Some Possible Lessons for Japan from China's Economic Reforms

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I. Introduction

China's economy has grown by an average of nearly 10% a year since the country embraced economic reform in 1978. In contrast, Japan's economy has been stuck in a rut ever since the asset boom of the 1980s turned to bust in the 1990s. We think Japan may have much to learn from China's experience in its attempts to revitalize its economy.

In our view, China owes its high rate of economic growth during the past 30 years not to the fact that it has adhered to socialism but to the fact that it abandoned it. China has not merely made the transition from a planned economy to a market economy; it is well on the way from socialism to capitalism, as we can see from the spread of privatization.

Alongside moving to a market economy, China has gradually opened up by, for example, creating special economic zones and granting preferential treatment to foreign-funded companies. In particular, it has gone from a state of partial opening up before it joined the World Trade Organization in 2001 to one of full-fledged opening up in which the economy has become increasingly integrated with the global economy. By opening up, China has not only gained access to foreign capital and technology; it has also gained access to new ideas, concepts and systems. Furthermore, increasing competition from overseas has even forced inefficient state-owned enterprises to exit the domestic market.

China's experience suggests that fostering a new system is strategically more important for successful reform than changing the old system. Yet another point is that, like China’s non-state-owned sector (private and foreign-funded companies) in its initial stages, no matter how weak a new system is or what its shortcomings are, it is a mistake to ignore its potential. China's experience of economic reform suggests to us that Japan needs to focus more on growth industries and venture businesses than on mature industries and large companies. Also, it might do more to encourage inward direct investment.

II. The transition to a market economy

The 1949 Communist Revolution in China led to the introduction of a planned economy in which private property in any shape or form was abolished and the production or exchange of goods for profit was banned. Only public ownership (in the form of state-run enterprises and collectives) was allowed, and there were no private or foreign-funded companies. Due to the inefficient allocation of resources and low morale of the workforce under this system, China's economy became stuck in a rut for many years. The gradual transition to a market economy that started in 1978, however, prompted people to use resources more efficiently as they began to pursue their own self-interests, and the principle of competition (Adam Smith's "invisible hand"), according to which only the fittest survive, has come into play.

Traditional socialism is based on the three principles that income should be distributed according to work, that the distribution of resources should be planned, and that ownership should be public and centered on state-owned enterprises. This is in stark contrast to capitalism, which is based on the principles that income should be distributed according to the contribution of the factors of production (including capital), that resources should be distributed by the market, and that the right to private property should be respected. Unlike Russia, China did not opt for "shock therapy" and try to introduce capitalism overnight. Instead, it took its time over reform, gradually replacing the three principles of socialism with those of capitalism in the above order.

During the first stage of reform (from 1978 to 1992) China gradually abandoned the principle that income should be distributed according to work. In rural areas, people's communes set up according to the principle of "rice cooked in a large pot" (meaning that everyone was treated equally regardless of whether or not they worked, i.e., egalitarianism) were broken up, and the household responsibility system was introduced. In industry, companies were allowed to pursue profit, according to the principle of "devolving authority and conceding profits" (meaning that companies were allowed to retain profits in exchange for accepting responsibility for their results). Allowing economic agents to pursue their own self-interests in this way stimulated China's economy. At this stage, however, the economy was still dominated by state-owned enterprises and the planned economy. Like private property, the market economy was still regarded as a necessary evil.

