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Economic Policy Management in China: Lessons for Developing Countries

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Abstract

China's economic reforms under Deng Xiaoping have ushered in an unprecedented rate of economic growth. As international firms seek to expand business investment and trade with China, China's approach to economic reform can be most clearly understood within the context of its own historical experience as well as that of its East Asian neighbors. Moreover, there are important questions regarding the nature of China's economic reforms, both for China's prospects for continued economic growth, as well as for other developing countries.

China's economic reforms have been shaped by three major determinants. First, Chinese leaders have sought to restore China's relative economic position in the Pacific Rim economy, drawing on the experience of its East Asian neighbors. Second, as China's reforms have led to a market-oriented economy, emphasis has been given to continued government control, particularly in light of the collapse of the Soviet Union and the ending of the Cold War. Third, China's economic reforms have been driven by a sense of ending historical isolation of the country, in particular by periodic foreign occupations.

China's strategy for economic reform has consisted of five underlying measures. First has been a commitment to market socialism, by which China retains the vast majority of state-owned enterprises that were established during previous efforts to achieve rapid industrialization. Second, drawing on the experience of its East Asian neighbors, China has engaged in a policy of economic mercantilism. China's mercantilism has meant the creation of export-oriented economic policies designed to create a surplus in the balance of trade and payments. Third, China has used its growing economic strength to attract and direct selected private foreign investment to key industries for technological innovation and export expansion. Fourth, China has begun a process of governmental reform to re-focus public sector intervention on building up China's human resource and physical sector infrastructure. Finally, China has continued with a program of demographic restraint designed to accelerate, in concert with the above economic reforms, the growth in China's per capita GDP.

With the exception of market socialism and demographic restraint, China's economic reforms are similar to the policies of many of its East Asian neighbors. China already has begun to generate trade surpluses and increased inflows of direct foreign investment. As long as these surpluses do not generate critical friction with its international trading partners, China will undoubtedly pursue mercantile policies for the forseeable future, even though the limits of mercantilism already have begun to show in such historically successful countries as Japan.

China's economic reforms offer a number of interesting insights for other developing countries. First, market socialism is not a necessary condition for economic growth, as its East Asian neighbors have demonstrated. Second, export-driven mercantile policies can, in the short run, generate trade and balance of payments surpluses that can accelerate a country's rate of economic growth. Third, targeted foreign investment inflows can have some beneficial effects on a country's rate of economic growth. Fourth, China's efforts to redirect public sector resources to infrastructure development is already well under way in other developing countries, and thus does not offer anything new. Fourth, China's program of demographic restraint may be a sufficient condition for economic growth, but it is not a necessary one. Finally, as economic growth proceeds, sustainability requires a convergence of economic norms, for which the ultimate direction is the classic model of free international trade.

I. Introduction

Anyone who has observed China's economic performance during the past ten years cannot fail to be impressed by the extraordinary rate of growth that has accompanied the liberalization policies of Deng Xiaoping.[1] With the passing of Deng in 1997 and the assumption of power by President Jiang Zemin, the policies of the Deng era are likely to be continued, thus raising the prospect of continued economic growth in the Chinese economy. Since China has achieved such extraordinary economic success in a relatively short period, it is useful to ask what lessons there are in the Chinese experience for developing countries. To do so, we first look at the determinants of China's economic policies, then examine the strategy of China's economic reforms under Deng Xiaoping. We then look at how these reforms resemble the economic management of other successful Asian economies, and finally, what lessons they offer for developing countries.

II. Determinants of China's Economic Management Policies

A. Regaining China's Relative Economic Position

China's economic policy management has been driven by three fundamental considerations. First, with the emergence of high performing Asian economies during the 1960's, it was increasingly clear that for China to retain an important role in the regional and emerging global economy, it would have to engage in a process of reform somewhat along the lines of those of its Asian neighbors. Deng Xiaoping was the primary architect of these economic reforms in China, which began during the early 1980's as China backed away from traditional Communist ideology in favor of market driven policies.[2]

Prior to Deng's rule, China's largely closed economic policies clearly were producing lower rates of growth than those of its neighbors, particularly Japan. As China's relative position became more obvious, it generated growing pressure for change. The passing of Mao Tse Tung in September 1976 set into motion the shift in political leadership that was essential to economic reform. As Deng became Chairman of China's political leadership, economic reform began to accelerate.

Throughout the 1980's down to the present, China's economic reforms have produced rates of growth that have given it a growing share of regional economic output. Figure 1 illustrates the relative difference in China's economic policies preceding and during the era of Deng Xiaoping. During Deng's rule and beyond, at current rates of growth, China stands well to displace Japan within the next two decades, a fact not lost on either the Chinese or their Asian neighbors.

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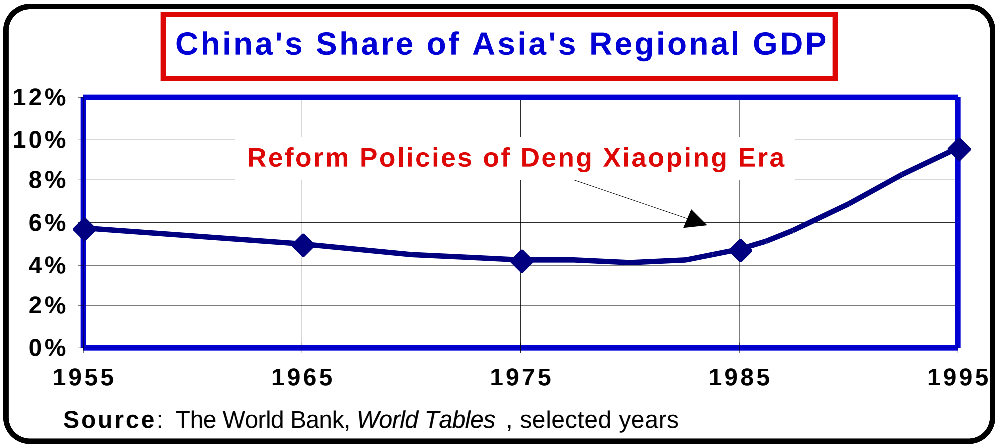
[1] For the 1985-1995 period, China's annual rate of growth was the highest in the world. As a comparison:

Country	1995 GDP($U.S.billions)	1995 GDP per capita	1985-1995 GDP Growth Rate
China	$ 691	$ 571	11.55%
S.Korea	$ 415	$ 9,159	8.00%
Thailand	$ 165	$ 2,730	7.90%
Singapore	$ 84	$27,900	7.35%
Indonesia	$ 197	$ 1,007	6.85%
Malaysia	$ 82	$ 4,131	6.80%
Hong Kong	$ 144	$23,161	6.30%
Taiwan	$ 256	$12,005	5.60%
United States	$6,648	$26,500	2.75%
Japan	$4,871	$38,844	2.65%

[2] For a recent analysis, see Robert Ash and Y.Y.Kueh, editors, *The Chinese Economy Under Deng Ziaoping* (New York: Oxford University Press, 1996).

Figure 1



B. Political Stability as a Condition of Economic Reform

A second determinant of China's economic policies is the need for political stability as a condition for continued economic reform and growth. Although China's economic reforms were already well under way prior to the Soviet collapse, the failure of Gorbachev's economic reforms under perestroika, and the rejection of Communist control that came with Boris Yeltsin's rise to power, caused considerable concern in China. China's leadership decided that continuing political control was essential to the process of economic reform.[3] It is this comparison as much as anything else that explains why China's leadership was willing to risk world criticism with its decision to repress political dissent in Tiananmen Square on June 3-4, 1989.[4]

China's relations with the Soviet Union had gone through a number of shifts since the early 1950's, when both countries were committed to mutual cooperation.[5] As events unfolded, and as China became estranged from its Russian partnership, there was growing concern that with the end of the Cold War, political chaos could ensue in China, much as it

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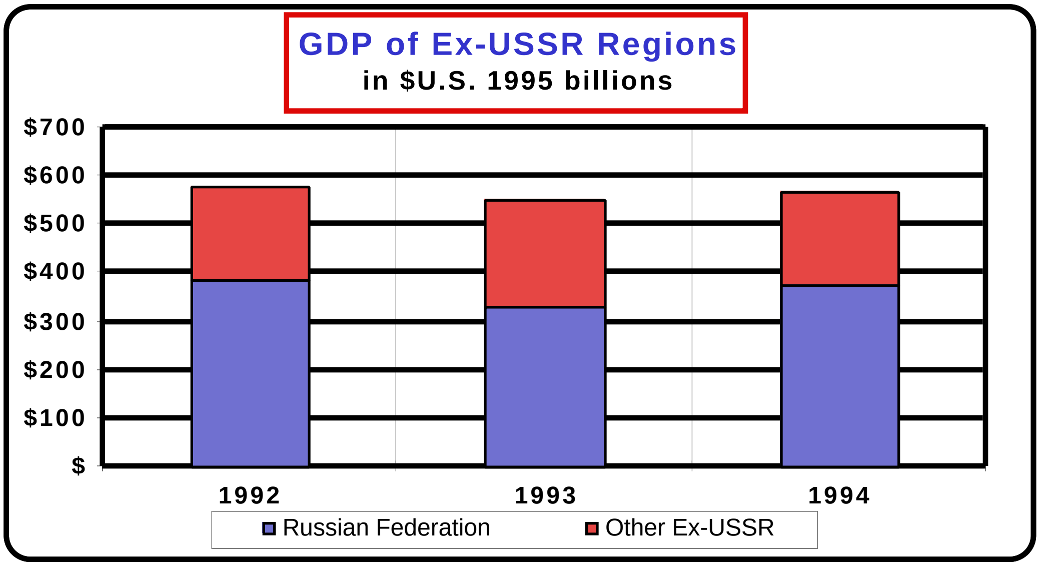
[3] It is useful to compare Mikhail Gorbachev's *Perestroika: New Thinking for Our Country and the World* (New York: HarperCollins, 1987) with Boris Yeltsin, trans. Catherine A. Fitzpatrick, *The Struggle for Russia* (New York: Times Books, 1994), in which Gorbachev's attempts to revitalize a flagging Communist system stand in clear contrast to the repudiation of Communism by Yeltsin.

[4] There is an extensive literature on the events in Tiananmen Square that has focused on the specific circumstances of the time and their meaning for the process of political and economic reform in China. China's leadership has referred to this as an incident and has affirmed that it would not impede the process of continuing economic reform, as events since that time have borne out. For references, see Lee Feigon, *China Rising: The Meaning of Tiananmen* (Chicago: I.R. Dee, 1990); Merle Goldman, *Sowing the Seeds of Democracy in China: Political Reform in the Deng Xiaoping Era* (Cambridge: Harvard University Press, 1994); and James Miles, *The Legacy of Tiananmen* (Ann Arbor: University of Michigan Press, 1996).

