

To lead by setting an example, (not by lecturing).

What you do not want done to yourself, do not do to others.

-- Confucius (551-479 B.C.)

## **China Approach in a Changing World**

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### **6º. FORUM DE ECONOMIA DA FUNDAÇÃO GETÚLIO VARGAS**

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#### **Abstract**

The Washington Consensus failed to recognize the need of the developing world and the limits of the western mode of industrialization. In last three decades, China experiments a new approach with self-determination, open-minded learning, decentralized experiments, and dual-track reform to simultaneously achieve high speed growth, social stability, and international partnership in peaceful development.

#### **I. Introduction**

Economic stagnation in 1970s created an opportunity for Robert Lucas at University of Chicago; he launched a counter-Keynesian revolution under the banner of microfoundations and rational expectations, silenced Keynesian economics for three decades until this crisis. In 1980s, Mrs. Thatcher in the U.K. and Mr. Reagan in the U.S. launched a free market revolution by privatizing, deregulation, and cutting-tax. The Friedman experiment in Chile in 1980s paved the foundation for the Washington Consensus (Williamson 1990). The collapse of

the Soviet Union in 1990 led the claim of “the end of history” by Fukuyama (1993). All these events created a rapid expansion of American-led globalization and marketization in the last two decades. The collapse of the American financial system in 2008 created a global crisis. People suddenly realized that there are several, not just one mode of market economy. The Japan mode, the continental European mode, the Scandinavian mode, the China mode, and perhaps the Brazilian mode, are all competing with the Anglo-Saxon mode of capitalism. As an evolutionary physicist trained in nonlinear dynamics and non-equilibrium thermodynamics, we already knew from biological evolution that social evolution is an open-ended diversified process. The dream of one world led by Anglo-Saxon mode of extreme individualism and unbridled market is only an equilibrium illusion promoted by flawed models in neoclassical economics. In this article, we will make a brief discussion on why the Washington Consensus is wrong not just for transition countries in East Europe and former Soviet Union (EEFSU), but also observations in this crisis in the US; explain why China could overcome all the odds to achieve and sustain rapid growth. Finally, we will discuss the future world order after this Grand Crisis.

## II. Empirical Facts and a Comparative Performance of the Mixed Economies

The Washington Consensus created a myth of an all-capable market with minimum government. This is not true. Let us first look at the initial conditions and the country performance in different periods (see Table 1 and 2).

**Table 1 Arable Land and Population cross Countries in 1993**

Region	Arable Land (%)	Population (millions)	Arable land per capita (ha)
China	10	1178	<b>0.08</b>
Europe	28	507	0.26
US	19	239	0.73
fUSSR	10	203	0.79
Japan	12	125	<b>0.04</b>
India	52	899	0.19
Brazil	6	159	0.31
Australia	6	18	<b>2.62</b>
Canada	5	28	1.58

Data source: Madison (1998).

**Table 2 World Economy in Historical Perspective**

(Annual average compound rate of GDP growth)

	WEuro	EEuro	Asia	US	Japan	fUSSR	China
1913-50	1.19	0.86	0.82	<b>2.84</b>	<b>2.21</b>	2.15	-0.02
1950-73	<b>4.79</b>	<b>4.86</b>	<b>5.17</b>	3.93	<b>9.29</b>	4.84	5.02
1973-2001	2.21	1.01	<b>5.41</b>	2.94	2.71	-0.42	<b>6.72</b>

Source: Maddison (2007) at <http://www.ggdc.net/Maddison/>

Asia data excluded Japan

You can see that Europe and the US led the world before 1950, but Japan and China led the growth in 1950-73 and 1973-2001 respectively. East Europe and former Soviet Union (EEFSU) even did better than West Europe before 1973 but self-destructed after 1973. A careful examination will also show that the state sector plays an important role in education, science, infrastructure, and rural development; development is not a fairy-tale story of laissez fair policy, especially for those of catch-ups by German, Japan, former Soviet Union, and China.

I did not family with the outcome of the Washington Consensus in Latin America. But I did a comparative study of transition economies in EEFSU and China. The stylized facts are in Table 3, 4, and 5.

**Table 3. Russia's Economic Declines in 20<sup>th</sup> Century**

(Each period started with 100%)

Period	1913-22	1940-45	1990-96
Russia/USSR	WWI&CW	WWII	Transition
National Income	55.6	83.1	<b>54.7</b>
Industrial Output	<b>31.0</b>	91.8	47.5
Agriculture Output	66.3	<b>57.0</b>	62.5
Capital Investment	40.3	89.0	<b>24.3</b>

Source: V.Tikhomirov (2000)

Russia's steepest decline in national income and capital investment occurred

in peaceful transition in 1990s, which was under the guidance of the Washington Consensus or the Shock Therapy!

**Table 4. Economic Performance during Transition**  
(Each period started from 100%)

Region	Date	1978	1989	1990	1998	2006
China		100	272	282	651	1327
			100	104	239	488
				100	230	471
East Europe		100	151	82.6	55.7	87.1
			100	54.7	36.9	57.7
				100	67.4	105
Russia			(100)	50.7	31.5	53.1
				100	57.4	96.6

Data source: United Nations Statistics (in constant 1990 dollar). Russia (1989) was estimated from USSR (1989).

