

“Why China is still poor”

Emerging Markets - 4th May 2006

By Yasheng Huang

As the heated discussion over China's currency and China's surging trade surplus with the United States shows, the world is anxious about China's export prowess. But the right way to frame the issue is not why China exports so much but why it consumes so little.

One of the most remarkable things about the Chinese economy is that the consumption/GDP ratio has continuously and steadily fallen since the early 1990s. In the 1980s, the consumption/GDP ratio was around 65%; by 2003, this ratio fell to 55%. In 2004, the investment/GDP ratio apparently exceeded 50%, the highest ever in the history of the PRC.

The reason behind the falling consumption is obvious – if one knew where to look. China's development strategy in the 1990s had a substantial urban bias that reduced the consumption potentials of China's biggest consumer base – its peasantry. By residency status, despite the rapid industrialization, rural residents still account for about 60% of China's population. No matter how many Bentleys and Gucci bags are sold in Beijing or Shanghai, which has so often excited the foreign commercial press by the force of its sheer numbers, the only way to get China's consumption up is to raise the living standard of its peasantry drastically.

Three crises

While western economists are awed by China's looming international presence, the term that better expresses the country's sentiment within China itself is *san nong weiji*. Coined by a rural official, Li Changping, in his 1998 open letter to the then premier Zhu Rongji, *san nong weiji* means three rural crises: crisis of agriculture, crisis of village governance and crisis of peasantry. There are many telling indicators of the sorry state of rural China, but the most jarring one is what has happened to its educational system. According to official data from 1987 to 2004, the number of primary schools in the rural area fell by 55%. Urbanization and a declining birth rate may explain some of this fall but clearly not all of it. Rural students still account for 65% of the student population, and the fact is that the number of primary schools in urban areas remained roughly constant during the same period of time. A group of China's top education experts produced a report in 2005 which showed that the drop-out rate among the rural junior high schools they studied was as high as 43%.

This is nothing short of remarkable. At a time when the reported GDP is growing from around 8% to 9% a year, the government has, seemingly deliberately, reduced the educational provisions for the majority of the country's youngest population. While the website of the Chinese ministry of education offers information on a variety of topics, including guidelines on summer camps, I have not been able to locate a single official document that offers a rationale for this monumental development.

Understanding how China's 1990s development strategy hurt its peasantry while simultaneously contributing to its export growth is a complicated affair, but sadly, despite its vital importance, discussion is more ideological than informational. For many western economists, foreign direct investment (FDI) and export manufacturing offer the most important way out for Chinese peasants. The oft-repeated empirical evidence to support this reasoning is that during the 1980s and 1990s more than 200 million – the majority being rural residents – were lifted above the absolute poverty level.

Deceptive view

This perspective is extremely misleading. First, much of China's poverty reduction took place in the 1980s, not in the 1990s. By various estimates, about 80% of the 200 million people who grew out of poverty did so in the 1980s, and a huge portion of this 80% did so in the first five years of the 1980s. There was virtually no FDI in the first half of the 1980s, and China's exports, while growing, comprised only a small fraction of the Chinese economy. Yes, taken as a whole, China's record in poverty reduction is impressive, but much of this poverty reduction has nothing to do with FDI or foreign trade.

This perspective is also misleading because it falsely equates external liberalization – FDI and foreign trade – with internal liberalization. My research shows that in the 1990s external liberalization was used to substitute, rather than to complement, internal liberalization. During much of the 1990s, financial resources became less available to China's indigenous entrepreneurs – many located in the countryside – and property rights of land – a vital source of income growth, wealth accumulation and old-age security for the Chinese peasantry – became less secure.

In scenes eerily reminiscent of what fuelled Che Guevara's revolutionary zeal in the Latin America of the 1960s, forcible, predatory and sometimes violent land grabs by local officials have occurred all over China's countryside since the late 1990s. Nobody knows how many peasants have lost their land – a commonly-cited figure is 40 million.

Entrepreneurs

The root cause behind the sorry state of Chinese peasantry is financial repression and a state-centred system of property rights. These institutional woes cannot be simply attributed to the legacies of central planning. Very early in the 1980s, as a part of the rural reforms, China moved quite far in financial liberalization in the countryside. Banks were instructed to support start-up businesses and to experiment with interest-rate liberalization. Widespread practices of informal finance were tolerated. In the 1980s, the vast majority of the start-up entrepreneurs were rural residents, and a sizeable fraction of them, ranging between 30% and 50%, reported being able to obtain loans from the banking system.

The new freedoms and a moderate amount of financial resources enabled these rural entrepreneurs to build thriving businesses, and some grew quite big in a matter of just a few years. The land leases were granted and then progressively lengthened. In some regions of the country, markets for land exchanges spontaneously sprang up. With more income and with a sense of security about their future, peasants began to spend on housing fixtures, clothing, home appliances. These impressive internal reforms were the single biggest factor in reducing poverty.

Reversal

In the 1990s, many of these productive policies were reversed. The authorities began to recentralize controls over financial resources, mainly to launch huge infrastructural projects in the urban areas. The milestone event was the 1994 tax reforms, which reassigned tax revenues massively in favour of the central government. Local governments, starved of resources but not reduced in size or political power, began to tax the peasants aggressively.