[5] There is an extensive literature on Soviet-Chinese relations from the period of the Russian revolution to the rise of Mao Tse Tung in China and the subsequent decline in international relations. Standard references include: A. Doak Barnett, *Communist China and Asia* (New York: Vintage Books, 1960); and, Howard L. Boorman, Alexander Eckstein, Philip E. Mosely, and Benjamin Schwartz *Moscow-Peking Axis: Strengths and Strains* (New York: Council on Foreign Relations, 1957). For more recent sources, see: Marshall Goldman, "China Rethinks the Soviet Model," *International Security* (Fall 1980); and by the same author, *U.S.S.R. in Crisis: The Failure of an Economic System* (New York: W.W. Norton, 1983).

seemed to be unfolding in Russia.[6] Today, China's leaders have not hesitated to point to the political chaos that surrounded the radical reforms in Russia and why they view this as contrary to the need for sustained economic growth and development.[7]

Figure 2



Source: World Bank, *World Development Report*, 1996.

Figure 2 illustrates the economic changes that accompanied the collapse of the Soviet Union in 1991. The Russian Federation represented the core economy, while twelve countries along the periphery declared their independence in a sequence of events from 1991 through 1995. As this process unfolded, the Gross Domestic Product of the Russian Federation and the newly independent states declined from 1992 to 1993, and then began a process of gradual recovery in 1994.[8]

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[6] See Anders Aslund, *Gorbachev's Struggle for Economic Reform*. Ithaca (New York: Cornell University Press, 1991); David Remnick, *Lenin's Tomb: The Last Days of the Soviet Empire* (New York: Random House, 1993); John B. Dunlop, *The Rise of Russia and the Fall of the Soviet Empire* (Princeton: Princeton University Press, 1993); Jack Matlock, *Autopsy of an Empire: An American Ambassador's Account of the Collapse of the Soviet Union* (New York: Random House, 1995); and Mikhail Gorbachev, *Perestroika: New Thinking for our Country and the the World* (New York: Harper/Collins, 1987).

[7] See Gao Shangquan and Chi Fulin, editors, *Theory and Reality of Transition to a Market Economy* (Beijing: Foreign Languages Press, 1995), pp. 13-14.

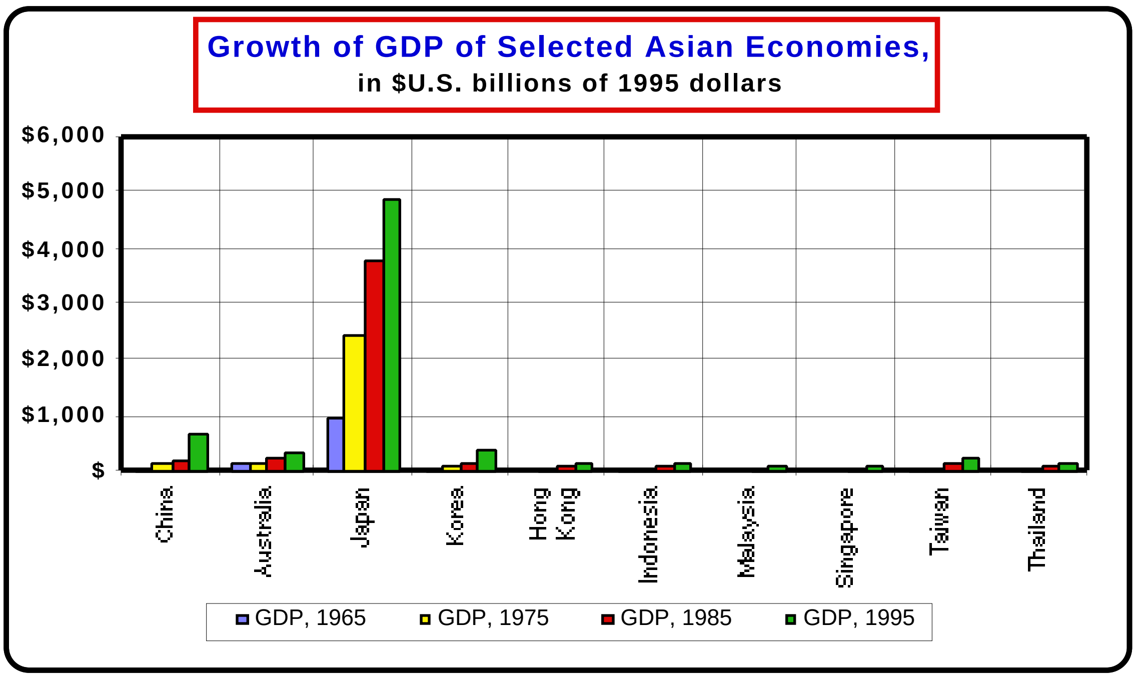
[8] As of 1996, outside of former countries of the Warsaw Pact and the Council on Mutual Economic Assistance Countries (COMECON), the former Soviet Union had dissolved into a smaller Russian Federation, with twelve independent countries. Economic data for 1994 for these countries are given as:

Country	GDP (U.S. $billions)	Population	Per Capita GDP
Russian Federation	$376.55	148.3	$2,539
Belarus	$ 20.29	10.4	$1,951
Ukraine	$ 91.31	51.9	$1,759
Armenia	$ 2.61	3.7	$1,172
Kazakstan	$ 18.17	16.8	$1,081
Uzbekistan	$ 21.51	22.4	$ 960
Moldova	$ 3.67	4.3	$ 854
Azerbaijan	$ 3.54	7.5	$ 472
Georgia	$ 2.06	5.4	$ 382
Tajikstan	$ 2.01	5.8	$ 346

The end of the Cold War and the collapse of the Soviet Union left China as the still largest remaining Marxist state. Since Marxist economic policies had proven a failure, China's leadership began a process of emphasizing a shift to a market socialist economy. Although market socialism had been advocated in Russia by such reformers as Evsei Liberman as far back as the 1960's, and had formed the cornerstone of economic reforms in Yugoslavia, Poland, and Hungary, China's leaders considered that a market socialist model could work to serve a dual purpose.[9]

The first objective would be to raise economic growth around market reform policies, and the other would be to retain a strong degree of political control, and for which the unfolding collapse of the Soviet political system was often cited as a basis for action.[10] As long as China's economic growth continues, this strengthens the government's claim to legitimacy to both the internal population and to outside observers.[11]

Figure 3



Source: World Bank data tables.

Latvia*	$ 5.82	3.7	$2,327
Lithuania*	$ 5.22	3.7	$1,412
Estonia*	$ 4.58	1.5	$3,052
Total/Average:	$557.34	285.4	$1,953

(* These countries had been annexed by the Soviet Union in 1940 during the Second World War and were often classified as outside of the Soviet Union, though part of the Warsaw Pact group of countries).

[9] E.G. Liberman, *Economic Methods and Effectiveness of Production* (White Plains, N.Y.: International Arts and Sciences Press, 1971). See also, R.C. Stuart, "Evsei Grigorevich Liberman," in G.W. Simmons, ed., *Soviet Leaders* (New York: Crowell, 1967), pp. 193-200.

[10] *Op.cit*., Gao Shangquan and Chi Fulin,*Theory and Reality of Transition to a Market Economy*, chapter 1.

[11] As an example, Gao Shangquan and Chi Fulin write, "Looking at the reform practices of various socialist countries, there were no successful examples of implementation of the first method (continued government control) prior to the disintegration of the former Soviet Union and East European nations in 1991. In other words, their reforms remained simply idle words or wordy documents which were not truly put into practice, and thus merely a waste of time." *ibid*, pp. 7-8.

Figure 3 illustrates how China's leadership can point to its role in maintaining the current political structure. Where China's share of regional GDP was once on the decline, economic reform has produced sufficient growth to propel it to second place in Asia's regional economy, and ninth in the world.[12]

Given Japan's current economic slowdown and China's continued economic expansion, at current rates of growth, China would surpass Japan's GDP within twenty years, thus placing it in contention as the world's largest economy. The question at this point is whether China's current economic policies can generate this kind of growth for several decades, and whether these policies can provide a useful model for other developing countries.

C. The Role of History in Shaping Chinese Policy

The third determinant of China's economic management policies is the role of history, namely, the re-assertion of China's position as a pre-eminent political and economic power in Asia and the rest of the world. China's current economic and political policies have been driven not just by ideology, but also by efforts to restore China to an historical role that it once enjoyed as a center of culture and politics in Asia.

As impressive as China's accomplishments have been in Asian history, from the eighteenth century down to most of the twentieth, its national history has often been one of civil war and foreign occupation. Its most notable civil war was the struggle between the Chinese Nationalists of Chiang Kai Shek under the Kuomintang and the Chinese Communists of Mao Tse Tung. This struggle, which unfolded in the 1930's, ended with the consolidation of mainland political power under Mao in 1949 and the exile of Chinese Nationalists to Taiwan, which today Chinese authorities in Beijing consider a renegade province.[13]

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[12] For 1994, the current rank ordering of country GDP is:

	Country	1994 GDP (U.S.$billions)	1990-1994 Growth Rate	2014 GDP (U.S.$billions)
1.	United States	$6,648	2.5%	$10,894
2.	Japan	$4,591	1.2%	$ 5,828
3.	Germany	$2,046	1.1%	$ 2,546
4.	France	$1,330	0.8%	$ 1,560
5.	Italy	$1,024	0.7%	$ 1,177
6.	United Kingdom	$1,017	0.8%	$ 1,193
7.	Brazil	$ 555	2.2%	$ 858
8.	Canada	$ 543	1.4%	$ 717
9.	China	$ 522	12.9%	$ 5,919
10.	Spain	$ 483	0.7%	$ 555

At current rates of growth, by 2014, China would be the world's second largest economy ($5,919), followed by Japan ($5,828), Germany ($2,546), France ($1,560), South Korea ($1,350), Argentina ($1,220), United Kingdom ($1,193), and Italy ($1,177).

[13] China's civil war and its aftermath have been covered extensively by historians and other commentators. Standard references include: John K. Fairbank, *China: A New History* (Cambridge, Mass.: Belknap Press, 1992); Jonathan Spence, *The Search for Modern China* (New York: W.W. Norton, 1990); and Harrison E. Salisbury, *The New Emperors: China in the Era of Mao and Deng* (Boston: Little Brown, 1992). Mao

As to China's various invasions by foreign powers, the principal European powers have been Great Britain and, to a much lesser extent, Portugal. Following the Opium War in China in 1839-1842, Great Britain established Hong Kong as a British colony. This became a symbol of foreign domination that China's leaders over several generations have been determined to reverse, and which will become a reality when Hong Kong reverts to Chinese authority on July 1, 1997. Beyond Great Britain, China's leaders have also not forgotten Japan's imperial ambitions during the 1930's, building on its annexation of Korea in 1910, the invasion of Manchuria in 1931, and the invasion of Nanjing in 1937.[14]

Following the consolidation of Communist power under Mao Tse Tung in 1949, China has engaged in a systematic effort to minimize foreign influence in political affairs. This encompasses its support for North Korea during the Korean War of 1950-1953, for claims over Taiwan dating back to hostilities over Quemoy and Matsu in 1961, and through more peaceful approaches such as the negotiated return of Hong Kong in 1997 and Macao from Portugal in 1999.