You can see from the Table 4 that China's real economy has increased more than 13 times for the last three decades; while EEFSU are still below the level of late 1970s. This is a natural experiment in testing competing economic schools between equilibrium approach and evolutionary approach (Chen 2006, 2008).

**Table 5. Peak Inflation Rate during the Transition**  
Measured by the implicit price deflator in national currency

Country	Peak Inflation (%) (Year)	Length of High Inflation (>40%)
China	13 (1988), 20 (1994)	0
E.Germany	9 (1990)	0
Poland	400 -581 (1989-90)	5 yrs (1988-92)
Bulgaria	334 -1068 (1991-97)	7 yrs (1991-97)
Romania	295 - 300 (1991- 92)	9 yrs (1991-2000)
Ukraine	3432 (1993)	6 yrs (1991-96)
Russia	1590 - 4079 (1992 - 93)	8 yrs (1991-98)

Data source is the United Nations Statistics Database.

China's rise is a historical example against conventional wisdom in neoclassical economics. China is a large country with many odds in development. China's arable land is only 10 percent, with 90 percent mountains and deserts, which made infrastructure development very costly. China had cyclic peasant wars or foreign invasions that wiped out more than half population 13 times in

history before the communist party finally united China and stands against foreign invaders. Therefore, China's development is not driven by consumer's demand or individual freedom but by nation building and consensus building for a better position in a competitive world. China's high growth is led by industrial development and technology progress, not foreign aids or private consumption. Some selective data on China's industrial output, infrastructure development, and other facts are given in the Table 6 to 9. Data source is China Statistical Bureau.

Table 6. China's Industrial Output

Year	1958	1968	1978	1988	1998	2007	2008	2009
<b>Steel</b> (Mton)	6	16	31.8	59	116	489	500	
Gr(%)	9.8	6.9	6.2	6.8	<b>14.6</b>			
<b>Car</b>	57	279	3k	36 k	507k	4.8m	5.0m	
Gr(%)	15.9	23.8	24.9	<b>26.4</b>	22.9			
<b>Vehicles</b>	16k	25k	149k	647k	1.6m	8.9m	9.3m	10m?
Gr(%)	4.4	17.9	14.7	9.1	17.6			
<b>CoTV</b>			4k	10m	35m	85m	90m	
Gr.			<b>78.2</b>	12.5		9.4		
<b>PC</b>				116k	2.9m	121m	?	
Gr(%)				32.2	<b>41.5</b>			
<b>CellPhone</b>				(started 2001)	547m			

Here, Gr for average annual growth rate for each decade. Listed items include steel production, vehicle and car production, color TV, PC computer, cell phone.

Table 7. China's Development Progress

Year	1958	1968	1978	1988	1998	2007	2008	2009
<b>ExWay</b>				0.1k	8.7k	53.9		
Gr(%)				<b>44.7</b>	20.3			
<b>UnvSts</b>				856k	2.1m	3.4m	18m	
Gr(%)			8.9	4.8	<b>16.7</b>			
<b>GrSts</b>	3k		10.9k	113k	199k	1.2m		
Gr(5)			23.4	5.7	<b>20.0</b>			
<b>StsAbr</b>		500		860	3.8k	17.6k	144k	
Gr(%)			14.9	15.3	<b>23.4</b>			

Here, listed items are: high speed express way, total number of university students, graduate students, and students studying abroad.

Table 8. **China's Living Standard**

Year	1958	1968	1978	1988	1998	2007	2008
<b>AvWage</b>			615	2000	7480	24900	
Gr(%)			11.8	13.2	<b>13.4</b>		
<b>ResDpt</b> (Byen)			21	600	5340	17253	
Gr(%)			<b>33.5</b>	21.9	13.0		

Listed items include average nominal wages, and resident deposits in banks. Their growth rate is parallel or even higher than GDP growth rate. The average annual inflation rate in China is 5.5%. So, the real wage growth rate is 7% per year for last 30 years.

Table 9. **China's Trade, Foreign Reserve, and FDI**

Year	1958	1968	1978	1988	1998	2007	2008
<b>TrSpIs</b> (\$b)			-2	200	360	2017	
Gr.(%)				5.9	<b>19.2</b>		
<b>ForRes</b> (\$b)			0.2	3.4	145	1528	
Gr(%)			28.3	<b>37.5</b>	26.2		
<b>FDI</b> (\$b)				5.3	52.1	200	
Gr(%)				<b>22.9</b>	16.8		

Here, data include trade surplus, foreign reserves, and FDI received. Growth rate is measured by average for each decade.

How to understand these economic indexes? Is there a China miracle or unsustainable explosion? Let us discuss the rational behind the different development modes.

