth of the nation’s gross domestic product and employs fewer than twenty million workers in a nation of 1.2 billion people. In any case, the apparent economic miracle began to slow precipitously after the initial boost in the eighties. In the early 1990s, Studwell reveals, it was discovered that the TVEs “had overstatement production by more than 40 percent,” wiping out a hundred billion dollars from the country’s national income accounts.

The regime’s heavy capital investment created much of the actual gain in GNP, thus exacerbating inequality and poverty. Khan and Riskin identify what is called “investment hunger,” especially among local governments that are now less constrained by Beijing. “The state allowed an expansion of credit to pump up accumulation and drive a wedge between growth of GDP and that of personal income.” Thus, they conclude, despite the impressive macro level gains of the 1980s, as the 1990s unfolded there was “an unusually rapid widening of income inequality . . . a much retarded rate of poverty reduction in the countryside . . . and a significant increase in absolute poverty in the towns and cities.”

The SOEs still control the “commanding heights” of the economy—steel, oil, autos, air-
planes, and so on. In comparison to the country’s largest fully private firm, together the two state-owned oil companies have revenues of more than eighty billion dollars and are comfortably placed on the Fortune Asia 25 list. In this sector, one finds that instead of the massive privatization that took place in the former Soviet Union with such disastrous effect, the regime has continued to feed the enterprises massive amounts of credit, recycling the savings of China’s billion people into outdated and poor-performing industrial behemoths.

These enterprises are truly from a different age—the age of Soviet-influenced heavy industry or the American variant, the massive auto complex at Ford’s River Rouge. These plants were, like their Soviet, American, or East European counterparts, impressive achievements—fifty years ago. But by world terms today, they are bankrupt. The regime is in a trap of its own making. Having created this heavy industrial base, it has also created a massive industrial working class—or rather, its working class created this massive industrial base, through brutal forced labor in the fifties and sixties. But to restructure now in a fashion that would allow these companies to be globally competitive will require huge layoffs and huge new capital investment. To make the PetroChina initial public offering credible to global capital markets required the layoff of hundreds of thousands and a promise to push billions in debts back to its state-owned parent company.

The regime believes that the only way it can preserve its own power is to keep “muddling through,” in Studwell’s words. Thus, the regime allows foreign companies to set up assembly plants in the special economic zones in coastal areas and, in the niches not already occupied by the state sector, encourages a limited domestic private sector to evolve from below. But it cannot allow the resulting inequalities and poverty this process causes to become so extreme that workers revolt. The regime fears a social explosion, called by the Chinese da luan, or total chaos, a fear made real by the labor insurgency now underway in the oilfields run by PetroChina. The pall of Hungary in 1956 and Poland in 1980 hangs over the Chinese Communists.

Meanwhile, the regime feeds enough credit to the SOEs to keep them alive, conditioning the credit on hoped-for restructuring, but not giving so much credit that inflation is unleashed. Inflation has been a continuing problem, causing the regime to punctuate the growth of the last two decades with periods of harsh austerity. What many in the West view as a struggle between hard- and soft-liners, or between a Maoist left and a market socialist right, is really a reflection of managing a business cycle with “Chinese characteristics.”

This is a risky business. The price controls of the late 1980s certainly tamed an inflation rate that reached 50 percent in 1988, but the austerity was a key factor in triggering the 1989 social revolt centered in Beijing’s Tiananmen Square. The protests received widespread popular support with marches of a million workers or more in several major cities. The regime could only kill the movement by relying on the murderous efficiency of crack troops from the People’s Liberation Army. After hundreds were killed, controlling wages was much less of a problem for several years.

But “muddling through” may not be sufficient. The credit that sustains the process must come from somewhere. The free trade zones on the Chinese coast are fed by foreign direct investment. But the SOEs and the domestic private sector rely on the recycling of the huge savings of ordinary Chinese people. Since the banking system is state owned and, in theory, the renminbi is not convertible into foreign currencies, Chinese workers, peasants, and small businesses are forced to finance the continued capital accumulation drive of the communist regime. The whole game depends on the regime’s continuing top-down control of that financial system. Thus, Studwell notes, promises in the early 1980s that the currency would be convertible as early as 1993 are now put off well into the future.

Of course, if the renminbi were freely tradable on the world markets, and if ordinary Chinese savers could freely hold their savings in foreign banks or invest them in the equities of European or American companies as their counterparts do in the West and much of Asia, there would be a massive bank run as the value
of Chinese assets would be forced to come into line with global values. The pressure on domestic values is so great, Studwell argues, that even without convertibility or an opening of the financial sector, a bank run is still a possibility. "Everything comes down to psychology . . . the psychology of the ordinary Chinese people," he notes.

From this vantage point, events like those of 1989 take on new meaning. In Studwell's eyes, here is where the world may finally wake up from its China Dream. In the case of China, the "hot money" that sparked the Asian financial crisis of the late 1990s is actually represented by the domestic savings of ordinary Chinese. The regime's credibility, and therefore its power, depends on maintaining the credibility of its economic policy. It is not just that the regime fears a Solidarity-like protest movement rising up in reaction to political repression or unemployment; it also fears the tearing away of the veil that covers up the country's financial fragility. This could cause the population to lose faith in the regime and, in turn, trigger a massive political upheaval.