To outsiders, China's foreign policies have sometimes been viewed as militaristic, while Chinese leaders have often considered them to be a re-assertion of Chinese historical claims to national sovereignty. With China's growing economic strength, its claim to greater national sovereignty is enhanced. In turn, this has generated growing concern that China and the United States may be moving in divergent directions over Asian economic and political policies.[15]

III. China's Strategy for Economic Reform

China's economic strategy under the Deng era can be characterized by five central elements: a. market socialism; b. export driven mercantilism; c. modernization through controlled foreign capital inflows and expanded domestic savings; d. government priority to infrastructure investment; and e.continued demographic restraint. With the exception of market socialism and demographic restraint, China's approach to economic growth has been similar to many of its Asian neighbors. [16]

A. Market Socialism

Though largely rejected in Central and Eastern Europe as the Cold War ended, market socialism in China has meant the retention of state enterprises within a larger program of

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Tse Tung's classic treatise is *On the Protracted War* (Peking: Foreign Languages Press, 1967), while Chiang Kai-shek's views are best summarized in *Resistance and Reconstruction: Messages during China's Six Years of War, 1937-1943* (Freeport, New York: Books for Libraries Press, 1970).

[14] Chinese authorities have long asked for a full apology from Japan over its occupation of China and the events in Nanjing in 1937. For a recent account, see Zu Zhigeng, *Lest We Forget: Nanjing Massacre, 1937* (Beijing: Chinese Literature Press, 1995).

[15] This view is perhaps most sharply portrayed in Richard Bernstein and Ross H. Munro, *The Coming Conflict with China* (New York: Alfred A. Knopf, 1997).

[16] Chinese economic reforms have been noted in a number of studies. References include: Andrew G.Walder, editor, *China's Transitional Economy* (New York: Oxford University Press, 1996); Donald Hay, Derek Morris, Guy Liu, and Shujie Yao, *Economic Reform and State-Owned Enterprises in China, 1979-87* (New York: Oxford University Press, 1994); Bruce L. Reynolds and Ilpyong J. Kim, editors, *Chinese Economic Policy* (New York: Paragon Press, 1988); Harry Harding, *Second Revolution: Reform After Mao* (Washington, D.C.: The Brookings Institution, 1987); John Hsu, *China's Foreign Trade Reforms: Impact on Growth and Stability* (New York: Cambridge University Press, 1989); Robert Kleinberg, *China's Opening to the Outside World: The Experiment with Foreign Capitalism* (Boulder, Col.: Westview Press, 1990); and Joseph C.H. Chai, *China: Transition to a Market Economy* (New York: Oxford University Press, 1997).

economic reform. These enterprises had been created under previous efforts to modernize within a largely closed economic system. Once established, they operated under a command system of output targets consistent with China's multi-year development plans and in pursuit of economic self-sufficiency. This was done in concert with the approach adopted by the Soviet Union, even though China under Mao placed equal emphasis on the role of collective agriculture as a key to economic growth.[17]

While many Chinese state enterprises did manage to meet planned output targets, because they operated under a command framework, they often were unprofitable. Thus, they have required periodic subsidies from the central government to meet their financial obligations. As there are some 140,000 of these enterprises in China, and as they have accounted for a substantial share of salaried employment and output, radical reforms such as privatization have been rejected in the short-term, with emphasis given to expanding the market framework in which they operate.

Under China's economic reforms, state enterprises are given incentives to improve efficiency through a variety of mechanisms.[18] First, credit allocation is being shifted from government ministries to banking institutions. Because these banks must generate funds from the domestic market as well as from abroad, they must compete on efficiency grounds in the selection of specific projects, which in turn encourages state enterprises to adopt greater accountability and efficiency in the use of such funds.

In addition to banking reforms, state enterprises are also being subjected to greater competition through market liberalization. As private enterprises are given greater freedom to enter new markets, state enterprises must embrace management reforms to compete in those same markets. This process is further enhanced as China has removed price controls in markets, allowing greater competition between customers and suppliers.

As state enterprises move to reform within a larger program of market liberalization, China's leaders look to expanded activity in the private sector to provide a growing level of output, income, and tax revenues on which reform can proceed. As long as private sector growth is vigorous, even as tax reforms are introduced, government can look to a sufficient stream of revenues to provide sufficient subsidies to state enterprises as long as short-term losses persist.

B. Mercantilism

The second element of China's strategy for economic reform is mercantilism, or economic nationalism, in international trade. For some time it has been clear that international trade has been one of the most important sources of world economic growth. Asian countries such as Japan, South Korea, Malaysia, and Thailand have demonstrated the benefits of international trade in terms of rising per capita incomes. Thus, China's

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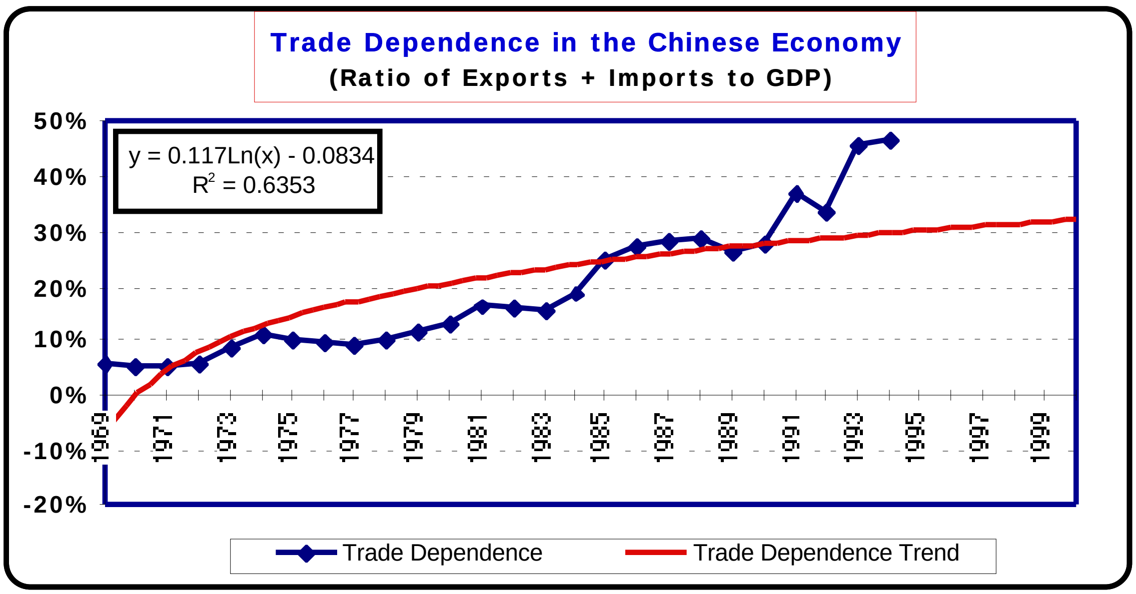
[17] There is an extensive literature on the background to China's shift from a planned economy to the current market economic reforms. See Thomas G. Rawski, *Economic Growth and Employment in China* (New York: Oxford University press, 1980); Alexander Eckstein, *China's Economic Development* (Ann Arbor: University of Michigan Press, 1975); Gregory Chow, *The Chinese Economy* (New York: Harper & Row, 1985); Christine Wong and Elizabeth Perry, editors, *The Political Economy of Reform in Post-Mao China* (Cambridge, Mass.: Harvard University, Harvard Contemporary China Series 2, The Council on East Asian Studies, 1985); and Guy Schulders, *La Chine du nouveau départ* (Paris: L'Harmattan, 1987). The literature distinguishes the emphasis made by Mao Tse Tung on agrarian-based collective socialism versus the Soviet Union's emphasis on industrial-based central planning, and links limitations in both approaches to the economic successes of Asia's high performing economies.

[18] *Op. cit*., Gao Shangquan and Chi Fulin, editors, *Theory and Reality of Transition to a Market Economy*, in particular, chapter III, "Reform of the State-Owned Enterprises", pp. 91-159.

leadership has shifted from a strategy of complete self-sufficiency to expanded trade liberalization, as is shown in Figure 4.

Although China has increased its dependence on international trade, it has done so along a policy of mercantilism rather than classical free trade.[19] Free trade is based on the assumption that two or more countries both stand to benefit from an expansion of international trade, with prices and exchange rates determined essentially by market forces. In contrast, the goal of mercantilism is to build up a surplus in the balance of trade by maintaining artificially low exchange rates, provide economic incentives to exporters, and pursue a policy of restrictive entry for consumer imports.

Figure 4



Source: World Bank data tables, and author's estimate.

A surplus in a country's balance of trade provides a growing level of foreign exchange reserves, especially if these reserves are used to attract direct foreign investment. Under mercantile economic policy, a surplus in a country's balance of trade is often viewed mistakenly as a measure of economic success rather than a country's per capita GDP, which is the classic free trade index. As long as it appears that a trade or balance of payments surplus is directly related to a country's per capita GDP, mercantile policies will find favor over classic free trade.

China's experience under economic reforms affirms the mercantile approach to international trade. Foreign exchange reserves have grown from less than U.S. $20 billion in the early 1980's to the U.S. $100 billion range in the late 1990's.[20] The problem is that

[19] The term "mercantilism" does not appear in official documents or in much of the contemporary literature on Asian economic policies. It does, however, have a well documented place in the literature on the evolution of economic theory and in the evolution of economic policy in Europe and North America. A classic source is Thomas Mun (1571-1641), *Englands Treasure by Forraign Trade, of the Balance of Our Forraign Trade is the Rule of Our Treasure* (1664), noted in Eli F. Heckscher, *Mercantilism* (London: George Allen & Unwin, 1935). Although Adam Smith's *Wealth of Nations* (1776) is the classic on economic liberalism, it was David Ricardo (1772-1823) whose *Principles of Political Economy and Taxation* (1817) that provides the foundation of all contemporary free trade theory and policy.

[20] China's foreign exchange reserves have grown considerably as economic reform has proceeded:

correlation of foreign exchange reserves to GDP and per capita GDP growth does not equal causation. Japan has very much found this to be the case in recent years and for economic reforms toward classic economic liberalization and free trade are now being pursued.[21]

It should be noted that mercantilism provides an alternative to international aid as a strategy for economic development. International aid is often funded through public international and bilateral agencies that may have differing objectives in a recipient country as well as differing objectives among the donor institutions. Moreover, publicly funded international aid often is not channeled to directly productive investment, thus risking a lower rather of growth in GDP than would otherwise be the case. And, lest this be overlooked, mercantilism appeals to national sentiments of independence whereas international aid suggests a lack of capacity in a recipient developing country, regardless of the circumstances.

Japan provides a clear example of the mercantile approach to international trade. As long as Japan's trade surplus does not produce a breakdown of international trading relations with its principal trading partners, it can use its foreign exchange reserves to provide controlled funding for projects to modernize various industries along internally competitive standards. In turn, domestic industries receive protection in the form of various non-tariff barriers to trade such as licensing requirements, and favored access to export finance. Emphasis also is given to the creation of large-scale export-oriented enterprises, in both production and finance, to derive competitive advantage in international markets. With large concentrations of firms in the domestic economy and an undervalued exchange rate, domestic consumers wind up paying higher prices for goods than are available in the international economy. Mercantilism thus is associated with a system of producer sovereignty, in contrast to the notion of consumer sovereignty under a classical free trade approach.