### III. What Is the Problem with the Washington Consensus?

The Anglo-Saxon model of market economy can be approximated by the so-called the Washington Consensus, which was proposed in 1990 (Williamson 1990). It includes a set of the standard policy recommendations by IMF, World Bank, and essentially the U.S. Treasury Department. Most policies were applied in the Latin America in 1980s first, and in EEFSU in 1990s, and finally in East Asia financial crisis in 1997. It could be summarized in 10 propositions:

Fiscal discipline

A redirection of public expenditure priorities toward fields such as primary health care, primary education, and infrastructure

Tax reform (to lower marginal rates and broaden the tax base)

Interest rate liberalization

A competitive exchange rate

Trade liberalization

Liberalization of inflows of foreign direct investment

Privatization

Deregulation (to abolish barriers to entry and exit)

Secure property rights.

Theoretically, it can be fully justified by neo-classical economics. Its central idea is the free market system could achieve everything. The government role should be kept to the minimum in the infrastructure building and protection of property rights. Once you have privatization, market incentive directed by liberalized price will achieve optimal social outcome. Once you liberalize the trade and exchange rate, you will see a free flow of FDI, knowledge, and technology from developed countries to developing countries. There is no market instability, market power, and asymmetric competition in a world with uneven wealth. Certainly there is no need for independent learning and development strategy for each country in adapting to a global market with rapid changes in technology and environment. Freedom, liberty, and democracy are symbols of American dream, which also implies big paychecks, big car, and big houses. But as any Chinese student educated in the Confucius tradition, we know from very beginning that the natural resource is scarce, the environment is harsh, foreign challenge is constant. We have to prepare the hardship and share limited resources with family and friends, and put public interests ahead of family and individuals

in order to survive. We also know the degree of freedom is widely different for rich and poor. The only means to lift from poverty is not wishful thinking from the Heaven or random gifts from the air, but painstaking learning and family investment in education not pleasure.

Mr. Reno, a thoughtful journalist turned into an investment consultant, developed three theorems from his observations and coined the term of the Beijing Consensus (1995). In his own words:

First, the value of innovation. The development strategy should not be trailing-edge technology (copper wires), but bleeding-edge innovation (fiber optic) to create change that moves faster than the problems change creates. [Ping Chen's observation: it was true for telecommunication, but not quite for agriculture technology. The key is finding appropriate technology under the dual-track experiment, not necessarily all bleeding-edge innovation. Say, China is very cautious in entering arm race and entertainment business, which are central in the US business].

Second, focus is the quality-of-life and chaos management. It demands a development model with sustainability and equality.

Third, the Beijing Consensus contains a theory of self-determination.

There are some interesting insights in the Beijing Consensus; especially the last two theorems. However, few western observers or even Chinese economists have ever reached a consensus that China's development model has any possibility to be duplicated by the others. This may be also true for the Anglo-Saxon model. No any later comers have the luck to conquer the vast land in Africa, North America, and Australia without comparable resistance from native residents. China's development has to be self-accumulation and self-finance since they had little hope of large scale of the US aid, such as those for Taiwan and Poland during and after the Cold War.

Why the Washington Consensus looks nice but practices terrible in developing countries and EEFSU?

First, its design is for the benefit of foreign investors, not for native residents. Liberalization in trade and exchange rate serves the short-term interests of multinational companies and speculative capitalists, but generates great shocks for domestic industries and financial markets. When monetary unification in East and West Germany is enforced on July 1<sup>st</sup>, 1990, it immediately destroyed the existing trade network between East Germany and former socialist countries, the flood of fancy western goods further destroyed the domestic market of the East German industry. These two causes led to industrial output declines one third. West Germany has to support a massive financial transfer up to near 50% of East Germany GDP for social safety not real investment. The resulted slow down of Germany economy and high interest rate was a big burden to European monetary policy as a whole. When IMF forced Korea liberalized its capital account during the midst of Asian financial crisis, a flood of foreign capital took over control of Korea's star companies and banks. When I visit South Korea after the financial crisis, I was told: the foreign owned shares of the top Ten Korean Companies were less than five percent before 1997, but more than fifty percent after the Asian crisis. That is why Asian countries including Korea, Japan, and ASEAN became China's close economic partners rather than rivals in the American led globalization after 1997 crisis. As taught by Confucius, you can make friends by winning people's trust, not by taking other people's property during their weakness.

Second, the Washington Consensus simply listed a set of conflicting goals without any working proposal on strategy and sequence. For example, it puts fiscal discipline and infrastructure investment as top two targets for government policy, but did not say a word about how to finance government projects in social safety net, lawful order, and infrastructure investment. Polish economists observed that once you liberalized trade first, they found out the western trade partners did not open their trade barrier. The results was dramatically rise of firm's bankruptcy and unemployment rate, which immediately put fiscal pressure to the government and left little room for system reform. If you privatize state own enterprises (SOEs) and selling public land for short-term revenue, you may soon end with losing an important source of long-term revenue for education,

social welfare, and infrastructure development. If you deregulate the market without first developing alternative system in right place; you would face the chaos of the whole social system, so that market would be ruled by mafia rather than investors. When I visited Russia in 1997, army officers, police and professors did not get pay for three years under the IMF fiscal discipline for inflation control. It forced local governments became a grabbing hand rather than a helping hand in development. The only winner is Russian oligarchs who transformed from state managers of socialist monopoly firms into private owners of capitalist monopoly giants. And it is worse than before. You only see large scale of capital flight from destabilizing Russia market, comparing to the large scale flow of FDI into China with mixed property rights under a stable socialist market.