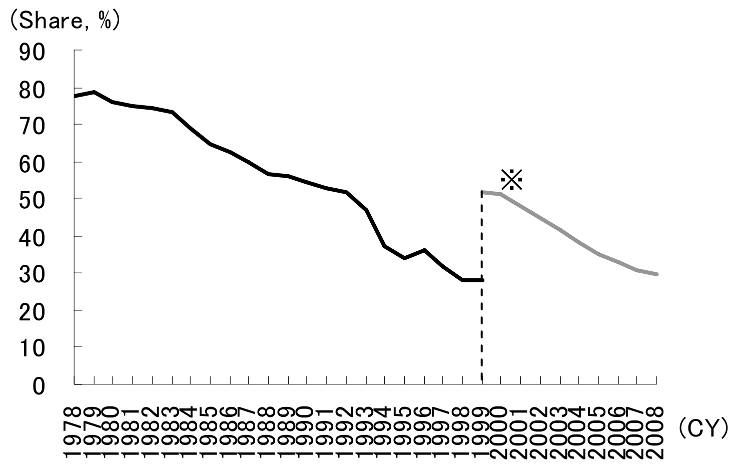
Following Deng Xiaoping's famous speech during his tour of south China in early 1992, the Communist Party decided at its 14th National Congress, held later that year, to make the creation of a "socialist market economy" the goal of economic reform. As a result, the market came to play a more important role than government planning and administrative guidance in the allocation not only of consumer goods but also of producer goods, labor, land and capital.

As the transition to a market economy progressed, private companies grew rapidly. However, many state-owned enterprises were unable to stand the increasingly fierce competition and faced growing difficulties, while the state-owned banks from which they had borrowed saw their nonperforming loans mount. It became increasingly clear that the government would eventually have to bail out the loss-making state-owned enterprises and banks, and that the productivity and profitability of private companies was far superior to that of state-owned enterprises.

As a result, in the mid-1990s the Chinese government began to privatize state-owned enterprises according to the principles of "keeping the large and releasing the small" and "the Strategic Realignment of the State-Owned Economy." While "keeping the large and releasing the small" restricted privatization to small state-owned enterprises, the Strategic Realignment of the State-Owned Economy led to the complete withdrawal of state-owned enterprises (including even large ones) from sectors where they competed with private companies, leaving state ownership of enterprises in only a few sectors of strategic public interest. The privatization of small state-owned enterprises was often done using management buyouts (MBOs). However, privatization of large state-owned enterprises was stymied by the fact that most of the shares in listed companies were owned by the state and could not be traded. However, following the stock market reforms that began in 2005, significant progress was made in ensuring that all shares owned by the state could be traded, thereby allowing even large state-owned enterprises to be privatized. At the same time, a start was made on privatizing China's state-owned commercial banks, with China Construction Bank, Bank of China and Industrial and Commercial Bank of China listing on the Hong Kong and Shanghai stock exchanges.

While China's state-owned enterprises have been gradually privatized, companies in its non-state-owned sector (private and foreign-funded companies) have grown (Figure 1). As a result, factors of production such as labor and capital have moved from inefficient to efficient sectors, raising the productivity of the Chinese economy as a whole.

Figure 1: State-owned enterprises' declining share of industrial production



Note: ※ marks a change in the universe in 1999 from all companies to only (1) state-owned enterprises and (2) non-state-owned enterprises of a certain size (namely, annual sales of RMB5 million or more). The effect of this is to increase state-owned enterprises' share. Also, we have substituted principal operating revenue for industrial production for the period since 1999.