One further aspect of Japan's economic approach is the application of product quality as a strategy in international competition. Total quality management, a philosophy developed in the United States several decades ago, has been used by Japanese firms to gain competitive international advantage, particularly in consumer electronics, and to a somewhat lesser extent, automobiles.[22] This approach becomes attractive when an

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Gross Foreign Exchange Reserves
(in U.S.$billions)

1982	$17.14	**1987**	$22.45	**1992**	$24.85
1983	$19.10	**1988**	$23.75	**1993**	$27.35
1984	$21.28	**1989**	$23.05	**1994**	$51.60
1985	$16.80	**1990**	$33.32	**1995**	$80.00
1986	$16.42	**1991**	$48.17	**1996**	$100.00

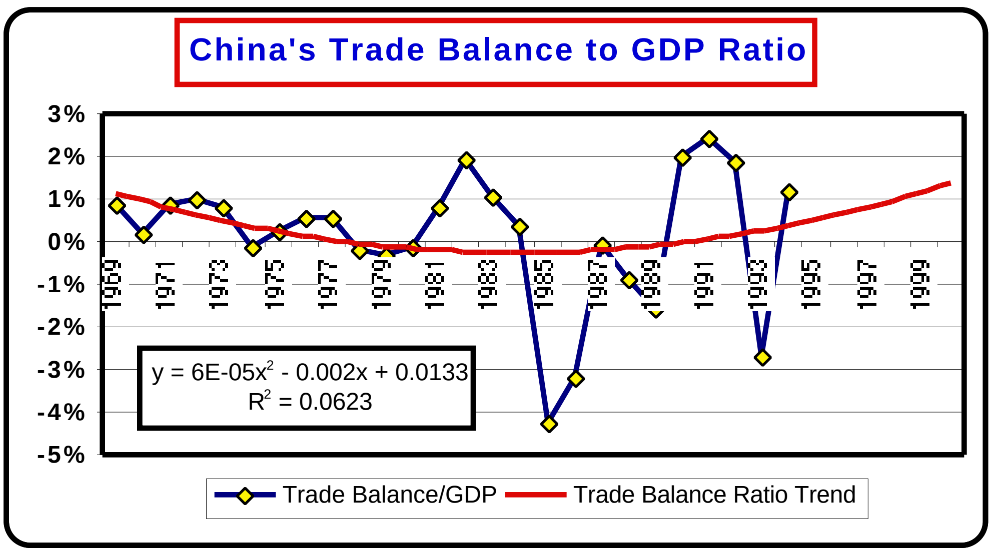
[21] Japan's approach to economic modernization through controlled international trade has been covered extensively. See Hyung-Ki Kim, Michio Muramatsu, T.J. Pempel, and Kozo Yamamura, *The Japanese Civil Service and Economic Development* (New York: Oxford University Press, 1995); Chalmers Johnson, *Japan: Who Governs?* (New York: W.W. Norton, 1995); Eamonn Fingleton, *Blindside: Why Japan Is Still on Track to Overtake theU.S. by the Year 2000* (New York: Houghton Mifflin, 1995); Ezra Vogel, *Japan as Number 1* (Cambridge, Mass.: Harvard University Press, 1979); James C. Abbeglen, *Business Strategies for Japan* (Tokyo: Sophia University Press, 1970); Isiah Frank and Ryokichi Hirono, *How the U.S. and Japan See Each Other's Economy* (New York: Committee for Economic Develepent, 1974); Yoshi Tsurumi, *The Japanese Are Coming* (Cambridge, Mass.: Ballinger Publishers, 1976).

[22] One key to Japan's export success has been the emphasis on quality management in production, much of which has been inspired by the work of W. Edwards Deming, an American statistician who worked as a consultant to Japanese industry. His earlier work is reported in *Statistical Adjustment of Data* (New York: John Wiley & Sons, Inc., 1943); more recent publications include *Quality, Productivity, and Competitive*

inevitable revaluation of the currency occurs following the accumulation of trading surpluses in the balance of payments. The increase in the price of exported goods can be justified through substantial increases in product quality. Japanese firms have repositioned a number of goods through emphasis on quality management as currency realignments have taken place to redress its balance of trade surplus, thus prolonging the surplus for further expansion.

The difficulty with mercantilism is that it does not provide for balanced growth in the markets in which a country's exports may be directed. Consumers in a free trade environment welcome the benefits of high quality and relatively inexpensive goods, while consumers in the exporting country bear the cost. In turn, consumers in a free trade environment also experience a loss of jobs as trade imbalances increase, while consumers in a surplus country enjoy expanded jobs and income. Despite periodic currency realignments, as trading imbalances increase, this leads to trade friction, as has been the case between the United States and Japan in recent years.[23] Because mercantilism can not be sustained, once a country such as Japan reaches income levels comparable to those of its trading partners, there is an inevitable shift toward classical free trade, as has been the case with recent reforms in Japan.

Figure 5



Source: World Bank data tables, and author's estimate

As China has embraced mercantile policies, it has begun to generate growing surpluses in its balance of trade, as can be seen in Figure 5. Although the early years of trade liberalization generated trade deficits, as China has focused its efforts on export-focused

Position (Cambridge, Mass.: Massachusetts Institute of Technology, Center for Advanced Engineering Study, 1982); and *Out of the Crisis* (Cambridge, Mass.: Massachusetts Institute of Technology, Center for Advanced Engineering Study, 1986).

[23] Purchasing power parity studies provide estimates of the extent of over or undervaluation of country currencies. A somewhat tongue in cheek, but reasonably accurate, proxy is the Big MacCurrency measure reported by *The Economist*. This index measures the cost of a McDonald's Big Mac hamburger in the various countries where franchise operations are found. In its April 12, 1997 survey report, China's currency is 52 percent undervalued relative to the dollar, thus favoring Chinese exports, based on the assumption that this standardized good should have an approximately equal price regardless of where it is produced and sold.

trade, the positive trend is likely to continue. This pattern is similar to the experience of Japan and a number of other high performing Asian economies.

With China moving to a net export trading position, trade friction is developing with some of its principal trading partners, notably the United States.[24] To reduce those frictions, China and principal trading partners such as the United States engage in regular consultations on measures to create a more balanced pattern of trade and investment. As long as China's policies generate surpluses in its balance of trade and payments, trade frictions will persist, much as has been the case in U.S.-Japan economic relations over the years[25].

As China has encouraged a positive balance in its international trade, it has worked to attract direct foreign investment to key sectors of the economy. Since direct foreign investment inflows represent credits in the balance of payments, as long as China can achieve a positive balance in trade, it can also increase the level of foreign exchange reserves. As can be seen in Figure 6, at current rates of growth, China's foreign exchange reserves already are in excess of U.S. $100 billion, and may rise by fifty percent over the next four years.

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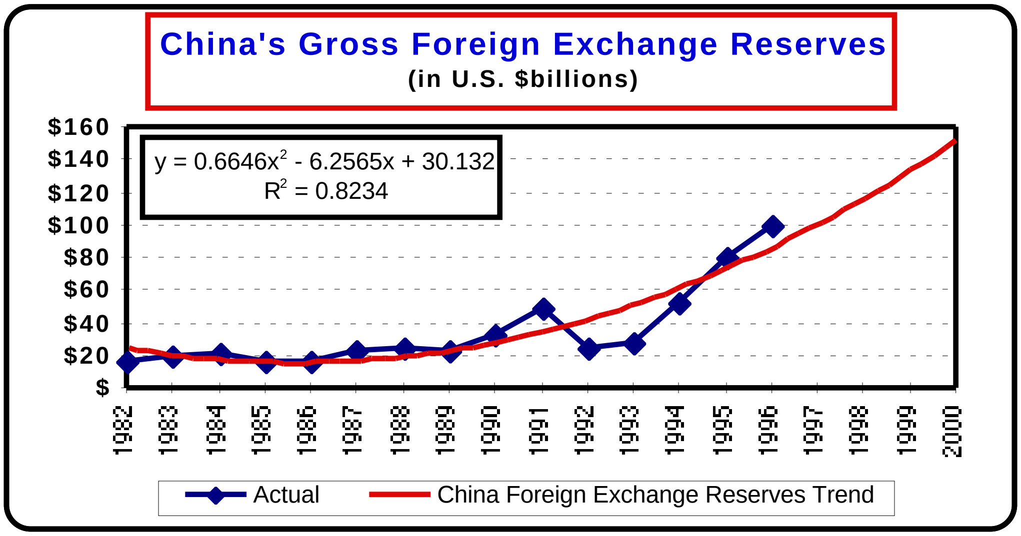
[24] China's current account trading balance with the United States, in U.S.$billions, has evolved as follows:

	U.S. Exports	U.S. Imports	Balance
1981	$ 3.0	$ 1.0	$-2.0
1982	$ 2.5	$ 1.0	$-1.5
1983	$ 1.9	$ 1.0	$-0.9
1984	$ 2.0	$ 1.5	$-0.5
1985	$ 2.8	$ 1.7	$-1.1
1986	$ 2.2	$ 2.0	$-0.2
1987	$ 2.2	$ 3.0	$ 0.8
1988	$ 3.0	$ 5.0	$ 2.0
1989	$ 3.5	$12.0	$ 8.5
1990	$ 2.9	$15.1	$12.2
1991	$ 3.1	$18.0	$14.9
1992	$ 5.0	$26.0	$21.0
1993	$ 8.0	$31.0	$23.0
1994	$ 9.0	$40.0	$31.0
1995	$13.0	$46.0	$33.0
1996	$12.4	$48.6	$36.2
1997*	$13.0	$51.0	$38.0* (projected)

[25] See, Yuka Hayashi, "Japan Unveils Its Final Plan on Deregulation", *The Wall Street Journal*, March 31, 1997, p. A9A, as an example of reform pressures to develop alternatives to mercantile-based growth in Japan, and Milton Ezrati, "Japan's Aging Economics", *Foreign Affairs* 76:3 (May/June 1997), pp. 96-104. On U.S.-China tensions, see David E. Sanger, "China Faces Test of Resolve to Join Global Economy," *The New York Times*, March 2, 1997, p. 1.

Figure 6



Source: World Bank data files, and author's estimate.

Consistent with its expansion of international trade, China has sought membership in the World Trade Organization, which would help it achieve most favored nation status. In turn, the United States has sought China's adoption and enforcement of a number of international copyright conventions as a condition for membership in the WTO. Because the United States is a major service exporter in such fields as computer software and music and movies, agreement on intellectual property right protection for these products would help to limit the imbalance in bilateral trade between the United States and China. That these negotiations have been tied to China's application to membership in the World Trade Organization reflects the difference between China's preference for a mercantile strategy in international trade while the United States largely has endorsed classical free trade policies.