Mr. Ramo is right when he observed the innovation momentum in Chinese economy. But he did not ask why China could even learn and innovate faster than the US? From Karl Marx to Max Weber, most western thinkers considered peasants are the most conservative population during the modernization process and the Confucius teaching was a barrier for science and technology advancement since it put virtue ahead of technology, self-interest, capital and wealth. China is the least candidate for development model even behind Islamic culture, which is a commercial culture in nature. China also has a long history of centralized government with educated bureaucrats, which was considered as another big barrier for democracy and laissez fair policy. Why these barriers for development suddenly turned into driving forces for Chinese economy?

We should point out one thing, which was constantly reminded me by Joseph Stiglitz, A Nobel Laureate at Columbia University: “Do what Americans do, don’t do what Americans say.”

Take the first proposition in the Washington Consensus, the fiscal discipline. This proposition sounds good in normal time but does dangerously during the recession or crisis, since it is an anti Keynesian policy. The US governments rarely follow this principle since the Reagan administration. On the contrary, once in recession, every the US President declared that “we are all Keynesian now” to bail out big business by taxpayer’s money. If anything went wrong, it was always the fault of someone else. If there is tremendous instability in international market driven by hot money before the Asian financial crisis, the US policy

recommendation was always dollarization, dollarization, and dollarization! When China adopted the American recommendation and use dollar as the exchange rate anchor first for the Hong Kong dollar, and then for the Chinese renminbi. New demand came from the American officials and even the Congress that China was manipulating the exchange rate to destabilizing the US economy. They forgot that it was the British Empire and the American power, which adopted the golden standard and the fixed exchange rate during their peak power in the world trade. After the world war two, The US enjoyed huge trade surplus until 1970s. Why American did not correct the world imbalance by sharply appreciate its dollar for the benefits of other countries in trade deficits? Why the US imposes trade embargo to China for three decades for the Korea civil war, which had nothing to do with Chinese and still trying to manipulate relations between mainland China and Taiwan until now. China, a unified country for two thousand of years, needs a political baby sitter for her own domestic affairs? I would say all these adversaries in fact turn into a national consensus among Chinese both at home and abroad: that China has to concentrate its own effort, not to arm race, not to financial gambling, but to technological advancement and mass education. The goal and logic is pure and simple. That is the third theorem in the Beijing Consensus: China's reform and development strategy is self-determined and self-innovation, not dictated by the Washington Consensus or IMF likes those in EEFSU. No any Chinese leader had the fantasy like the Russian President Boris Yeltsin, he speculate that once he dismantled the communist party, Russia could join the NATO and got massive aid from the West. China did never try since China already learned the painful lessons from any foreign aids from British, Japanese, and Soviet that always came at a price of a dependent economy.

If that is the geopolitical reality, what is the development strategy for China and other developing countries? I will take a first attempt to answer this question by my own observations. I expect more inputs and criticism from my fellow countrymen and fellow economists.

#### **IV. The China Approach for Global Competition and Technology Changes**

I used the term of "China approach", because there is not a set of stable characters, which can describe a "China model." China is constantly experimenting and changing to adapt a changing world. The People's Congress is

busying in updating laws and regulations, which may be useful last year but obsolete this year. The nice concept of “the rule of law” in the western democracy becomes an excuse of maintaining the status quo for powerful interest groups; who refuse to change even if the reform is good for the country but not necessarily good for their industry or group. In the past three decades, Chinese leaders and Chinese people discarded all ideological and historical barriers in open-minded learning and bravely tested all possible ideas through trial and error. The following principles are abstracted from these experiences, which seem useful in dealing with a complex world full with uncertainty and opportunity.

**First principle, find growth opportunity first; and then gradually push bold reforms after the reform base is consolidated, the momentum gained, and people’ trust built up.**

This is also my advice to my American friends last November in New York at the eve of G20 Summit in dealing with the world crisis. Why? During a crisis, everyone fights to guard his/her own interests; so that there is little room for reform; even if a visionary leader clearly knew what the problem with the system was. Any politician has limited political capital, the first move is critical for later projects.

China started its reform from the family contract system, which was an immediate success. Once you had a flow of goods in domestic market, everyone was happy and the reform government could earn the trust from the people and move to the tougher job: reform SOEs, which had to deal with factory closures and lay off workers from the obsolete industries. When the economy was expanding, these unemployed state workers had opportunity to move to other sectors at a time government still has the revenue to cushion the smooth transition. To identify such a growth opportunity, economists routinely assign this job to entrepreneurs, not the governments. That is the difference China made in economic history. In a developing country, governments have more resource and human capital than the private sector to move an underdeveloped market. Neoclassical economics has little experience in poor countries. They often mistook the experience in mature market to instruments in emerging market.

