

Jeffrey D. Sachs *China since the late 1970s*

Hi. Thanks for including me in this wonderful conference. I wish I could be there in person, if only to say hello to Leszek and all my friends. But I am very sorry but the dates did not work out and my crazy schedule right now and I was very happy that I could tape, a brief intervention. I was asked by Leszek to speak about the issue of convergence of China since the late 1970s and make some observations. This is of course a subject dear to my heart both because China itself is an absolutely fascinating case but also because China's path of development has been compared so often to the choices made in Central and Eastern Europe and the former Soviet Union after 1989 that it's really very worthwhile to understand properly what happened in China. And I think, what's said about China in general that, well, China is a reflection of the success of gradualism versus shock therapy. This is an essentially silly approach to a fascinating and more complicated and much more subtle set of issues. I believe that Wing Woo is there with you in the room and will elaborate, but let me lay out some of the general issues as I see it.

Of course we have to start with the basic underlying geography and demography and history. China is a vast, populous country, the most populous country in the world and for about a thousand years, from 500 to 1500 A.D. it was almost surely the technological leader in the world and probably the richest and best ordered country in the world. After 1500 years it went to a long-term relative decline at least it's debatable whether that was absolute or not. Lot of history debates what happened to China, one thing that definitely happened so that China really closed its borders for about, oh from roughly 1434 to about 1840, really closed its borders to international trade and sea-based navigation in fact. Adam Smith, about mid-way through that process in 1776, noted at length that China had become a closed economy, was no longer benefiting from technological improvements taking place in the rest of the world. China of course was forcibly opened up by Great Britain in the Opium Wars of 1839-1842. Freedom to sell opium to China and that was the banner of the war it of course was a kind of imperialist opening of China's international trade. What's interesting is that it led to the establishment of several coastal cities of China, the open ports of the 19th century. And those became a hundred years later, more than a hundred years later, the basis of China's remarkable post-1970s spurt. So China's geography of a coastal, Pacific basin population of now maybe of about 300 000 000 people living in the coastal provinces, with major urban centers that are industrial, areas and seaports, dates back to the middle of the nineteenth

century. Of course what happened was that Japan developed rapidly at the end of the 19th century under the major restoration China began a process of industrialization but then went into a prolonged period of turmoil. From the time of China's revolution in 1910-11 to the war-lord period of the 1920s, to Japan's invasion of China in the 1930s, to civil war in the 1940s, to the maoist revolution in 1949 China was in turmoil. And so basically during a long period of economic growth elsewhere in the world, China had stagnation, decline, turmoil, war, violence, occupation and that meant that by the 1950s China was extremely poor and obviously vastly poorer than its inherent state of social organization, its geography, its knowledge and other inheritances would suggest. There was space therefore, given this terrible period of the past, for rapid catching-up growth. The kind of space in a way that Franco had left for Spain to catch up, the kind of space that the period of communist rule, socialist rule in Poland from 1945 to 1989 had meant that there will be a springing forward, catching-up phase for Poland and other countries, of course, of Central Europe after 1989. But China's catching-up period really took two phases: one was the radical, mainly misguided and sometimes tragically misguided and disastrous course under Mao, roughly from the People's Republic of 1949 to Mao's death in 1976, the arrest of the Gang of Four in 1977 and Deng Xiaoping raise to power in 1978 and then the reform period after 1978. Now, the Mao's period was marked by upheaval, by terrible social experimentation of socialist agriculture, socialist industrialization, industry placed in the deep hinterland of the country for fear of vulnerability to invasion from the seacoast, disasters like the Great Leap Forward between 1959 and 1961, in which tens of millions of people perished of starvation because of the crazy, misguided and essentially ignorant policies of the Chinese leadership at the time. But, and it's a big but, there was progress, even during the maoist periods, some critical areas: public health, literacy, the demographic transition, all really progressed a lot during the maoist period. Life expectancy rose sharply, infant mortality rates came down, the so called "bare-foot doctors" made a real break-through in rural public health, in hygiene, in overcoming long burns of infectious diseases, especially sub-tropical and tropical infectious diseases. Infant mortality declines contributed to big declines in fertility rates, families have fewer children. And then one child policy later on was implemented but these meant that the population growth rate declined markedly. All of that was an incredibly important base for the post-1978 take-off. Mao destroyed the incentive-base for the economy, but his system did contribute to the public health, the education, the literacy and the demographic transition. And that became as a very important platform for post-1978 development. Now in the reform period, very briefly, there were essentially maybe three phases that one could note. First was an absolutely