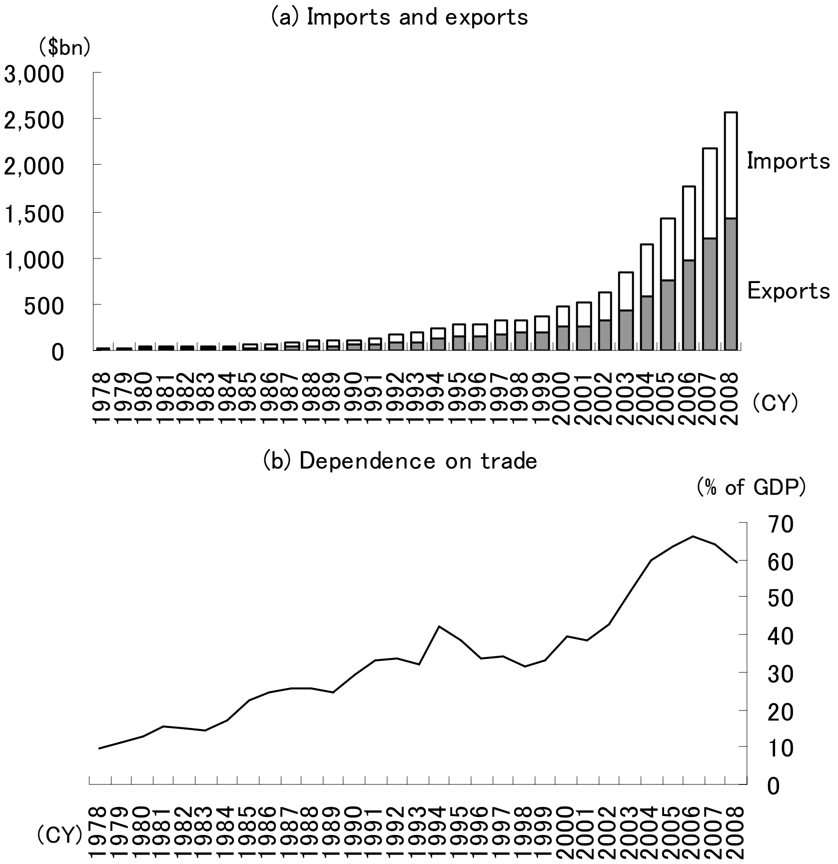
Source: NICMR, from National Bureau of Statistics, *China Statistical Yearbook* and *China Statistical Abstract* for each of the years concerned

III. No reform without opening up

Alongside moving to a market economy, China has gradually opened up by, for example, creating special economic zones and granting preferential treatment to foreign-funded companies. In particular, it has gone from a partial openness before joining the World Trade Organization in 2001 to full-fledged opening up in which the economy has become increasingly integrated into the global economy. The change is reflected in the fact that China has become much more dependent on trade (total imports and exports as a percentage of GDP, Figure 2). Furthermore, foreign-funded companies now account for just under 60% of both imports and exports.

Through trade and inward direct investment China has been integrated into the global economy according to its comparative advantage. In order to catch up with the developed economies in the 30 years following 1949, China pursued a policy of concentrating its efforts on developing heavy industry. However, any attempt to force economic development in a way that did not accord with China's comparative advantage (namely, by concentrating on capital-intensive heavy industry) inevitably

Figure 2: China's growing dependence on trade as result of growth in imports and exports



Source: Source: NICMR, from National Bureau of Statistics, *China Statistical Abstract 2009* required government intervention and government control of how companies were run. Far from achieving the goal of catching up with the industrialized economies, China's reliance on this sort of planned economy only impeded economic growth and left its people no better off for many years. After China embraced economic reform in 1978, this strategy was abandoned and, as a result, the focus on heavy industry gave way to one that allowed light industry to drive economic development and exports in a way that accorded more with China's comparative advantage. Foreign-funded companies queued up to set up operations in China in order to take advantage of its low labor costs. In turn, this enabled China to acquire foreign capital, technology and business know-how.

Furthermore, opening up has done much to stimulate domestic reform. In a closed economy inefficient systems can survive for many years in the absence of competition and a standard for comparison. In an open economy, however, efficiency is the basis for comparing different systems, and people accept a market economy and the existence of non-state-owned companies when they see the shortcomings of a planned economy and state-owned enterprises. It was the very inefficiencies of China's state-owned enterprises seen in comparison with private and foreign-funded companies that prompted the state-owned enterprises to reform and to withdraw from competitive sectors of the economy.

Also, by opening up, China gained access to new ideas, concepts and systems. In particular, when joining the WTO in 2001, China adopted many new policies, including increasing the transparency and accountability of the government and deregulation, which were needed to meet WTO rules. Opening up is therefore a key element of reform. If it had not opened up China would probably not have enjoyed the economic development we see today.