C. Targeted Foreign Capital Inflows for Industrial Modernization

The third element of China's economic strategy has been the modernization of industry through controlled foreign capital inflows.[26] China has established enabling legislation for four types of direct foreign investment: 1. equity joint ventures; 2.cooperative (contractual) joint ventures; 3. wholly foreign-owned enterprises; and 4. foreign-invested joint stock companies.[27] In turn, it has set priorities for foreign investment in China in the following order:

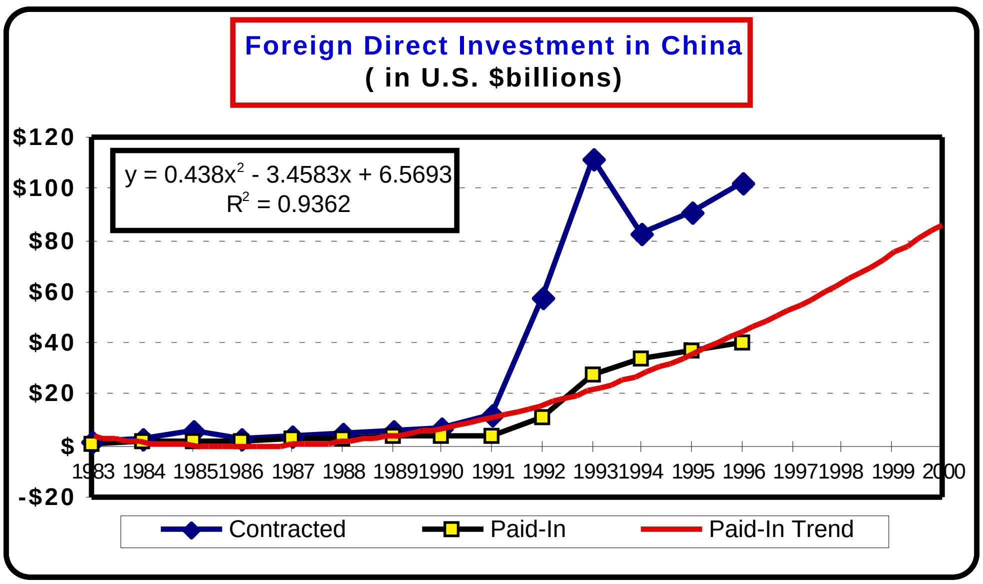
[26] *Op.cit*., Gao Shangquan and Chi Fulin, *Theory and Reality of Transition to a Market Economy*, in particular, chapter VI, "Develop the Market Economy While Opening to the Outside World", pp. 298-308.
[27] U.S. Department of Commerce, *National Trade Data Bank*, March 3, 1997. Legislation for foreign-owned enterprises dates back to 1986 and 1990.

Table 1
China's Foreign Investment Priorities

1.	Comprehensive and technological agricultural projects
2.	Infrastructure and basic industries such as highways, railways, harbors, airports, steel and non-ferrous metals
3.	"Pillar industries", including machinery, electronics, petrochemicals, automobiles, and construction materials
4.	Projects involving advanced technology, technical renovation, and energy conservation
5.	Projects supplying products meeting international market demand, upgrading the quality of Chinese products and increasing China's exports
6.	New technology and equipment to utilize natural resources
7.	Projects that utilize human and natural resources in the western and inland areas

Source: U.S. Department of Commerce, *National Trade Data Bank*, March 3, 1997

Figure 7

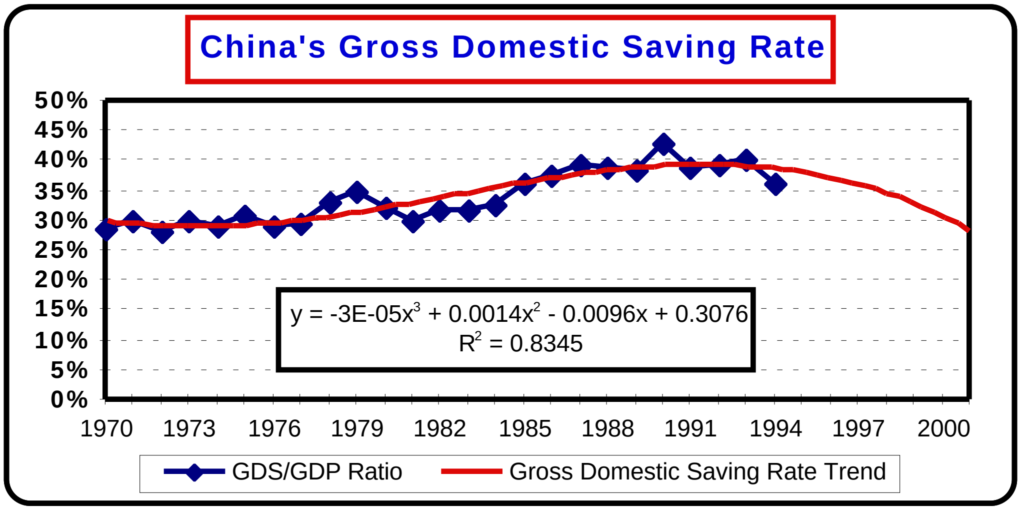


Source: U.S. Department of Commerce, *National Trade Data Bank*, March 1997, author's estimate

China's opening up of its economy to foreign investment has produced both expanded flows and rising productivity. Figure 7 illustrates the growth of foreign direct investment in China. At current rates of growth, paid-in direct foreign investment stands to reach over U.S. $85 billion by the year 2000. As long as economic criteria are applied to the allocation of these capital flows, they should produce positive rates of return for China's overall growth of GDP. It should be noted, that in this regard, China has had a more open policy toward foreign investment than some of its Asian neighbors, notably, Japan.

As China has encouraged controlled foreign direct investment flows, it has sought to strengthen these resources through increased domestic capital formation. As foreign direct investment raises per capita income, domestic saving is increased. To raise the rate of domestic saving, domestic firms and their foreign partners develop products with a strong export focus rather than to serve the domestic market alone. In turn, spending on imported consumer goods is restricted partly through licensing controls, and also by the extent to which China's currency remains undervalued in purchasing power parity terms.

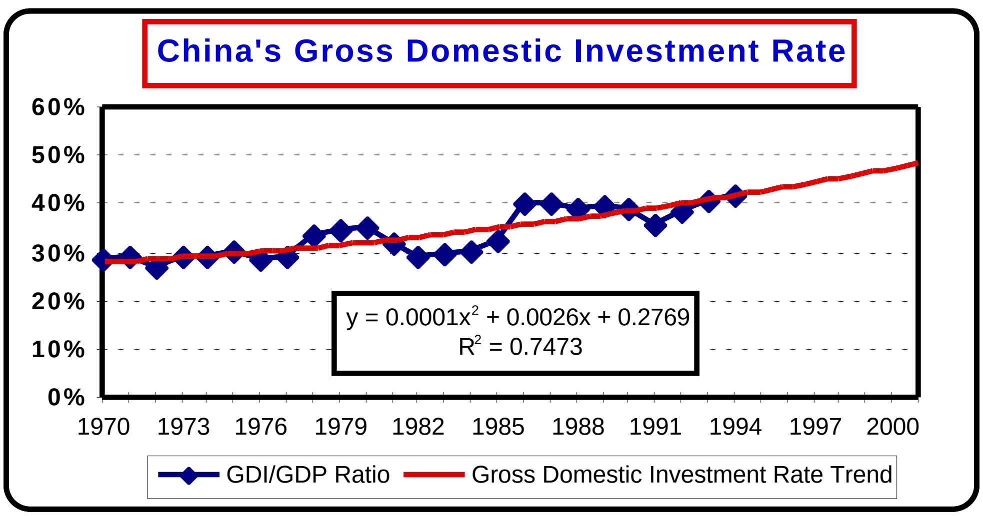
Figure 8



Source: World Bank data tables and author's estimate.

As China's domestic saving has risen, so too has its domestic rate of investment. Figure 8 shows that even prior to the reforms under Deng Xiaoping, the domestic saving rate has increased progressively from under 30 percent in 1970 to over 40 percent in 1995. In turn, the domestic investment rate has risen from just under 30 percent in 1970, to just under 45 percent in 1995, as is shown in Figure 9.

Figure 9

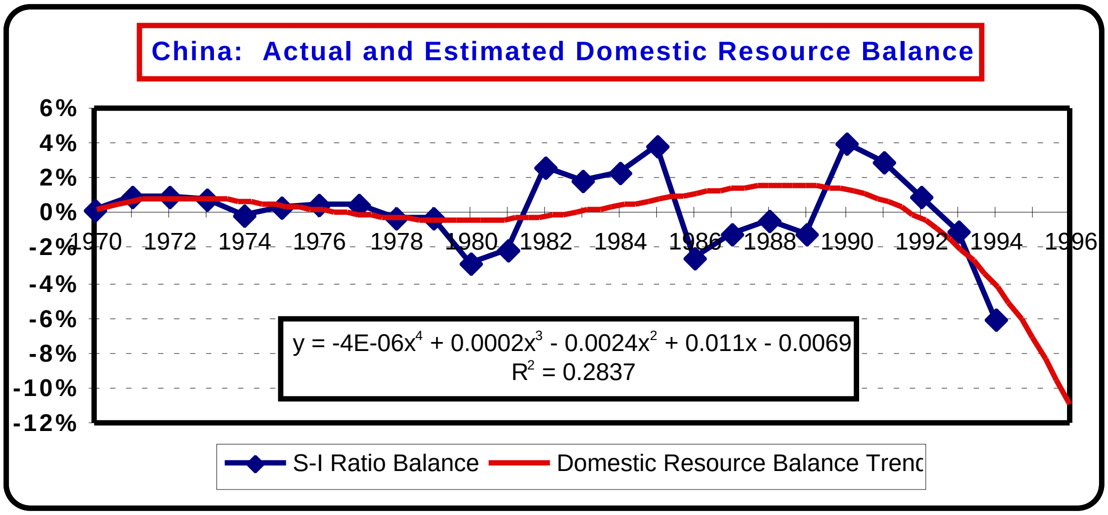


Source: World Bank data tables and author's estimate.

Although China has succeeded in increasing the rate of domestic saving and investment, as economic liberalization has proceeded, these flows have not always been in balance. Figure 10 shows that as economic reform has proceeded, the domestic resource gap has increased, thus increasing the reliance on foreign capital inflows. To this extent, China's mercantilist policies may be directed to generating trade surpluses, but they are less successful in generating domestic resource self-sufficiency, which in turn is likely to produce both domestic and international pressure for shifts in the direction of classic free trade policies.

Under present trends, China's domestic resource balance has gone from positive to negative, as is shown in Figure 10. Given the goal of maintaining relatively high growth rates, China's leadership have adopted more liberal policies regarding foreign direct investment in the economy, thus helping to maintain the overall rate of national investment.

Figure 10



Source: Figures 7 and 8, and author's estimate.

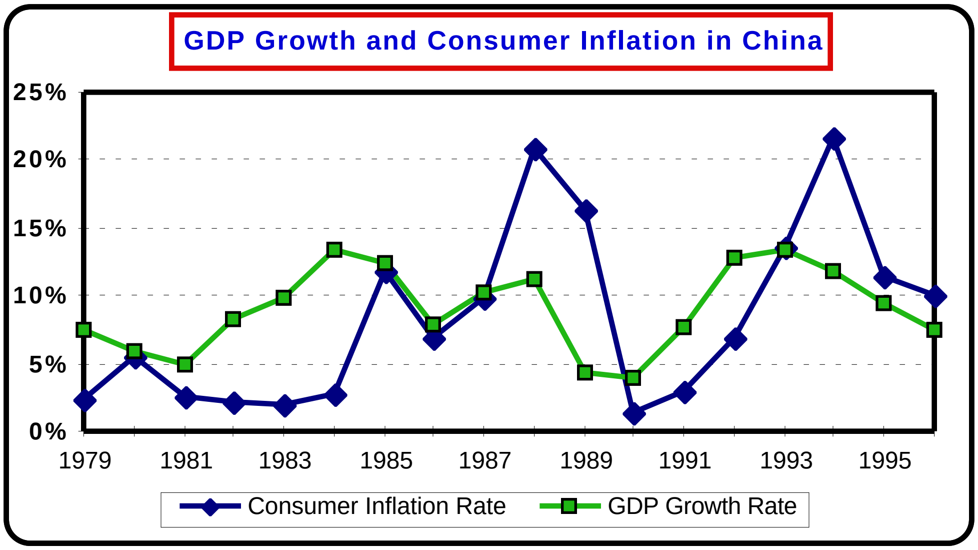
Overall, China has used its program of targeted investment to develop joint ventures and other forms of international partnerships to maintain relatively high rates of growth. As long as these policies do not result in turn in the kinds of trade and balance of surpluses that occurred with Japan, they are likely to help maintain the momentum of growth for several years to come.