rapid kind of shock therapy, if you will, but it wasn't top-down, it was bottom-up of the end of the commune and brigade agriculture system. And this was a kind of a spontaneous revolution, as it was covering hundreds of millions of very poor peasant farmers, roughly from 1978 to 1981. In the end it was blessed by the Central Committee of the Communist Party and by the Communist Party Congress, but it was a bottom-up approach, not a top-down reform: people hated the communes, there were taxes on peasants, the State wasn't providing anything to the peasants, so there was just taxing them, a forced labor in many ways. This was ended in the so called "house-hold responsibility" of individual land-plots was returned. Now from 1981-1985 I would say that three things happened. One is the fruit of that house-hold responsibility system started to be observed in rising crop production. Second was the freedom to establish rural industry, the so-called township and village enterprises. These were private or quasi-private or sometimes truly township or village efforts. But it led to the creation of millions of new jobs in many, many small, rural enterprises, where farmers were no longer tied to their brigade but could now work in industry and services, rather than in agriculture. And the third thing that happened during this 1981-85 period was the opening, beginning opening of the economy and very interestingly Deng Xiaoping went with a designated set of special economic zones that were essentially the trading port-cities of the 19th century. And gave them freedom to experiment with export-led growth, light manufacturing for exports and the attraction of foreign capital and foreign technology, whether in straight outsourcing operations, private capital inflows, foreign direct investment. It was the beginning of the opening of the Chinese economy.

Now, interestingly the catching-up of agriculture was a kind of one-step process. There was a big jump of productivity with the new house-hold responsibility system, but then a leveling-off. So well, agriculture gave a boost, it wasn't a prolonged impulse for growth, it was a kind of one-time adjustment, between 1978-1985. The township and village enterprise was another big boost, probably more long-standing and as important as the agricultural boost and of course they were related because food surpluses allowed for the township and village enterprises. But in the long term, and I think this is extremely important to understand, in the long term, that is viewed from 1980 till now, the real long term powerful impulse of growth, in my opinion, has been the international side, it's been successful globalization. China really has had export-led growth. It's a tremendous boom of exports, unprecedented. Exports rising from around \$ 20 billion a year in 1980, to probably to about \$ 300 billion a year of merchandised trade of exports in the year 2003. Something on the order of sixteen fold increase. That has been caused by, and it's now a cause of massive foreign investment for

export production overwhelmingly to the coastal areas, entities, special economic zones, first and now more generally to coastal regions with good access to international trade. Very strong geographical dimension, to this. The coast is the site of this export-led growth, the hinterland much, much less. The coast grows fast, the interior fast by international standards, but much more slowly than the coast. The coast provides the saving and the investment surplus for the hinterland. Without the coast the hinterland would grow much more slowly. And of course the most remarkable phenomenon perhaps is the massive migration of the population from the interior to the coast to take the advantage of these jobs. And the so called floating population, which is an informal migration population, may number 150 million people right now, could even be as large as 200 million. A mass shift from rural to urban and from hinterland or West to East, from interior to coast of the country.

