
It’s a great pleasure to be with you here tonight. I want to congratulate The 1990 Institute on its extraordinarily productive record of performance over the past four years. You are doing a very important piece of work and deserve every encouragement.

As to China and our interest in China, it derives from several sources. The major source is that one of the great economic experiments of our time is under way in China. There has been no example in history of a totalitarian society converting itself into an essentially free market society with political freedom for its citizens. Russia and China are now trying to be the first to make that transition. I leave out the former captive countries of the Soviet Union, such as Hungary, Czechoslovakia – now the Czech Republic, and so on, because they were capitalist, free countries and became totalitarian states not by their own will but by pressure from the outside. We have therefore been very much interested in seeing how the situation has changed in both China and Russia.

However, I must confess that we like China better than we like Russia, as judged by our behavior. We’ve been in China three times whereas we’ve been in Russia once, and that once was 1962. When I’ve been asked ever since to go back to Russia, my standard response has been: “I’ve been there. Why should I?”

We have made three visits to China: in 1980, when I went as part of an exchange program under the auspices of an American-Chinese Committee; in 1988, when we went to attend a conference that was held in Shanghai by the Cato Institute, and in 1993. The 1988 and 1993 trips were planned and made far more productive by a former student of mine, Steve Cheung, who is
now a Professor of Economics at the University of Hong Kong and is extraordinarily knowledgeable about what is going on in China.

I thought that it would be of some help to you, in indicating how much confidence you can put in what I am going to say, if I read to you excerpts from reports I made in 1980 and in 1988 about my impressions on the occasion of those trips. In 1980, I reported to the sponsoring organization a summary of my views. I will give you a few excerpts from it.

I wrote that my introductory impression was one of “immense personal good will, great efficiency in the small, tremendous bureaucracy and inefficiency in the large.” I may say that I have seen no reason to change any of those three characterizations on the basis of the two subsequent trips we have made to China.

“On an absolute level,” again, this is in 1980, “China is a very poor, backward economy…. With respect to change as opposed to level, the situation is more complex. There clearly has been a decided improvement in the economy in the past three years or so. The Chinese attribute this to the new ‘pragmatic’ policies adopted under Vice Premier Deng.…

“My own impression is somewhat different…. The mere restoration of order after the death of Mao and the gaining of power by Deng was bound to permit a rapid recovery and a jump up in economic level.…

“The reforms – the attempt to introduce market elements, the opening up of contacts with the West, the encouragement of foreign investment, and so on – are in a desirable direction. But the test of whether they will be carried out and what their effects will be is still for the future.

“The potential is enormous. The present level is extremely low.…

“My own conjecture is that there will be considerable progress in the next few years as some of the newly announced policies work themselves through the system. At the same time I am pessimistic that the progress will be long continued. Opening up the system involves dispersing power and responsibility, and that will produce threats to the security of the centralized political apparatus, which is likely to respond by closing things down again.”
Those threats were slower to emerge than I had supposed they would be, but they did emerge in 1989 and they did lead to the Tiananmen episode, which certainly constituted a severe check to economic development.

In 1988, I summarized my reaction as follows: “We were greatly impressed by what we saw. The few free markets, selling almost exclusively farm products and covering small areas in hard-to-get-to locations, had grown into extensive free markets selling a wide range of products, involved not only in retail but also in wholesale trade, catering to small-scale private enterprises….

“Most impressive of all were the obvious signs of enterprise and progress in some smaller towns and villages that we visited. Almost exclusively agricultural when we were in China in 1980, some had become largely industrial….

“Most such enterprises were governmentally run or sponsored, but by local government not the central government, and hence subject to competitive pressures. The important thing is decentralization and competition, best of all among strictly private enterprises, but better between decentralized government units than not at all.”

Then after Tiananmen Square, when I wrote a newspaper column, I said, “I have every confidence that sooner or later movement toward a market controlled economy will continue. But will that be in one year or in ten?” As it turned out, it was nearer to one year. By 1990, progress and growth had been resumed.

As to our 1993 visit, when we spent eight days on a very intensive trip beginning in Chengdu, going on to Chongqing, and then Shanghai and Beijing, I regret that we were only able to visit cities and were not able to visit any rural areas. I should have insisted that we visit some rural areas, but that is in retrospect.

However, I had very mixed feelings. There are signs of great progress, but there are also some very negative features. The progress is unmistakable. In Chengdu, we were shown a marvelous underground shopping mall that a little over a year ago was a bomb shelter remaining
from Mao’s days when he was greatly concerned that the Western world was going to attack and had bomb shelters built everywhere. It had been transformed in a little less than a year into a modern, up-to-date shopping mall with prominent stores lining both sides of a corridor. There was even a night club. We talked at length with the man who was most responsible for developing the shopping mall. He explained that it did have government participation, that it was not strictly private, but that most of the funds were private funds invested in it. He also talked about the difficulties he had getting around some government regulations. But it was obviously a successful enterprise and a modern, up-to-date enterprise. It had been completed in a remarkably short time at a cost that could not have been matched, I suspect, anywhere else in the world.