In the wake of the Asian financial crisis, in the name of effecting financial stability, many of the small-scale financial institutions that supported rural entrepreneurs in the 1980s were closed down. This was a curious move as the state-owned banks instructed to take them over were in

fact far less healthy and saddled with non-performing loans. The state also forcefully imposed itself on land transactions. Conversions from agricultural to non-agricultural uses of land required not just approval from the state but the state assumption of the land title itself. Cumulatively, these policies had a debilitating effect on the rural private entrepreneurs. The fraction of those who reported receiving loans fell to around 15% in the late 1990s. The postal savings system, which took in deposits but did not give out loans, acted to suck resources from the rural to the urban areas. Rural credit cooperatives were instructed to support agriculture, but not industry. Without resources or assets, China's rural residents, who created the economic miracle of the 1980s by building millions of small-scale non-agricultural businesses, were denied the opportunity to partake in industrialization and globalization as business owners, entrepreneurs or outsourcing operators for foreign firms. They did what they could – making labour contributions.

This is why in the 1990s the rural residents flooded the coastal, urban regions in search of manufacturing jobs, which were in fact partially financed by their own savings. This massive migration produced substantial downward pressures on industrial wages. According to the 2004 private-sector survey, between 2001 and 2003, while the GDP nominally grew, wages in the private sector in fact stagnated. While this might contribute to export competitiveness, it does nothing to boost domestic consumption. The marginal gains to the rural labourers, after taking into account the huge social and relocations costs, must have been modest indeed, as indicated by the fact that after the authorities reduced some rural taxation in 2003, factories in Guangdong immediately began to report labour shortages.

Long-term effects

The damage of the 1990s' strategy will be long lasting. A macroeconomic effect is the failure of rural consumption to keep up with the general economic growth and an increasing reliance on investment as an engine of growth. The modest income gains for rural residents are one reason, so is the curtailing of capital gains from the squandered entrepreneurial opportunities in the rural areas. In more recent years, the land grabs have probably done the single biggest damage to China's consumption potentials. In a socialist state, while urban residents have enjoyed a modicum of old-age security, the rural residents have none, other than the promise of material income provided by their land. Land grabs reduced rural incomes and at the same time increased the anxiety about their future. A predictable effect is an increase of precautionary savings out of an already meagre income.

A more subtle microeconomic effect is that China is more embedded in a low-wage, thin value-added, commodity-based business model than otherwise necessary. Faced with an ocean of cheap and increasingly less educated rural workers, factory owners have no incentive to improve the work environment, invest in innovations, and move up the technological ladder. Now, as China is under pressure to revalue its currency further, the situation will get worse as the pricing option is extremely limited and the only alternative to keep up the margins is to squeeze wages. There are also huge political and social damages. China's rural/urban income inequality is one of the highest in the world, and on top of this income inequality, the land grabs have a particularly pernicious effect on wealth distribution. A huge portion of net worth on the part of the rural residents – more than 60% of the book value according to one estimate – was tied up in housing structures on the land. Instead of allowing the original rural dwellers to reap the asset gains due to their incumbency rights, the land grabs have enriched the corrupt local officials and their business associates.

Chinese local officials often invoked the need to attract FDI as a justification for these huge land development projects – industrial parks need to be constructed and power plants need to be built. Even if this is a plausible motivation, it is built on a self-defeating logic. My prediction is that the day when angry peasants storm into a foreign factory protesting the manner in which their land was seized is the day that will finish off China as an alluring FDI destination.

Protests

Social stability, effected via rule of law and fair and equitable market exchanges, is the best source of confidence in a country. Sadly, the development model that China embarked upon in the 1990s has done substantial damage to this virtuous source of social stability. According to the Wall Street Journal (Chinese edition), in 2005 the Chinese government received some 30 million petitions to address various grievances. This is a remarkable number considering the fact that, after the Cultural Revolution, between 1979 and 1982, there were only 20,000 similar petitions. In 2004, according to the official data, more than 74,000 protests – many in the countryside – broke out in the country. This is a sharp increase from the 10,000 recorded in 1993. More ominous is that the triggers of these protests have become more mundane over time. Sometimes, a fender-bender on a crowded street could turn into a riot involving tens of thousands of people and last for days. Developments such as these should at least prompt the question whether or not Chinese economic growth is partially immerserizing .

Many in the international community have so far been oblivious to these adverse developments, and they have been preaching China's development model to other poor countries. It is time to reassess China's development experience. The first thing we need to recognize is that, while China's economic achievements are substantial and real, a portion of the urban prosperity – the modern buildings, infrastructure, industrial parks and amenities – is redistributive in nature and is financed by the foregone benefits and the actual costs incurred by China's poorest population. This arrangement entails monumental economic, social and political costs. Right road

The good news is that the current leadership, which came into power in 2002, is trying to remedy these inherited problems. China's policy-makers have once again put agricultural reforms and the welfare of the peasantry on the front burner. They have reduced rural taxes and begun to waive the exorbitant fees for rural basic education. They have just announced an investment programme – dubbed “the new socialist countryside” – to improve the living standard of the Chinese peasantry further. These are very good moves, and the sign that these policies are working will be a rise in the rural consumption/GDP ratio. On top of these policies, I would also advocate financial liberalization in the rural areas and political reforms empowering the Chinese peasantry. Nevertheless, China is on the right track to abandon its development strategy in the 1990s. The sooner it does that, the better it is for the prosperity and stability of its citizens in the long run.

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