Almost every leader from a village to a province is searching a market niche for their comparative advantage through learning by trying. I was wonder how a

high-flying American economist, armed with a neoclassical doctrine, without any knowledge of local history and social conditions, could give policy instructions to ministers and even Presidents in developing countries. The Chicago doctrine of the efficient market hypothesis is wrong when they believe no such market niche or opportunity exist under the random walk on Wall Street. Believe me, there are more unexplored opportunities exist, otherwise, this is the end of science itself. I found surprises almost every year or every month. The difference is that if you have the will and resource to go through the discovering process.

**Second principle, the dual-track system is needed for maintaining stability and encouraging innovation.** The so-called rationality and democracy will prevail in textbook economics if there is no uncertainty and innovation. In real world, the rationality will breakdown and democracy will always fall behind if bold experiments have to be done by adventurers with bounded rationality. The best strategy to progress in a complex world is the dual-track system, which emerged during the long history of China's development under non-equilibrium environment. Not just price reform, but also institutional reform is conducted in the dual track system. For the majority parts of the economy, existing system is kept functioning for social stability; for the few sectors or so-called special economic zone (SEZ), all kinds of innovations are tried with limited risk, which was confined within the bounded region. Old regulations are selectively deregulated and new regulations are tried. Failed lessons are learned, and successful models are imitated by other regions. Here, Chinese innovative regulation is not set by checks and balance among interest groups, but by consensus building during the experiments by leaders, entrepreneurs, and community participants.

**Third Principle, there is a clear division of labor between central and local governments with clear obligations, resources, initiatives and accountabilities.** The central government is mainly responsible for national security and regional coordination; while local governments take the leads in development and institutional experiments. This is **the decentralized experiment, not the top-down design by foreign advisors or bureaucrats.** This is the driving force of China's innovations observed by the author of the Beijing Consensus. Interestingly, this division of labor is also a checks and balance in Chinese style. For example, central regulators are more pro multi-national

companies by their charm of advanced technology and monopoly power, while local governments will more strongly support local industry to compete with multi-national companies. A good example is the auto industrial policy, we will discuss later. In the spring 2008, China's central government tried to raise exchange rate, interest rate, and minimum wage law under the pressure of liberal economists, there was waves of bankruptcy of export manufactures in the coastal area. The strong resentment from the local government immediately caused the attention from the Political Bureau. The State Council quickly made a U-turn before the shock waves of American financial crisis reached China. On the other hand, if large accidents occurred such as pollution, food poisoning, or mine collapse and local governments are hesitate to take swift actions, the central ministry will quickly fill the gap and relocate local officials. You may see China system is more effective than the Bush administration in dealing with natural disasters and pollutions.

**Fourth principle, the leadership and initiatives are emphasized as more critical than capital, resource, and infrastructure in regional development.**

Before 1980s, poor people always complain the unfairness of the God or grievance in Nature for their poor environment, poor resource, and scarce opportunity. Migrants from the poor region to rich region were strongly resisted by the regional differences in welfare system, a familiar scene in developed countries as well. After 1980s, people's mentality has been completely changed. When I visit poor regions in inland China, almost every villager will tell you a touching story that how a neighbor village got rich by a visionary leader with new ideas in production or new knowledge in marketing. Their only sorrow is that their village has yet to discover a new leader to lead them out of poverty. They put their hope to their young kids working in coastal cities or studying in universities. They also welcome new comers from college volunteers to foreign investors. When western analysts made a series forecasting of coming China collapse, Chinese people already moves ahead with their new ways of innovation and coordination. When Tibet falls behind in face hard constrain of ecological conditions, Chinese central government simply formed a sister partnership between every Tibet county and an inland province. Every participating province is trying hard to win the race, not by profit-seeking but by infrastructure-building,

ranging from technology training to ecological system design. And the results are not comparable by conventional standard of venture capital or fiscal subsidy.

**Fifth principle, the mixed economies provide sustainable public finance, which is the very foundation of development projects and reform measures.**

China's stability lies in the low cost social insurance system, the collective ownership of land. The average size of farm land for one family is less than half a hectare. Historically, privatizing land ownership led to cyclic peasant wars when the cities could not absorb landless peasants during famine and disasters. The laissez fair policy never works in a large country with huge population, scarce resource, and frequent disasters. The Confucius tradition is simply about a theory and practice of functional government. China's majority population is peasants, if privatizing the land like EEFSU, there would be a huge welfare tax which will soon bankrupt the government, since the welfare system for limited SOEs was near bankrupted in 1980s, exactly the current situation for the BIG THREE auto companies in Detroit.

China developed Pudong, a new Shanghai in just a decade without issue much debts. All the city restructuring projects are financed by selling user right of public own land, an idea learned from the British ruled Hong Kong. As long as the City government determined to start a long-term city plan, which was designed by Chinese but with multiple inputs of foreign consulting firms, the government credit to enforcing the plan would attract domestic and foreign investors to carry the plan, a win-win scenario for all the partners regardless its ownership or foreign origin. The land rents are so large that local governments could afford tax concessions to attract investors and relieve pains for dislocated villagers without raising tax to manufactures. This is an option far better than American way of raising property tax or issuing municipal bonds that would be a future burden for local development.