IV. The distinctive features of China's gradualist approach to reform

In its transition to a market economy, China has followed a gradualist approach to reform rather than the "Big Bang" approach or "shock therapy" advocated by Washington D.C.-based institutions such as the International Monetary Fund (the so-called Washington Consensus).[1] In contrast to Russia and Eastern European countries, which were hit by an economic crisis after they set off on the aggressive path to reform in the 1990s, under the less disruptive path it chose China achieved a high rate of growth for a long period while maintaining social stability.

The most distinctive feature of China's gradualist approach has been to experiment with reforms before adopting them. If a reform proved successful in the experimental stage when applied to particular areas or enterprises, it was then adopted nationwide. For example, in 1980 China started opening up by establishing four special economic zones, including Shenzhen; then it extended this reform first along the coastal regions and, finally, to all parts of the country. Similarly, when China began to reform its corporate sector in 1978, it began by granting more managerial autonomy to just six state-owned (in those days still called "state-run") companies in Sichuan Province; and when it later embarked on other key reforms such as the household responsibility system and the shareholding system each time it began by first trying it out on a small scale. This strategy has the twofold advantage of limiting the damage if reforms prove unsuccessful while winning support for them if they prove successful.

Another distinctive feature of China's gradualist approach has been to retain the old system while little by little extending the application of the new system. At the early stage of reform, new market economy-based rules were applied to the non-state-owned economy (such as township and village enterprises), new products, or special economic zones on one hand. On the other hand, state-owned enterprises were still subject to target levels of production, input and profits to be submitted to the government. However, input and output exceeding those targets was allowed to be traded on newly developed markets whose scope had widened from raw materials and finished goods to labor, foreign currencies, and capital. During this transition period, the planned economy coexisted alongside the market economy for a long time as a

1 The "Washington Consensus" was originally discussed as an approach to economic development rather than as a transition strategy. The originator of the concept, John Williamson, set out a list of recommended reforms to attain economic development in his paper "What Washington Means by Policy Reform" (in John Williamson, ed., *Latin American Readjustment: How Much has Happened?* Washington D. C.: Institute for International Economics 1990). The ten recommendations are: (1) fiscal policy discipline, (2) less indiscriminate income redistribution, (3) more spending on public services such as education and healthcare, (4) broadening the tax base and adopting moderate marginal tax rates, (5) market-determined interest rates, (6) competitive exchange rates, (7) trade liberalization and the liberalization of inward foreign direct investment, (8) the privatization of state enterprises, (9) the easing of regulations that impede market entry and exit, and (10) legal security for property rights. The economic reforms that China adopted have largely followed these recommendations and have enabled it to make remarkable progress in development. In our view, China's dramatic economic growth of the last 30 years supports rather than refutes the Washington Consensus.

"dual-track system" both in the economy as a whole and in its various components such as the corporate sector, price formation, trade, and foreign exchange. Typical examples are the coexistence of the state-owned and the non-state-owned sectors, the dual pricing system for the same goods (a planned price and a market price), and the dual exchange rate system under which the state-owned sector and the non-state-owned sector, such as foreign-funded companies, were subject to different rates, until 1993.

In order to ensure that economic reform goes smoothly, government has to ensure that as many people as possible benefit while as few as possible suffer. Compensating the losers through transfers of income from the gainers is one effective way of reducing opposition to reform. For example, the dual pricing system, which set separate prices for activities covered by a plan, at first enabled China’s state-owned enterprises to obtain raw materials and foreign currencies at a lower cost than if they were purchased in the market. This system therefore contained a mechanism for safeguarding vested interests.

Eventually, however, simply respecting vested interest and delaying reform of the old system for too long will result in lower economic growth overall and force the government to adopt a more radical approach to reform. If a gradualist approach is to succeed, growth of the new system has to create the conditions in which the old system can be reformed.

In China's case, the rapid growth of the non-state-owned sector has done just this. During the last 30 years the proportion of industrial production accounted for by the state-owned sector has declined from 80% to under 30% while the non-state-owned sector (private and foreign-funded companies) has replaced it as the driving force of the economy. Not only has the non-state-owned sector created jobs that could be filled by those losing jobs as a result of reform of the state-owned sector, but also many non-state-owned companies have taken over declining state-owned enterprises.