What are the escape routes for the regime? A massive debt-for-equity swap is one. Because the debts the state has piled up using domestic savings must actually be repaid and in the meantime must pay interest, they can get very expensive. The state-owned banks now hold massive amounts of nonperforming loans made to the SOEs and the TVEs. And the government has huge unfunded pension liabilities. Studwell estimates a debt to equity ratio of nearly 500 percent for the state sector—outstripping even South Korea on the verge of its economic collapse in 1997. By creating stock markets, the regime has tried to encourage Chinese savers to invest instead in equity issued by these same state companies. The regime dreams of mutual funds rescuing it from the pension trap it faces. Equity holders typically expect capital gains over time and hope that inside managers will pay out regular dividends, but neither is legally mandated. Corporate insiders in China need not fear the disciplinary effect of a potential takeover by competitors or financial players because there is, as of yet, no competitive market for corporate control in China. This shift to equity finance explains the stock market mania that hit China in the 1990s. The regime engaged, it appears, in a massive "pump and dump" scheme touting share ownership in companies that may actually be worthless. In the first half of 1992, the Shanghai stock market index registered a gain of 1200 percent.

A second strategy has been to turn to foreign stock markets, first in Hong Kong, but more recently to the New York Stock Exchange. There, Chinese companies have had less success. The pump and dump has not fooled quite as many investors. Whereas Chinese companies trade their stock both at home and on the Hong Kong exchange, the shares sold in Hong Kong, Studwell notes, trade at a substantial discount, as much as 85 percent, giving some idea of the discount factor that one might have to apply to the entire Chinese economy if its assets were freely tradable.

Finally, the regime has encouraged the establishment of foreign investment in the so-called Special Economic Zones. But even their explosive growth makes a small dent in this massive country. More important, their potential future growth is limited. Most of these plants are only final assembly points in a global assembly line, so that the value added by Chinese workers is a small percentage of top-line revenue. The sector shipped $150 billion worth of goods in 2000, but less than 25 percent of that was value added in the free trade areas in China. The state sector cannot compete in quality and reliability with the foreign suppliers that feed parts into the assembly plants. In addition, the companies are heavily dependent on the infrastructure provided by coastal proximity to Hong Kong and Taiwan. Interestingly, as Khan and Riskin note, despite what free trade theory might predict, the industrialization in this and the TVE sectors "so far . . . have been quite employment-hostile" with a "drastic" decline in increases in employment even as output spurted ahead.

Studwell and Khan and Riskin slowly but surely puncture the China Dream. Western companies that thought the era of reform would open up a market of 1.2 billion consumers are, Studwell says, "waiting for Godot."
Hundreds of millions of dollars have been wasted on exploratory projects pushed by overly ambitious Western CEOs, investment bankers, and government trade representatives. The reality is that China is still controlled by an opaque undemocratic regime that has its own plans. Its drive to accumulate and to compete with the rest of the world on the basis of that accumulation process has not lessened despite appearances to the contrary.

Is there a viable alternative? Perhaps. Studwell wants the state to get out of the economy altogether, yet he argues that only state power can simultaneously prevent the collapse of the currency and the banking system and keep the lid on social protest. More promisingly, Khan and Riskin outline an ambitious set of policy reforms that emphasize balanced growth and social equity. Unfortunately, they leave out any assessment of the political reality of modern China. They suggest that the state must undertake these reforms, but there is scant evidence of any significant base of support within the existing Chinese state interested in balance and equity as opposed to accumulation and competition. As they rightly point out, the regime consciously set about to increase inequality in order to force competition among sectors of the population.

If the direction in which Khan and Riskin point—a process of genuine economic development in China based on balance and equity—became part of the program of an independent and democratic Chinese labor movement, then a very different future for the country could open up.

Stephen F. Diamond teaches international economic law at the Santa Clara University School of Law in Santa Clara, California.

The New Killing Fields: Massacre & the Politics of Humanitarian Intervention

Introduce your students to our extraordinary Winter 2002 issue, which brings together in one collection the essays of some of the most accomplished and engaged journalists and public intellectuals working today. Many of these authors have written full-length books on these subjects. Here, their essays function both as introductions and supplements to their longer work. Nowhere else will you find such a diverse yet highly focused examination of these issues.

Accounts from Yugoslavia, Rwanda, and East Timor by such writers as David Rieff, Peter Maass, Joanne Barkan, Bill Berkeley, Darryl Li, Geoffrey Robinson, and Erin Trowbridge, essays by Nicolaus Mills, Michael Walzer, and Michael Ignatieff, and book essays by Susie Linfield, Laura Secor, and Jeffrey C. Isaac give your students perspective and depth.

In addition, the Spring issue of Dissent continues the discussion with articles by William Shawcross, Kira Brunner, George Packer, Richard Lloyd Parry, and Samantha Power.

For information about classroom orders, e-mail: editors@dissentmagazine.org or call 212-316-3120.