D. Government Spending Priority to Infrastructure Development

The fourth component of China's economic strategy is the re-alignment of government spending in support of infrastructure development. To do so, China has re-created its central bank and granted greater autonomy in the setting of monetary policy, leaving to government overall responsibility for fiscal policy.

Given some of the changes brought about by China's reform, as this shift has occurred, it has also produced uneven rates of growth in real GDP as well as in China's overall rate of inflation, as is shown in Figure 11. The goal is to stabilize toward a lower trend level of inflation while at the same time maintaining relatively high rates of growth in GDP.

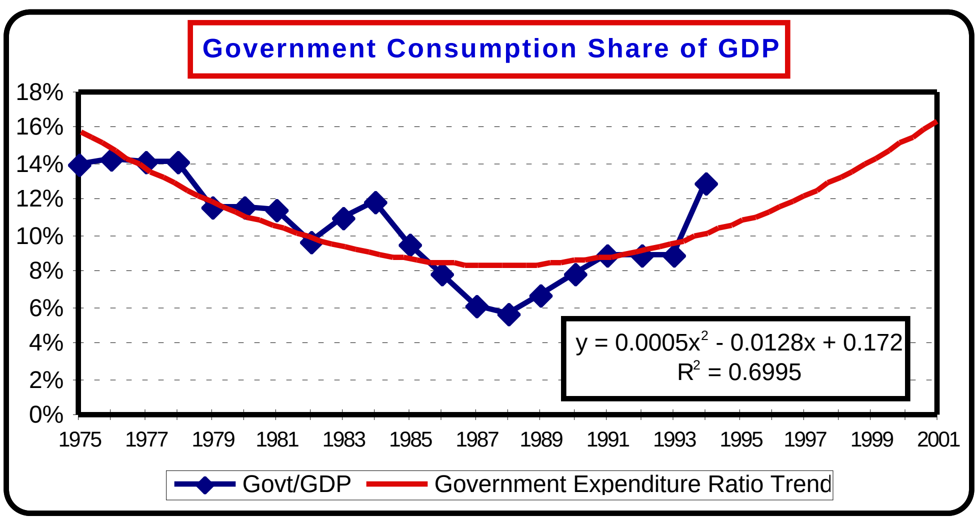
Figure 11



Source: World Bank data tables.

China's central government spending accounts for approximately ten percent of GDP, a figure that is low in comparison to West Europe, but not significantly different from some of it East Asian neighbors. At the same time the government consumption share of GDP is rising, reflecting growing demand for infrastructure development, even as state-owned enterprises have experienced growing economic losses.

Figure 12

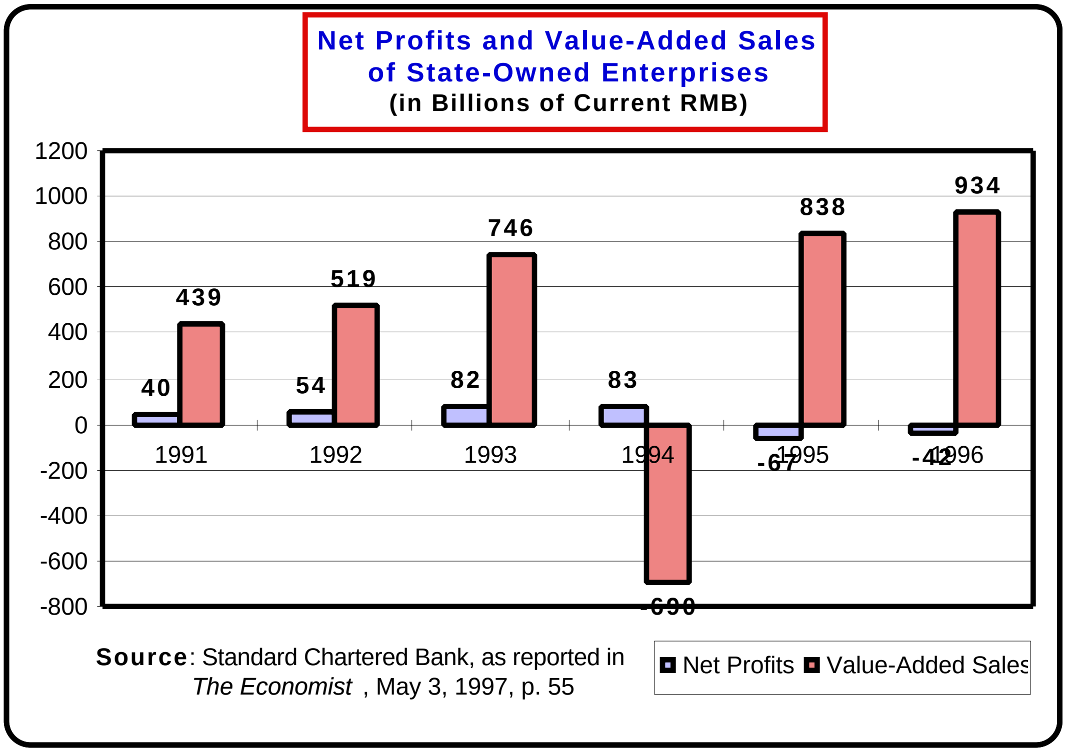


Source: World Bank datafiles and author's estimate.

Figure 12 shows that as China's economic reforms have been implemented, there has been an initial reduction in the government consumption share of GDP. However, as reform pressures have risen, government has tended to expand its consumption share of GDP, and which is likely to have downward pressure on the projected rate of GDP growth in the future. This is particularly so as long as government spending is financed either by higher taxes or by greater deficit financing, which generates higher pressure on the underlying rate of inflation.

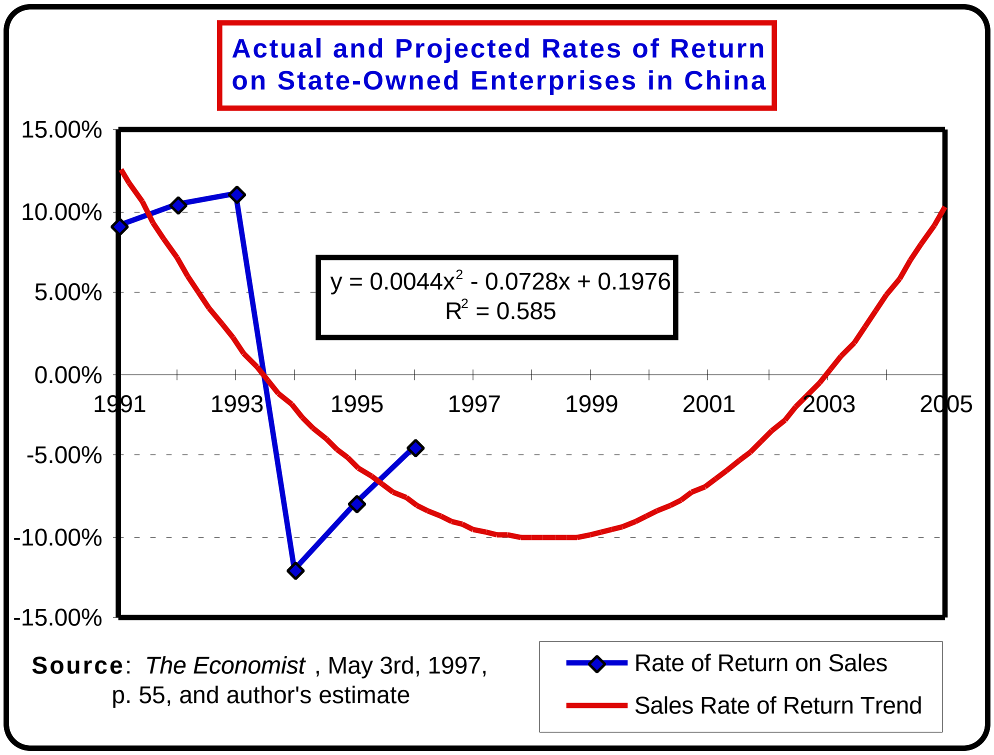
How important are losses to China's state-owned enterprises? Figures 13 and 14 show that in the early 1990's, state-owned enterprises managed to turn modest net profits on value-added sales. However, as greater competition has emerged with the opening up of markets, many of these firms have begun to experience significant losses. As losses increase, these firms have few choices: They can request operating subsidies from the government; they can restructure through acquiring private sector partners, mostly joint ventures with international firms; or they can go bankrupt.

Figure 13



Recent estimates of government subsidies have been around U.S. $11 billion, which would represent about 1.4 percent of GDP. As this ratio rises, China's leaders have begun to examine ways of restructuring these enterprises, particularly as pressures increase on raising domestic spending for education, health, and physical infrastructure.

Figure 14



Of central government expenditures, for 1993 China spent the largest share (39.5 percent) on economic services, with a little less than half this amount of national defense (16.4 percent), and with education and health accounting together for less than 3 percent.[28] The relatively low rates of spending on education and health are likely to rise in future years as increasing emphasis is given to human capital investment.

E. Continued Demographic Restraint

The final component of China's economic policies is its program of demographic restraint. Although population growth rates do not by themselves determine economic growth, they can have some bearing on the process.[29] As is shown in Figure 15, current policies are reducing the rate of population growth, which is expected to reach a stable level of approximately 1.5 billion by 2025.

China's program of limiting population growth does not in and of itself constitute economic reform.[30] What it does represent is an attempt to bring about a demographic shift

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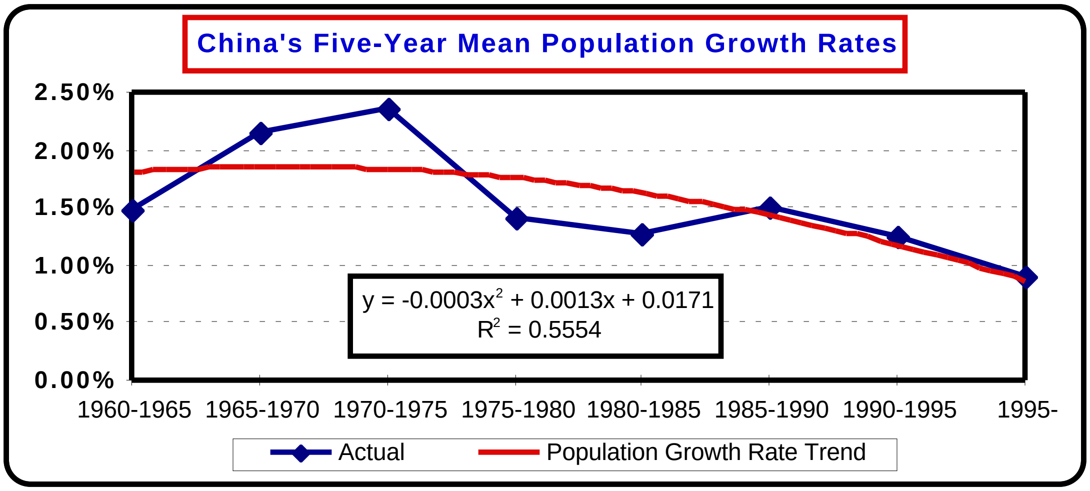
[28] World Bank, *World Development Report 1995* (New York: Oxford University Press, 1995), p. 180.