State sector and the collective sector also serve a cushion for business cycles. At the peak of China's growth, there were one hundred fifty million rural workers migrating to coastal cities. If they can find the job, they earn extra income for kid's education or house renovation. If they cannot find the job, they can return to village without social problem. During the recent global crisis, about 20 million rural workers lost their jobs in coastal manufacture. I met some of them last fall in Sichuan, and found them still having a smiling face. I asked them why? Some feel

relieving since they reunited with their family. They found the living standards in China's inland village are even better than urban cities because of clean air and water, improved road, satellite television, mobile phone, and internet access. They are thinking start their own business near their home town, the coastal area is no longer the only choice. The most important thing is that land tax is abolished since 2006. Now the city residents fight for their "rights" to buy rural housing for their retired parents.

In China, every county leader understand the accounting of political ecology: you need at least two or three big manufactures to provide stable tax revenue, so that your public service could be clean and effective without dirty deals between officials and grey economy. You need a lot of small business that provide a lot of jobs but little tax revenue. You also need good schools and good hospitals to keep talents working for your region. There is no such thing of permanent divide between labor union and big business, which may lead to a large number of layoffs when the company failed by not reaching any sustainable solution. If the local officials fail to maintain social stability and economic growth, you lost your life long political capital and end up with a bad name in local history, a punishment worse than the hell in the Chinese culture.

**Sixth principle, the Chinese discipline based on competition at all the levels across the country not checks and balance by interest groups in western style. China's rule of law is not based on ex ante procedural justice, but ex pot outcome justice.** Therefore, China could dramatically simplify legal process based on regional experiments, without tremendous legal costs created by conflicting regulations driven by interest groups like the U.S.

There is a wide spread image that China's rapid development is conducted under an authoritative government without check and balance. That is far from the truth. Historically, China had numerous rebellions and coups led by military leaders like the Roman Empire. Even during the Cultural Revolution, Lin Biao, a war hero and deputy chief in military command, could not mobilize even a company or battalion without proof from the Central Military Committee, a collective leadership. There is a fierce open race among public servants on innovation and experiments. At any level, decision is made by collective consensus, not by personal power. Any bold intellectuals, public servants, or oversea Chinese investors could visit a county or city council, to present your

business plan or reform ideas, if you could convince a local committee; you have a chance to try with increasing support from the local governments if your initial results are promising.

China democracy is not competition by words but by race by deeds. There is one constraint to enter the race: you cannot serve a public position where you were born and raised, in order to avoid family connection and political corruption. Every major head of local governments would rotate his/her position between rich and poor regions for every two to four years. Even though there is a wide report of corruption occurred during the transition to the market, but to my knowledge, China system performed better than other developing countries in the normal time and more effective during the earthquake last year and global crisis this year even comparing to developed countries. In the critical issue of Hong Kong transition, there was no selfish motive to take over Hong Kong for personal gain in political election, comparing to the unwise decision in German monetary union. China's legitimacy lies not in electorate vote, but in political and economic performance. And they will continue to improve and to innovate.

**Seventh Principle, there is a new coordinative partnership among governments, entrepreneurs, workers, and farmers** that is beyond the scope of capitalist economy. Governments do not select winners, but provide incentives to pioneers and innovators in learning and reform.

I want to tell you a real story, the rise of Cherry Automobile in Wuhu, a middle size city in the poor Anhui Province, the same birth place of the family contract system. It was initiated by a young Assistant Mayer (later promoted to deputy Mayer and then Mayor), who convinced a young engineer from the Number One Automobile with seven other colleagues to give up their comfortable careers at the joint venture with the Volkswagen in 1997 and broke the joint monopoly between SOE and multi-nationals in the domestic and foreign auto market in just seven years! Multinational companies in China sometimes behave better than in their home country, since they face strong competition from local companies, including state companies, private companies, and collective companies. Each company has to win support from local governments and local community, not by maximizing shareholder's value but by what they have brought to local community: not only jobs, but also education, culture, public service, and human network to a larger world.

**Eighth principle, a visionary government could create and coordinate the market, but not captured or driven by the market. The critical condition of a lively organization is the human factor, not the rigid institutional design. Market instruments, such as market price, interest rate, exchange rate, advertising, brand names, are strategic weapons in global competition, not driving force of economic development, since development is a long-term process while market fluctuations are short-term in nature.** Governments hands off may be a better option only if the political process cannot break the government capture by special interest group, such as the case of American decease when government regulation was captured by financial oligarchs (Johnson 2009). No any well-designed institution could function without capable officials with a public goal.