Now, what made this possible? Was this really the fruits of gradualism? No, first of all many parts of the reforms, particularly the dismantling of the communes, covering perhaps 700 million people wasn't gradual at all. Absolutely as radical as anything that happened in Central and Eastern Europe. The difference was that once the peasants were free, once the commune system was over, China had a vast labor surplus, ready to work in a new, private sector. Now, think of the Chinese economy as having three sectors. You have the peasant population by 1980 in the private sector, but as peasants. Second you have the state enterprise sector, the part familiar to Central Europe in 1989, but not covering 80 or 90% of the population as in Central Europe, but only around 20% of the population, because roughly 65 – 70% were in the first, peasant-agriculture sector. Then the third sector is the new private sector, heavily export-oriented. And that started very small but grew enormously fast. Here is the key analytical point: what allowed such dramatic growth of that new private sector? In my view and in the work that I have done with Wing, it was the vast surplus of labor in sector number one. Because you have peasants becoming industrial workers. It wasn't the shift from state enterprise to private sector, as Eastern Europe has had to achieve. No. It was the shift from agriculture to industrialization, which is very different from the kind of sectoral shift that had to take place in Eastern Europe broadly speaking. Yes, there was a shift from agriculture to industry, but agriculture was only 15%, maybe as much as 20 % of the population, but not 65 or 70%. And in agriculture in Eastern Europe it was highly capital-intensive, bureaucratized, collective farms and state farms, not peasant agriculture. So in the view that Wing and I have been taking for many, many years it was this vast surplus labor that was not part of the state system as soon as there was the end of the communes and brigades. To fuel the dynamism of growth.

Now finally: why could the coast take off so dynamically? First, they are coasts, that's a huge advantage geographically. From Shanghai, down through Fujian and the province, down through Guangdong, including Shengzen the city in the People's Republic just outside of Hong-Kong, to Hainan island. You have coastal access, good ports, massive population ready to take an function as workshop for the world and light industry and in parallel textiles, electronic assembly and so on. So this was a ready-made local for low-cost, mass-volume production, labor-intensive. And the Chinese played it absolutely right, they made there special economic zone very liberal, very free-marked oriented, good tax incentives and basically for inexpensive labor you could bring in technology, you could bring in capital – foreign direct investment and make a lot of money. And that's what happened. And so we've had one of the great, really *the* great export boom in all history. And in my view, that's been the overwhelming fuel over the 1990s for this kind of dynamic, hugely successful economic growth. The Chinese have played export-led growth very, very well. Where did gradualism *per se* come in? Well, there was only gradual reform of the state enterprises. Now how could China get away with gradualism and Eastern Europe not? Because the state enterprises were only 20% of the labor force, not 80%. And they have big problems – China's state enterprises are loss-making – big budget items, big drain and investment spending. So China didn't solve the state enterprise problems any better than anybody else. But it could handle it because it was a small fraction of the overall economy. That's why facile comparisons of gradualism and shock therapy, which are simplistic, journalistic ideas don't make sense in understanding China. In China it was the structure, rural population, coastal access, off-shore Chinese population to bring in foreign capital and technology that made possible the boom. China did not figure out the state enterprise sector.

Now what are the challenges going forward for China? There are several of course. One is that the urban-rural divide has widened enormously just as has East-West divide. That's deep economic geography. This is coastal-led growth, this is urban-led growth, that's leading to a lot of social tensions. The growth does percolate, it does diffuse, but it takes time. And it doesn't diffuse rapidly and perfectly. That's why you have mass migration to the coasts, rather than lots of capital flowing into the interior of the country. So, that's one challenge.

The second big challenge is how to handle a mobile and increasingly sophisticated population from the political point of view. You know there is a real but dramatic aspect of China's gradualism, the kind that links it in a way to Poland, and that is June, 4th 1989. In Poland that was the first free election. That was what brought in the post-communist era, the

era of democracy and market reform. It was also the day of Tienanmen. And China has not really solved the political issues raised at Tienanmen. And just now Woo Jing Tao has been calling for democratization. Yes, socialist democratization, but China knows it can't go on with its autocratic political system. So there is a huge, huge political challenge. I do believe China will find its way to democracy. I think it's going to be a long process, not the matter of a couple of years but many. But I think it's going to happen. But it's going to be very, very complex process, filled with all sorts of risks in China and for the world. And one that we'll be watching very, very closely for many years to come.