[29] The literature on the linkages between population and economic growth and development is extensive. See Assaf Razin and Efraim Sadka, *Population Economics* (Cambridge, Mass.: MIT Press, 1994); Bernardo Colombo, Paul Demeny, and Max Perutz, editors, *Resources and Population* (New York: Oxford University Press, 1996). Paul Ehrlich, *The Population Explosion* (New York: Simon and Schuster, 1990); and Julian L. Simon, *Population and Development in Poor Countries* (Princeton, New Jersey: Princeton University Press, 1992), for two opposing views on population growth.

[30] China's family planning policies have been widely debated. See Ko-P'ing Ch'u, *Population and the Environment in China*, trans. Jiang Baozhong and Gu Ran (Boulder, Colorado: L. Rienner Publishers, 1994); Steven W. Mosher, *Journey to the Forbidden China* (New York: The Free Press, 1985); and Steven W. Mosher, *China Misperceived: American Illusions and Chinese Reality* (New York: Basic Books, 1990).

while other economic reforms are being instituted. To the extent that China's economic reforms generate positive rates of growth, the corollary slowdown in population growth simply results in a higher level of per capita income over a given forecast horizon.

Figure 15



Source: World Bank data files, author's estimate.

Beyond China's economic reform strategy, we summarize here the range of economic reform choices that China has either adopted or put under consideration as part of the policies begun under Deng Xiaoping. Overall, they represent a re-alignment of economic resources based on market pricing incentives, even as they may be implemented within the context of China's economic reform strategies already noted. What distinguishes China's economic reforms is that they are based on a continuing commitment to market socialism, to economic mercantilism rather than classical free trade, and that foreign investment will continue to be oriented toward modernizing industries that China's leaders look to for export-driven growth.

IV. China's Economic Policies in Comparison to Other Successful Asian Countries

We have already noted some comparisons between China's economic reforms and economic policies in Japan. The essential similarity is that China is now looking to pursue the same kinds of mercantile export-driven policies that were so successful for Japan. These policies are also similar to policies adopted by South Korea, Hong Kong, Taiwan, Thailand, Malaysia, and Singapore.[31] Yet, as China looks to export-driven policies for

[31] The literature on Asian economic reform and growth is extensive. See Myo Thant, Min Tang and Hiroshi Kakazu, *Growth Triangles in Asia* (New York: Oxford University Press, 1995); Ian Brown, *Economic Change in South-East Asia* (New York: Oxford University Press, 1997); Pasuk Phongpaichit, *Thailand: Economy and Politics* (New York: Oxford University Press, 1996); Wing Thye Woo, Stephen Parker, and Jeffrey D. Sachs, editors, Economies in Transition: Comparing Asia and Europe (Cambridge, Mass.: MIT Press, 1997); Kunio Yoshihara, *The Nation and Economic Growth: The Philippines and Thailand* (New York: Oxford University Press, 1995); Arthur Cotterell, *East Asia: From Chinese Predominance to the Rise of the Pacific Rim* (New York: Oxford University Press, 1994); M.G. Quibria, *Critical Issues in Asian Development* (New York: Oxford University Press, 1995); M.G. Quibria and J.M. Dowling, *Current Issues in Economic Development: An Asian Perspective* (New York: Oxford University Press, 1997); Eui-Gak Hwang, *The Korean Economies* (New York: Oxford University Press, 1994); Byung-Nak Song, *The Rise of the Korean Economy* (New York: Oxford University Press, 1994); Hugh Patrick and Yung Chul Park, editors, *The Financial Development of Japan, Korea, and Taiwan* (New York:

success, the limitations of mercantilism have also become more apparent in neighboring countries of the Pacific Rim. Thus, China may find that successful economic growth does not have to take the form of mercantilist policies, even though trade liberalization will undoubtedly produce higher rates of growth than if trade is restricted.

Table 3

Comparative Economic Indicators

	1960	1965	1970	1975	1980	1985	1990	1995
Five-Year Annualized Real GDP Growth Rate								
China	4.81%	5.00%	5.20%	5.78%	5.52%	9.72%	7.57%	12.90%
E.Asia & Pacific	3.87%	5.60%	8.10%	8.00%	8.00%	7.95%	7.90%	9.40%
L.America & Caribbean	4.10%	5.00%	6.10%	5.20%	5.20%	2.97%	1.70%	3.60%
Sub-Saharan Africa	5.63%	5.20%	4.80%	3.30%	2.80%	2.18%	1.70%	0.90%
Consumer Price Index Five-Year Annualized Growth Rate								
China	0.20%	2.20%	1.62%	1.20%	2.59%	4.15%	13.07%	8.40%
E.Asia & Pacific	3.00%	3.10%	4.13%	5.50%	6.20%	7.00%	9.90%	9.90%
L.America & Caribbean	9.00%	12.00%	14.94%	18.60%	39.41%	83.50%	179.40%	482.80%
Sub-Saharan Africa	3.00%	3.40%	4.08%	4.90%	9.92%	20.10%	18.80%	39.20%
Gross Domestic Saving Rate								
China	10.00%	10.00%	28.77%	30.56%	32.18%	34.49%	42.50%	44.00%
E.Asia & Pacific	14.00%	11.00%	25.60%	27.70%	30.70%	31.00%	41.10%	37.00%
L.America & Caribbean	21.00%	19.00%	20.60%	22.50%	22.90%	22.50%	20.30%	20.00%
Sub-Saharan Africa	15.00%	17.00%	16.10%	17.40%	21.20%	12.30%	12.00%	16.00%
Gross Domestic Investment Rate								
China	9.50%	10.50%	28.49%	30.32%	32.20%	38.97%	39.00%	42.00%
E.Asia & Pacific	12.90%	9.40%	22.60%	28.70%	30.40%	32.50%	40.10%	36.00%
L.America & Caribbean	20.40%	20.40%	21.30%	25.00%	24.30%	17.70%	18.20%	21.00%
Sub-Saharan Africa	17.30%	19.40%	21.30%	20.80%	20.40%	12.10%	15.30%	17.00%
Trade Dependence								
China	5.20%	8.10%	15.50%	19.97%	23.99%	27.37%	35.23%	45.35%
E.Asia & Pacific	21.70%	10.65%	30.95%	32.18%	33.45%	38.16%	44.60%	52.13%
L.America & Caribbean	14.65%	13.20%	13.00%	18.12%	25.25%	28.81%	27.07%	25.44%
Sub-Saharan Africa	24.60%	24.75%	23.35%	33.73%	48.73%	55.60%	49.56%	44.18%

For other Asian high performing countries, instead of market socialism, many of them have fostered the growth of large export-oriented enterprises, with extensive links between producing firms and financial institutions. Japan has some of the world's largest financial and manufacturing corporations. Without exception, these institutions have focused operations on export-driven strategies. This is no less true for South Korea, Hong Kong, Taiwan, Singapore, and Malaysia. Thus, market socialism in the sense of relying on government enterprises is not essential for export-driven policies.

As China is doing, other Asian high performing economies also have adopted a program of targeted incentives for the inflow of foreign direct investment. Japan has been one of the most restrictive countries in the region in terms of foreign investment. As its balance of payments surpluses have increased, Japan has become a source of international capital outflows. These flows have gone not just to developed country markets in North America and Europe, but also in neighboring Asian countries. Smaller Asian economies have found these international capital flows to be of benefit, and some also have gone to China. Yet, for historical reasons and for China's drive for regional independence, thus far, China has looked as much to other investing country funds as much as from Japan.

Lastly, China's demographic policies are somewhat unique to the Pacific Rim region. To be sure, China is the most populous country in the world, and there are regions in China with some of the highest densities found anywhere. However, Japan has also reached a point of high population density and its population growth has also slowed

Oxford University Press, 1994); and David Mole, *Managing the New Hong Kong Economy* (New York: Oxford University Press, 1997).

considerably.[32] In Japan's case, it has been the shift in relative economic prices rather than a direct program of limiting population growth that has led to a slowdown in its own rate of increase. What this suggests is that while policies that reduce population growth may be a sufficient condition for sustained economic growth, they are not a necessary one.

V. The Relevance of China's Economic Policies for Developing Countries

If we place China's economic management policies in the context of Asia's economic growth, and if we compare these policies to those in Africa and Latin America, there are some useful lessons that can be derived. We note here what seems to have worked and what has not.

A. The Limits of Market Socialism for Economic Growth

Market socialism has appeal for countries that historically have followed policies of import-substitution industrialization. It is not just China that had established state and parastatal enterprises in pursuit of economic growth and development. So too did many countries in Latin America and Africa.[33] Yet in many of these countries, import substitution has worked poorly because the management goals for public enterprises have been driven by criteria other than economic growth. Other than differences in goals, one other limitation of public enterprises is that they have restricted access to finance. By definition, equity financing is generally excluded, even though equity finance can be critical in developing new products and markets.

Import-substitution industrialization based on state enterprises largely has been abandoned by countries in Latin America, [34] and in Africa[35]. What has taken its place is

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[32] While China's annual population growth rate has slowed to just under 1 percent, Japan's annual population growth rate was 0.6 percent for the 1980-1994 period, and 0.3 percent for the 1990-1994 period.

[33] The Argentine economist Raoul Prebisch was most noted for advocating this policy for Latin America, and several African countries also had adopted similar approaches, which in both cases was built around the infant industry argument for industrial protection of John Stuart Mill in the nineteenth century. See R. Prebisch "The Economic Development of Latin America and Its Principal Problems" *Economic Bulletin for Latin America* 7 (February, 1962), pp. 1-22; "Latin American Industry: Past Evolution and Present Characteristics", (New York: United Nations, 1966), pp. 5-9; J.G. Palma, "Structuralism" in John Eatwell, Murray Milgate and Peter Newman,editors, *The New Palgrave: Economic Development* (New York: W.W. Norton, 1989), pp. 316-322, and in the same volume, "Raoul Prebisch", pp. 291-295. The argument over import-substitution industrialization in Latin American countries evolved into a literature on dependency as a byproduct of Marxian theory. See Theodore Dos Santos, "The Structure of Dependency" in *American Economic Review, Papers and Proceedings* (May 1970), 60:3, pp. 231-6; J.G. Palma, "Dependency: A Formal Theory of Underdevelopment or a Methodology for the Analysis of Concrete Situations of Underdevelopment?" *World Development* 6 (1978), pp. 881-924; J. Serra, *Desarrollo Latinoamericano: Ensayos Criticos* (Mexico: Fondo de Cultura Economico, 1974); and A.G. Frank, *Capitalism and Underdevelopment in Latin America* (London: Monthly Review Press, 1967). For Africa, see Samir Amin, *Unequal Exchange* (Brighton, England: Harvester Publishers, 1976); and *Neocolonialism in West Africa* (Harmondsworth, England: Penguin Publishers, 1973).