In contrast, the decision by Russia and Eastern European countries to opt for radical reform caused a great deal of friction and social unrest as well as leading to an economic crisis. In planned economies the main cause of failure has tended to be the inability of the authorities to keep track of and adapt to the constant changes in production technology and consumer preferences. Ironically, those Western economists who have argued in favor of shock therapy have made the same mistake as Marxist economists who have argued that planned economies are superior to market economies: namely, they have underestimated the difficulty of getting accurate information. Shock therapy assumes that the authorities are able to know in advance how economic agents will react to their policies under the new system. In reality, however, the authorities can only obtain very incomplete information about this new world and, moreover, they have little room to alter course if something unexpected happens after the starting pistol has been fired. Furthermore, while shock therapy may be a good way of destroying an old system quickly, creating a new system inevitably takes a long time and entails a disruptive transition.

IV. The economic reforms Japan needs to implement

Since 1990, the Japanese economy has been stuck in a rut while the Chinese economy has experienced a great leap forward. The difference in the progress of the two economies can be related to the extent of economic reforms each has realized.

At one time, Japan was held up, somewhat facetiously, as socialism’s only success. Since its "lost decade" (two decades?), however, Japan has exemplified the failure of socialism. In Japan, socialist values, such as a tendency to depend on the government and a strong preference for equality over efficiency, still widely obtain in practice, even though Japanese acknowledge, in principle, the need for greater competition in order to stimulate the economy.

Japan is, in fact, a highly equal society by international standards. Hence, it should put more emphasis on differentiating rewards according to performance than on equality. Former Prime Minister Junichiro Koizumi’s press for reform with "no sacred cows" aimed at such a change, but his program largely failed because of fierce resistance from vested interests at both the planning and implementation stages.

Reform is always a painful process. Even when reforms promise to increase the size of the economic pie for everyone, they are not always implemented. Because the benefits are not always distributed equally, although everyone may agree on reform in principle, those who are likely to suffer tend to object when it comes to putting reforms into practice.

China's experience of economic reform suggests that fostering the new system is strategically more important for success than changing the old system. Furthermore, it is a mistake to ignore the potential of the new system no matter how weak it is in its initial stages or what its shortcomings are. In China’s case, a critical part of the reform was to support the development of the non-state-owned sector (private and foreign-funded companies) not just to wind down the old state-owned system. Learning from China’s experience, Japan should focus on fostering growth industries and venture businesses rather than on supporting mature industries and large companies. Also, it might do more to encourage inward direct investment. The entry of more foreign-funded companies into the Japanese market could bring not just a transfer of technology and resources but also more competition.

In Japan, efforts to safeguard vested interests have impeded reform. Since the asset boom of the 1980s turned to bust, in the name of stimulating the economy, one government after another has sunk a total of more than ¥100 trillion in, mature, declining, sunset industries such as construction. This misguided strategy lowered the investment efficiency of the economy as a whole and delayed the upgrading of the country’s industrial structure. China's experience highlights the importance of balancing the safeguarding of vested interests with supporting development of the new, post-reform system.

The idea that fostering a new system is more important than changing the old system is relevant to Japan’s hollowing out problem. There is a consensus that industrial upgrading is necessary in order to avoid hollowing out. The search for new growth sectors should not be limited to manufacturing but should extend to include the service sector, which is still less productive in Japan than in other industrialized economies. There remains plenty of room for this sector to grow, if sufficient deregulation is achieved. A transition to a postindustrial society through expansion of the service sector is a common pattern for industrialized economies and should not be confused with hollowing out. Industrialized economies need to develop new industries that reflect the growth of information technology, software and networking, and not limit themselves to the traditional boundaries of manufacturing. Unfortunately, Japan's past successes make it more difficult for it to think along these new lines.