China has not solved the problems of state enterprises, they are moving towards privatization, *de facto* or *de jure*, in one form or in another. They have big fiscal challenges still that have not been solved. China has joined the WTO, that's going to lead to stresses in China as well as opportunities, but most of all it would benefit China, by guaranteeing China's access to international markets, which is vital for China's continued economic success. So China is on the path of convergence. And it's using its geography, its history, the gap between actual and potential very effectively. It's gone for global integration, for market reform of course and for coastal opening and it's used its geography to best advantage for these purposes. It's not a triumph of gradualism in this sense, it's a triumph of recognizing the deep structure of the economy and using the processes that already were evident in 1850 though are not under really sovereign China or strong China, using the same market forces those coastal cities as the starting point for vast economic change.

If you look out 10 or 15 years for China to continue the convergence, it's going to require another huge step, which is going to happen, I think. And that's for China to become a major center of global science and technology. And I think China's on its way to do that.

I wanted to conclude by making an observation about convergence, more generally and it relates to China. There are several places where a country can get stuck on the convergence process. Of course one way is that it get stuck because its domestic policies are no good. Maybe they are opposed by the Soviet Army, as they were in Central Europe, maybe they are just bad ideas of a closed economy or lack of integration with neighbors. So there are domestic policy failures that can lead to a failure of convergence. But there are two others that I really want to stress. One is the failure of convergence at the very lowest levels. There are countries that are so poor, particularly in Africa today, that they even don't get their first foot on the ladder of economic development. And instead they are in a downwards spiral of population explosion, disease, ill health, lack of infrastructure, which means that they even do not get started in development. So the first area of convergence is to overcome that first

threshold level, to break free of absolute poverty. And there are still dozens of countries that have not done that in the world and we have to help them do that.

Once that's happened, then the next part of convergence is foreign investment, integrating in global productions systems, export-led growth, market-based development, raising skills of the population, education and health. And China's clearly on that kind of dynamic path right now. And that can take you to several thousand dollars per capita income, that kind of catching up growth. But then it's possible to get stuck at another level and this is very relevant for Poland also. After reaching several thousand dollars per capita many countries have gotten stuck: Mexico, Brazil, Argentina. And in my view the next level of getting stuck is the failure to transit from a catching-up scenario to a technological innovation phase. Countries have to become themselves science and technology innovators to bridge the last part of the gap, say from 10 thousand per capita to 30 thousand per capita. So investing in science, technology, engineering capacity, innovation capacity, higher education become the next challenges. Latin America paid very little attention to research development, to science and technology, to state-sponsored national science foundations, to higher education, to national laboratories. Korea, Taiwan, Japan of course in its past, Singapore now, Israel are examples of countries that reached the second catching-up threshold and then do successfully move on to the innovation phase. And they get right through the 10 thousand per capita limiting and continued to grow afterwards. And Poland, certainly, rest of Central Europe and China are going to confront that next barrier for convergence. The one that helps to turn the economy into a high innovation economy. And those are not just market institutions, those are mix of public sector, private sector, non-profit institutions, academia, business, national laboratories, national science support. And that is a critical phase that China is just now getting into and that Eastern Europe needs to be very much involved in.

So, to conclude, China's convergence has been spectacular. It is using geography right, it is market-based, it is globalization-based, it's been under a one-party state, that is under stress because the politics are going to dictate pluralism and move to democracy, which has not happened effectively yet. And this is a big challenge still getting out of the cost of gradualism and the sense of state enterprises that remain, big loss-makers, that hasn't been accomplished. But China was able to turn a free, economically free peasantry into a dynamic manufacturing and service sector labor force on the coasts. And that I think in a nutshell is the essence of China's convergence.

Have a great conference. Look forward to seeing you in Warsaw or in New York or in other locations sometimes soon. Thanks a lot.