In Chongqing they were in the process of developing a market in currency futures. In 1988, we would not have regarded that as a remote possibility, but this is 1993 and they will be dealing in commodity futures in Chongqing. They’re talking about damming the Yangtze River, but that’s so complicated, difficult, and undesirable a project that it probably will never be done. However, that’s an amateur’s opinion.

One of the things that we have observed in visiting underdeveloped countries that are trying to come into the modern world, which includes especially India in comparison to China, is that what happens at first is the development of a lot of tourist hotels. I don’t know why these underdeveloped countries need such fancy tourist hotels, but they all do. We were very impressed by the quality of the tourist hotels in the various Chinese cities. There was enormous improvement from 1980 to 1988. In 1980, essentially all hotels were government owned and run, and were very inferior. By 1988, there were some joint venture hotels of a much higher standard; by 1993, there were many.

Shanghai had blossomed between 1988 and 1993. The skyline had been transformed. There were some high-rise buildings in 1988, but they were few. The main attraction then was the Bund along the waterfront. But now there are shopping streets that glitter like the Ginza in Tokyo. I may say that the visual changes were least of all in Beijing.
Those are the good things. On the other hand, some of the visual progress is highly deceptive. There are Potemkin villages. To illustrate: in Shanghai, not all that glitters is gold. We were driven down a street in the Pudong development district – one of the prides of China – and there was a street that looked like one of the shopping streets in town with one store after another with a famous name on it. We were told that the street had been developed in great haste with a large input of subsidies because a year before Deng had visited Shanghai and had expressed disappointment that the Pudong development was not going fast enough. So they said: “You come back in a year and we’ll show you.” But that’s not really economic development. That’s a waste of funds.

More important, because it illustrates a general principle, a bridge across the river from Pudong to Shanghai was just being dedicated as it happens on the day that we were there. There was a great celebration because it was the second or third longest suspension bridge in the world. It so happens that among the group of Chinese friends we were traveling with from Hong Kong was one who was a transportation expert. He said that there was general agreement among transportation people that it would have been much cheaper to build tunnels under the river than to build a bridge over it. The bridge cost something like two or three times as much, especially in terms of the amount of valuable land space that is required for such a structure. But you can see why it was built. You can’t have much of a celebration for cutting ribbons in a tunnel, although they have undoubtedly been trying to do it in the Chunnel in Britain. This is a government activity and if the government is going to do something, it wants to do something to show off – something that glitters, that will get the newspapers, that will be the third longest suspension bridge in the world. Tunnels just don’t have the same kind of cachet.

However, when you calculate GDP, the full cost of that bridge goes into GDP and then enters into GDP growth. But it’s fake growth. It’s a waste of resources, not real growth. I may say that that happens not only in China. It happens in the United States – most recently the billions of dollars that American enterprises have had to spend because of the Americans with Disabilities
Act, which has been of very limited benefit to the truly disabled. That has been part of the rapid growth in U.S. GDP in the past year, but it doesn’t represent growth in the well-being of the American people. The same is true in China. GDP figures do not distinguish between capital investment that is truly productive and capital investment that is a waste.

Again, consider foreign investment. One of the things that has sparked Chinese development has been the amount of capital investment from abroad. Again, there are two kinds: some of it is good and some of it is bad. Capital investment that receives no subsidies from the government and no special privileges benefits China. But capital investment that is in China only because it is subsidized involves a burden on the Chinese people to benefit the foreign investors. For example, there is special tax treatment in the early years for so-called foreign venture enterprises and in many of those cases the foreign venture is a fake. It’s a way of getting special tax treatment. It doesn’t really contribute to the productivity of the enterprises, especially the local domestic enterprises that will no doubt have to show that they are a foreign venture in order to qualify, but there are many ways that that can be done. I talked to some small entrepreneurs who were quite frank that the only reason they had a foreign venture was in order to qualify for special tax treatment. By now I have forgotten, but they explained how they satisfied the requirement that exports account for a minimum fraction of sales. I am not talking about anything that is peculiar to China. We have the same thing in many other countries, and in the United States. One state, I believe Tennessee, paid a tremendous amount to induce BMW to build a plant there. It’s doing exactly the same thing. It’s showing off. It’s doing something for publicity, not for the community. The cost of the subsidy to BMW will have to come out of the pockets of Tennessee taxpayers. All this means that you have to take the numbers that statisticians grind out with a pinch of salt.

Even so, there is no question that there has been great progress in China. It’s interesting to ask, “Why has China done so much better than Russia?” I believe that the answer is straightforward. China has had one major advantage that Russia has not had; namely, the “outer
Chinese.” Hong Kong, Taiwan, Singapore, and the Chinese in the United States have made the basic difference between the rapid Chinese development in recent years and the lack of any similar and rapid development in Russia.