This principle is not new for China, since the US also created Fannie Mae and Freddie Mac. However, the US failed to guide them before the financial crisis. In China, governments play a strong role in creating and regulating the market to a much larger scale. For example, when informal stock markets emerged in streets in many cities, there were numerous cases of flaws and cheatings caused by information asymmetry. If take spontaneous course of natural selection like Wall Street, it may take a hundred years to develop a disciplined financial market. According to the Coase theory of transaction costs, government hands off is the best choice. However, Chinese government did not treat stock market as a simple means of financial instruments. They saw a possibility to utilize the stock market to raise fund in firm restructure and changing incentive mechanism. The central government quickly moved in to consolidate them into Shanghai and Shenzhen stock market both for competition and scale economy.

There were huge demand for small commodities such as kitchen tools but severe shortage of supply in 1980s, since its profit margin is very small and no economy of scale. The Yiwu county government in the remote area of Zhejiang province found a niche market in small commodities. They moved in to upgrade the market space and improve transportation, communication and marketing. Surprisingly, Yiwu emerged as a worldly renowned market center for small commodities with huge economy of scale.

Some western economists are puzzling why Chinese governments slowly liberalize interest rate, exchange rate, and even entry of FDI. Their logic is

simple, to protect infant industry, so that they could concentrate on technology advancement, while government take care insurance against financial shocks from abroad, a realistic assessment of asymmetric game between multinational banks and Chinese firms. For example, the US kept interest ceiling for a long time for mortgage market before 1970s for stabilizing the US housing market. If China float its exchange rate, the burden of foreign exchange rate risk would fall to Chinese firms, most of them have little knowledge and resource to against speculative capital. Instead, under the managed exchange rate, central bank has to absorb all the shocks with political will and financial skill. So far you can see China's central bank did a good job even comparing to the US Fed. China's open-door policy is selectively open for adapting the needs of China's development, not to the interest of foreign capital. If your investment could bring technology and management China need, you are welcome with much assistance. If our investment is only aimed to take China market by obsolete technology, you are not welcome. The degree and timing of openness is also depends on China's ability to compete in global market and the needs in reform agenda. When China's domestic firm is still in learning stage, the door is slightly open for information signaling and learning, when domestic firm is up to compete, the door is more widely open. Sometimes, China leaders were even ahead of industrial leaders. Before China entry WTO, majority of Chinese economist had very pessimistic expectations for China's auto, financial, and agriculture industry. Some economists even blame Chinese leaders made too much concession to western pressure. However, Chinese leaders made the bold move to push further reform. The results are beyond everyone's expectations. After the Berlin Wall collapse, few believed that state own companies could compete with private firms. After China's entry of WTO, China's trade surplus even grows faster than before. Then the western public opinion reversed. They claim that China's "unfair" competition is because of China's non-market economy. They use the label of non-market economy as a weapon for trade barrier, instead of the fact that China's domestic product market is more open than western countries. If their logic is consistent, you should be more confident to compete with a non-western standard market economy, or learn some useful lesson in China's rise.

In neoclassical firm theory, mainstream economists always believe in the price flexibility, which may be good for consumers, but not for producers, since

product cycle and investment cycle are much longer than fashion cycle. Regulator should consider that all business contracts are sign in nominal form. Fluctuations in exchange rate and interest rate serve the financial sector at the expense of industrial sector. Life cycle of products takes years while financial fluctuations can be amplified in less than a second. That is why financial deregulation led outsourcing of manufacture from the US in large scale. The exchange rate policy is an essential part of industrial policy. During the early stage of China's reform, China set artificial high exchange rate to discourage imports of consumer products, so that China could use limited hard currency in importing technology. When China started export-led growth strategy for further accumulation hard currency and accelerate technology upgrade, China depreciate its currency for better competitiveness. Currently, China maintains more or less stable exchange rate, mainly for political consideration. Since all China's trade partners in Asia are happy with China after the East Asian financial crisis, and export firms are also worry about exchange rate risk, only speculators and property owners in the coastal area demand currency appreciation, why China should change its sustainable course to please unpredictable American politicians? In the theory of international finance, there is no consensus about the nature of the exchange rate movements, from random walk theory to deterministic model of PPP and Interest rate parity. We found strong evidence of exchange rate resonance driven by the US business cycles (Chen 2009). In reality, there is no such thing of equilibrium exchange rate, only manageable or sustainable exchange rate. From my observation, China's exchange rate is under China's control because of China's high growth, high saving, and cautions regulation. I have severe doubt that the US monetary policy is manageable and sustainable in the long run. Let us wait and see before take any judgments not from facts but from beliefs.