[34] See Winston C. Dookeran, editor, *Choices and Change: Reflections on the Caribbean* (Baltimore: The Johns Hopkins University Press, 1996); Javier Martinez and Alvaro Diaz, *Chile: The Great Transformation* (Washington, D.C.: The Brookings Institution, 1996); Laura Randall, editor, *Changing Structure of Mexico: Political, Social, and Economic Prospects* (Armonk, New York: M.E. Sharpe, 1996).

[35] Africa's economic reforms, as with those in Latin America, typically have been classified under conditionality and structural adjustment, terms developed respectively by the IMF and the World Bank, to identify programs of market-oriented reforms. See Tyler Biggs, et.al. *Africa Can Compete* (Washington, D.C.: The World Bank, 1996); Tyler Biggs and Pradeep Srivastava, *Structural Aspects of Manufacturing in Sub-Saharan Africa* (Washington, D.C.: The World Bank, 1996); Kapil Kapoor, editor, Africa's *Experience with Structural Adjustment* (Washington, D.C.: The World Bank, 1995); Pierre Landell-Mills, Ramgopal

structural adjustment built along the lines of economic liberalization, in international trade, in agriculture and in industry. To the extent that these countries have engaged in market liberalizing reforms, they have experienced increases in economic growth[36].

B. Mercantilism as a Development Model?

Although mercantile tendencies exist in all countries, as Latin American and African countries have embraced economic liberalization, they have placed relatively less emphasis on mercantilism than has been the case in East Asia. This is not to justify the application of mercantilism as a means to economic growth, particularly if we look at how this has slowed the longer term prospects of such countries as Japan. Yet in the medium term, China's export-driven policies do offer an example for Latin America and Africa, especially as they shift from import-substitution policies. The limits of mercantilism are that where all countries adopt this approach, the benefits of international trade are limited, and world economic growth is reduced below what it could achieve on a more open market basis.

C. Managed Foreign Investment versus Economic Efficiency

Developing countries throughout the world, even though that have less obvious mercantile policies than those found in East Asia, have long put into place investment codes designed to attract foreign capital. What need to be kept in mind is that foreign investment, particularly equity capital, is fairly mobile. Countries that seek to increase foreign capital inflows can only succeed to the extent that the risk adjusted rate of return is at least equal to the opportunity cost of capital. In this sense, it is not enough to develop enabling legislation to direct foreign capital inflows to a recipient country's priority sectors. Markets must be sufficiently flexible for adjustments to occur when new information appears. When this does not occur, countries wind up increasing the capital-output ratio, and which eventually leads to a reduced level of investment.

One common experiment that is found in China as well as in many developing countries is the establishment of free enterprise zones. These are tax-free zones in which firms can operate wholly-owned or joint ventures with local partners new businesses that serve primarily the export market. Mexico's *maquiladora*, or tax-free export zones, along the U.S. border, are one example of this approach, and China has already established similar zones in Guangdong. All of these provide some basis for increasing the inflow of foreign investment, but they are far more limited than open-ended policies designed to expand the overall level of investment.

The essential problem with controlled foreign capital inflows is simple. They tend to create distortions in the flow of investment. As firms seek greater flexibility, these zones become targets for corruption, which ultimately lowers the operating efficiency of investment. At best, they serve as intermediate steps to universally open capital flows, just as labor market reforms need also to be developed to improve the efficiency of labor resources in a country's program for economic growth. Finally, for those countries that succeed in generating trade and balance of payments surpluses, as these surpluses become large in a country's overall economic mix and in the context of global trade and investment, they inevitably generate tensions on the evolution of the global trading system. Thus, as

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Agarwala, and Stanley Please, *Sub-Saharan Africa: From Crisis to Sustainable Growth* (Washington, D.C.: The World Bank, 1989); Christine W. Jones and Miguel A. Kiguel, *Adjustment in Africa* (New York: Oxford University Press for the World Bank, 1994); and in particular, Eliot Berg, coordinator, *Accelerated Development in Sub-Saharan Africa: An Agenda for Action* (Washington, D.C.: The World Bank, 1981), which set the stage for structural adjustment programs of the World Bank in Africa.

[36] See in particular, World Bank, *From Plan to Market, World Development Report 1996* (New York: Oxford University Press for the World Bank, 1996), which discusses the comparative impact of economic reforms in East Europe and East Asia.

with mercantilism overall, skewed capital inflows eventually lead to diminishing returns to growth.

D. Reshaping Government Priorities for Infrastructure Development

As developing countries embrace market-driven reforms, the role of government is reduced accordingly. This is not to say that governments have no constructive role to play in economic growth, but rather that with the limited resources at their disposal, they can improve their efficiency by concentrating on those activities most conducive to growth. In China, as elsewhere, shifting resources from subsidies for inefficient state enterprises can also expand the level of investment in education and health, as well as in the development of a country's physical infrastructure.

To place government reforms in a comparative context, Table 5 illustrates some common social indicators for countries grouped by geographic region. With the somewhat limited exception of Sub-Saharan Africa, most countries have achieved notable improvements in life expectancy and in enrollment ratios for primary and secondary schooling. As investment in these sectors is an essential complement to the shift to market-driven reforms, reducing the range of responsibilities for government action can enable the public sector to nourish development in those areas most likely to yield higher levels of per capita income. Countries in each of these regions that have concentrated public sector resources to education, health, and infrastructure development over state enterprises have generally achieved higher rates of economic growth than for countries that have not done so.[37]

[37] See Ha-Joon Change and Robert Rowthorn, *The Role of the State in Economic Change* (New York: Oxford University Press, 1996), for a critical perspective on this issue. See also, William Easterly, Carlos Alfredo Rodriguez and Klaus Schmidt-Hebbel, *Public Sector Deficits and Macroeconomic Performance* (New York: Oxford University Press, 1995); Ahmed Galal, Leroy Jones, Pankay Tandon, and Ongo Vogelsang, *Welfare Consequences of Selling Public Enterprises* (New York: Oxford University Press, 1994); Joseph Stiglitz, *Whither Socialism?* (Cambridge, Mass.: MIT Press, 1994). Stiglitz emphasizes the role of information as guiding the understanding of institutional innovation more than a simple comparison of market socialism versus classical market systems.

Table 4

Comparative Social Indicators	1960	1965	1970	1975	1980	1985	1990	1995
Comparative Health Indicators								
Life Expectancy								
China	40.5	48.5	57.9	62.5	66.4	68.0	69.0	69.0
E.Asia & Pacific	42.0	48.9	56.9	60.9	65.2	66.6	68.0	68.0
L.America & Caribbean	55.4	57.6	59.8	62.0	64.3	66.1	68.0	68.0
Sub-Saharan Africa	40.5	42.7	45.0	47.2	49.6	49.0	51.0	52.0
Fertility Rate								
China	5.8	6.6	5.3	3.3	2.5	2.3	2.1	1.9
E.Asia & Pacific	5.9	5.6	5.3	4.1	3.2	2.9	2.7	2.2
L.America & Caribbean	6.0	5.6	5.3	4.8	4.3	3.7	3.1	2.9
Sub-Saharan Africa	6.6	6.6	6.6	6.6	6.6	6.7	6.4	5.9
Infant Mortality Rate								
China	165.0	125.0	90.0	88.0	72.0	35.0	38.0	30.0
E.Asia & Pacific	155.5	118.6	90.5	80.6	71.8	54.9	42.0	35.0
L.America & Caribbean	106.9	96.2	86.5	74.6	64.4	53.2	44.0	41.0
Sub-Saharan Africa	167.2	155.9	145.3	133.4	122.5	167.0	104.0	92.0
Population per Physician								
China	8330.0	5626.2	3800.0	2884.8	2190.0	1730.0	1366.6	1079.6
E.Asia & Pacific	12423.2	9032.5	6567.2	4843.7	3572.5	3235.3	2930.0	2653.5
L.America & Caribbean	2561.6	2287.1	2042.1	1924.9	1814.4	1463.2	1180.0	1037.3
Sub-Saharan Africa	49467.4	36803.1	27381.1	24049.8	21123.8	26760.0	23540.0	20707.5
Comparative Education Indicators								
Primary Enrollment Ratio								
China	109.0	109.3	109.6	115.2	121.0	124.0	135.0	120.0
E.Asia & Pacific	102.6	103.7	104.8	108.8	113.0	119.8	127.0	119.0
L.America & Caribbean	88.4	91.4	94.5	99.6	104.9	105.9	107.0	105.0
Sub-Saharan Africa	39.7	45.0	51.0	62.9	77.6	75.0	68.0	77.0
Secondary Enrollment Ratio								
China	21.0	21.8	22.5	34.0	43.0	39.0	48.0	60.0
E.Asia & Pacific	19.4	21.3	23.4	29.0	36.0	29.4	24.0	61.0
L.America & Caribbean	14.0	19.6	27.4	32.5	38.6	32.9	28.0	45.0
Sub-Saharan Africa	3.6	5.0	7.0	10.0	14.4	23.0	17.0	24.0

Source: World Bank data, and author's compilations

E. On the Uses and Limits of Demographic Restraint

Although China has embarked on a vigorous program of slowing the increase in population, countries in Latin America and Africa have done so to a far lesser extent. Because the linkage between population growth and economic growth is a tenuous one, what is clear is that for developing countries, as long as market incentives are in place, countries can achieve higher rates of economic growth, and for which the corresponding rate of population growth can be determined by corollary considerations[38].

The demand for children in developing countries is often a proxy for a shortfall in agricultural labor when urbanization occurs, and as an informal system of social security. Improvements in education and technology thus tend to reduce a country's rate of population growth, as experience has shown. Thus, while China does offer an example of a model for population policy, it is not necessarily a suitable choice for many developing countries.

[38] See Nigel Crook, *Principles of Population and Development* (New York: Oxford University Press, 1997); Jason L. Finkle and C. Alison Mcintosh, *The New Politics of Population* (New York: Oxford University Press, 1994); Anne Hélène Gauthier, *The State and the Family* (New York: Oxford University press, 1996); Kerstin Lindahl-Kiessling and Hans Landberg, *Population, Economic Develoment, and the Environment* (New York: Oxford University Press, 1994); and Warren C. Sanderson and Jee-Peng Tan, *Population in Asia* (Washington, D.C.: The World Bank, 1995)

VI. Conclusion

China's economic reforms have produced unparalleled rates of increase in economic growth. Much of this growth is based on domestic and international private sector investment in firms that are export-oriented. While state enterprises still form a cornerstone of China's commitment to market socialism, it is the growth of tax revenues generated by private sector reforms that enables these enterprises to forego more market-driven adjustment. Over the longer term, China's policies to direct foreign capital inflows to export-driven sectors of the economy will succeed only to the extent that the East Asian mercantile model can be sustained. Surpluses in China's trade and balance of payments inevitably generate trade frictions and stall the pace of growth. For developing countries, mercantilism can serve at best limited ends in the medium term. To succeed, all countries will have to embrace sooner or later the classic model of international trade. Japan, one of the pioneers in export-led growth, may be the leader in the shift from mercantile policies to classic free trade. This shift may affect China's economic reforms, as well as those of other developing countries, as global economic integration proceeds.