I come to a second feature that concerns me: one thing of which there is absolutely no shortage in China are bureaucrats. There is no sign of any lessening of the central bureaucracy or of central control whether it’s in Sichuan, Shanghai, or Beijing. That came out very clearly during our talks with some of the leaders. When we asked them what their plans were for the future and so on, they all sounded as if their answers came off the same tape. In every case we were told, “Oh, we’re going to have banking reform,” and in every case we were told exactly what the banking reform was going to be. There was no disagreement, very little indication of independent thought or independent ideas on what should be done. There is still a centralized bureaucracy that is in control. There’s a clear party line.

What’s more, Hang-Sheng Cheng referred to the socialist market economy. Now you know that that is a contradiction in terms. That’s like talking about a married bachelor. If it’s socialist, it’s not a free market; and if it’s a free market, it’s not socialist. Of course there can be and always is a mixture. Every free market country has some elements of governmental and central control. In every totalitarian country, even China and Russia before the recent changes, there is some element of a market. The question is: which is dominant? My impression is that there is no sign on the part of the political leaders in China of a readiness to give up power, to let the market really take over.

What they mean by a socialist market economy is that there is going to be controlled reform from the center. There seems to be a strong feeling in Beijing that decentralization has already gone too far and needs to be corrected. They want more centralized collection of taxes and more centralized control over lending in the various cities.

There’s a lot of talk about privatization, but much of what is called privatization of state enterprises is merely formal in order to take advantage of the benefits of a shared foreign venture.
That’s why you have Type A stock and Type B stock. In order to qualify for tax benefits, which
requires a certain fraction of foreign ownership, there’s a special class of stock for that purpose.

More important than anything I’ve said so far, from the people I talked to in Beijing, I
concluded that the model on which they are now operating is the model of Japan and not the
model of Hong Kong. When they talk about a socialist market economy, they are basing it on a
mistaken view of how Japan works. There is the mistaken view in China and also in the United
States and elsewhere that Japan was developed by a Japan Inc. – that a powerful Ministry of
Industry and Trade International (MITI) picked out the industries that should be developed,
directed capital to those industries, and was in that way responsible for the extraordinary success
of Japan. That is factually a bunch of nonsense. The great successes in Japan were achieved by
entrepreneurs who defied MITI. Honda never got MITI’s permission. MITI thought that the
automobile industry was an industry in which Japan could never get anywhere and so they tried to
reduce the number of automobile companies to three so that the domestic market could be amply
served. Honda couldn’t initially get permission to start its factory. The same thing is true of Sony.
The things that the MITI supported were all failures: shipbuilding and steel-making; those are the
things they supported, not automobiles.

However, the Chinese, like so many Americans, have a misconception. They think that there
was centralized control of development in Japan and that it produced great success. At the time
Japan was growing most rapidly, back in the 1960s, government spending totaled about 20 to 25
percent of national income. One reason Japan is now slowing down is because government
spending has gone up rapidly relative to their income.

At any rate, the right image for China should be Hong Kong not Japan. The reason the image
of Japan appeals to the Chinese is that it comes from the center. It can be “reformed” by being
controlled from the center. They talk about the socialist market economy as one in which the
government tells the market what it wants the market to do and then the market turns around and
does it. But there isn’t any such thing as a market in that sense.
What produces progress are individuals who have private property and who have incentives to promote their own well-being. A market is simply a place where people meet. It’s not an active participant.

The momentum of growth is great and will continue. It’s been sparked in the south in Guangdong province. Hong Kong has played a tremendous role in that development. So has more recently the input from Taiwan and from the West, the United States in particular.

But China is headed for a crisis. You cannot long continue with economic development and continue to have a centrally controlled political society. There was one clash at Tiananmen Square. That was a preview and it was resolved by government force. But there is another clash coming. I don’t know when – maybe in a few years, maybe in five years, maybe in ten years. I’m not talking about the immediate problems. China has been on a five-year pattern of ups and downs in inflation and at the moment it is hitting a very difficult spot with respect to inflation, but that will be surmounted. I’m talking about a fundamental conflict between the economic path they’re on and the political path. One or the other is going to have to give. I believe that the takeover of Hong Kong, which is now very close indeed, may be the first indication of which way it’s going to go.

China has tremendous potential. It has able people, intelligent people, hardworking people, entrepreneurial people. It has a lot of supporting capital from abroad. So if it were to take the Hong Kong route, it could grow very rapidly. There is no limit to its potential, to its wealth.

At the moment, China has two systems operating more or less at the same time: the Hong Kong system and the Beijing system. Beijing says that they are going to have one country with two systems. That will not happen. One system or the other will dominate. The real question, I believe, about the long-run future of China is which system will dominate. That’s the really interesting question. Thank you.