**Ninth principle, learning in open economy and adapting to global competition is a self-determined dynamics based on national conditions. China could go thus far, because several generations of Chinese leaders could focus on China's development trajectory without political swings and foreign disturbances.** This is the strategic wisdom left by the Great Leader Deng Xiaoping to his successors. The standard growth theory is a story of growth driven by random shocks in technology or population. There is no role for a visionary

government from Napoleon to Deng Xiaoping in neoclassical economics. There were numerous speculations that China may go wrong expected by western political forecasters. For example, China would reverse the reform after 1989 tragic event; Taiwan separatist movement may trigger a war in Taiwan straits in 1996; China could take over Hong Kong and destroy the capitalist economy after 1997; China would launch a nationalist movement and closed its door after NATO bombing the Chinese embassy in Belgrade in 1999; China's financial sector would collapse after entry of WTO with harsh conditions; recent pressure on trade policy and exchange rate policies; in addition to numerous claims to China's sovereign and territories. At every challenge came to China, leaders and people together, not just got angry and emotional, like any populist leaders in newly democratic countries, but take the challenges as learning opportunity. Chinese leaders took lessons from Hong Kong and Taiwan businessmen to constantly improve their needs in China investment; they invited foreign investment bankers as strategic partners to improve China's banking sector; they hired experts from Russia to Israel to improve their technology, they learn governing model from the Singapore government. China quietly solved its border conflicts one neighbor country after another, including Russia and Burma.

China uses his deeds not words to demonstrate that China is a reliable partner, not a threat to its neighbors. When I visit Japan in 2007, Japanese economists told me that a long-term concern of China threat to Japan was nearly over. Many Japanese firms were afraid that moving their manufacture to China would damage their strength in the global competition. After a decade of stagnation, Japanese firms finally decided to move their manufacture to China. To their surprise, Japanese economy got recovered not because of long period of zero interest rate, but because increasing integration into China's development, a win-win situation. It was Korea, who takes the lead in promoting the Northeast Asian economic union, including Korea, Japan, and China, after the painful lesson in the East Asian financial crisis in 1997. We could expect a rise of the Greater Asian and Pacific Union in coming decades not based on western types of democracy, rule of law, and financial market, but by coordinated development among sovereign countries. The shared Asian value and Confucius teaching is an Asian alternative based on family support, nation building, and consultative governing, to western

system based on individualism, consumerism, and checks and balance among interest groups.

## **V. The Future World Order after This Global Crisis**

Some people begin to worry the after world if the American leadership is gone when the confidence in the dollar goes with the wind by the Fed's recklessly printing greenbacks. I am not worry since I know Americans are great people with great talents. The Grand Crisis is simply an awaking call to American spirits. They have to deal with their competitors equally, and then American may discipline financial oligarchs and have a better distribution of wealth. I do not think that Americans want to start a trade war to restore their confidence. Any confidence comes within themselves, not from the weakness of competitors. However, several changes already occurred since the crisis.

First, the universal value system dominated by the American doctrine is over. "The old Washington consensus is over," U.K. Prime Minister Gordon Brown declared in April 3, 2009 at G20 Summit in London. A surprising voice from the Anglo-Saxon camp signals a new era of coexistence of diversified ideas and cultures in a new world order. This is a tremendous opportunity both for young generation of Americans and people around the world to have a more equal dialogue and more coordinated partnership in the world development.

Second, China is happy to form a wider partnership with African and Latin American countries in addition to their traditional partners in Asia, Oceania, and Europe, since modern transportation and communication develops a closer link to anywhere on the earth.

Third, from China's two thousand year's history, China developed resource-saving but labor-consuming technology, which feeds a quarter of the world population with only seven percent of arable land. Capitalist crises are repeated in history, because western labor-saving technology often destroyed more jobs than it created, which resulted constant social disruptions and conflicts. New technology develops more varieties in products that could absorbed more skilled labor if education could catch technology advancement and the limited property right system does not prevent the knowledge of know how to serve developing countries. China would take the lead in a more balanced development among innovation, equality, and sustainable environment. The unbridled freedom and

selfish greed have little room to take over the society in China and perhaps East Asia as well.

Fourth, as the basic principle in international relations and economic exchanges, the Confucius principle is more simplified and effective than the western legal tradition. It simply teaches that “what you do not want done to yourself, do not do to others.”

On the surface, the current crisis was originated from the sub-prime crisis in the US, which was resulted from deregulation and excess speculation in financial market. However, there are deep roots of the Grand Crisis. American government was captured by the financial oligarchs (Johnson 2009), only breaking them apart or establishing international anti-trust law could diminish the chance of the next financial crisis (Chen 2009). The mainstream economics in macroeconomics and financial economics is responsible for fueling the delusion of a self-regulating and self-stabilizing market (Krugman 2009); an intellectual movement of rethinking neoclassical economics is advancing a new thinking in economics. We believe that a sustainable development will prevail, along with international coordination in market regulation and environment protection.

I think there is the third cause we have to address. American led arm race and nuclear weapon should come to an end. A new type of welfare system has to deal with not only aging society in the developed countries and China, but also dangers in explosive population growth in the Mid East and South Asia, where social stability is destroying by diminishing chance of jobs and increasing gaps between rich and poor. Current state of the welfare system based on financial market and tax cannot survive the increasing labor mobility and global competition. China approach of multi-layer welfare system under the mixed economies provides a promising alternative, not just for developing countries, but maybe also inspiring for American workers. Certainly, this is a tough choice which should be made by each country himself. But the problem of poverty, terrorism, and crime need international effort in a long term perspective.

My final words, the human factor is more essential in development than capital or technology, a lesson from China revolution and China reform, but missing from mainstream textbook economics.

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