

# 1. Capitalism, Chinese Style

ALTHOUGH THE PARTY FAITHFUL still refer to China's economic system as a "social market economy with Chinese characteristics," a more apt description is a "mixed state and private economy with *European* characteristics." These characteristics include a pervasive, interventionist government role as producer, regulator, and corporate owner; a growing and innovative private business sector (currently producing more than one-third of China's non-agricultural output); and a variety of joint ventures between government, domestic, and foreign business. (Two of these characteristics also bring to mind the formerly stagnating economy of Japan.)

What Britain's prime minister, Tony Blair, has referred to as the "Third Way"—supposedly something between central planning and American-style capitalism—and Germany's chancellor, Gerhard Schroeder, described no less elliptically as the *Neue Mitte* ("New Middle"), both embody those mixed attributes that increasingly apply to the Chinese economy.

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Two recent developments, in addition to China's admission to the World Trade Organization, indicate the direction in which China's economy is evolving: first, efforts by the China Securities Regulatory Commission (CSRC) to reform China's dysfunctional stock markets; second, the recent welcome extended to private businesspeople to become members of China's ruling Communist Party.

Bringing the Shanghai and Shenzhen stock markets up to speed is a requisite for sustaining, in the future, China's past high economic growth rate. China has the world's highest savings rate—more than 35 percent of annual GDP, compared to less than half that rate in most major economies. Effective securities markets help guide savings into efficient and profitable investments, but this vital function has not been performed effectively in China. Instead, so-called policy loans to state-owned enterprises (SOEs) have been provided by the state-owned banks, in the process siphoning capital that could otherwise be available to non-state enterprises were securities markets more ample and more effective. In fact, China's securities markets have been thin and their trading volume low. One indicator is the small proportion of GDP represented by the market capitalization of stocks listed on China's markets (by comparison, in the United States the market capitalization of listed stocks is more than twice U.S. GDP).

To expand and improve the operation of securities markets, the CSRC (China's counterpart of the Securities and Exchange Commission in the United States) confronts two major problems: (1) continued government holdings of two-thirds of the voting shares of the "privatized" former SOEs among the 1,100 companies listed on China's exchanges and (2) the failure of corporate governance of the listed companies to contribute to improving the functioning of equity markets.

To remedy these deficiencies, the CSRC has made several important market-oriented reforms. First, government holdings

are being gradually reduced, although the pace has been constrained by a fear that the markets would be destabilized if the pace were accelerated. This dilemma—rapidly reducing government holdings, without unduly destabilizing the markets—is perhaps more tractable than has been assumed. For example, a portion of the government shares might be converted to nonvoting preferred stock and transferred to the state banks, thereby offsetting some of the nonperforming loans on their fragile balance sheets, while extruding the government from intervention in corporate management.

Second, the CSRC has encouraged the listing of new nonstate companies, adding about a hundred new listings annually—a rate that should accelerate if and as new companies meet the financial and other standards set by CSRC for initial public offerings (IPOs).

Third, the CSRC has been making serious efforts to educate corporate management, as well as both government and retail shareholders, about the importance of improving corporate governance to enable securities markets to function more effectively.

Improved corporate governance is essential to make management accountable to prospective shareholders and thereby motivate savers and investors to acquire securities, thus widening and deepening the markets. This requires increased transparency in corporate management, frequent and regular financial reporting in accord with rigorous accounting standards, and the appointment of independent (nonaffiliated) members to corporate boards, audit committees, nominating committees, and compensation committees, practices far removed from the familiar practices of business management in China. Where ownership remains predominantly in the hands of the Ministry of Finance and other government ministries that hold majority shares in listed companies, management remains beholden to those entities and the interests of *retail* shareholders are largely ignored. Max-

imizing shareholder value is typically not high among the objectives of government owners.

Another indicator of China's circuitous path toward a more market-oriented system is Jiang Zemin's decision on July 1, 2001, to open the way for new entrepreneurs to become party members. (Before that, several thousand businesspeople were already among the party's 65 million members, but most of them became members when they were employed by the state—for example, by SOEs, by state ministries, or by the military.) The July 1 decision anoints "new" capitalists as potentially acceptable party members, thereby overriding the deeply ingrained ideological stance against the profit-oriented business class, which was previously viewed as something to be resisted rather than embraced.

In the short run, Jiang's decision is no less significant as a symbol than as a significant reflection of accelerated market-oriented reform. Probably the number of capitalists admitted to party membership in the next year or two will be relatively limited to forestall opposition by leftists in the party to this "anointment" of capitalists. In the middle to longer run, however, the pace will quicken, and capitalist membership in the party will swell along with the burgeoning of private business in the Chinese economy. Hence, the policy influence of the business sector is likely to increase significantly in the future. One consequence will be greater pressure to strengthen the rule of law as a precondition for economic performance and for the growth of the business sector. Another consequence is likely to be enhanced pluralism within party councils, reflecting the diversity of business interests across a wide range of economic and regulatory policies and practices.

The vector of near-term and longer-term changes under way in China's economy suggests something more like the mixed system of Europe's "New Middle" economies, rather than a prototypical American system. To be sure, the economic performance

of the European economies has been something less than lustrous, and it is at least debatable as to whether the expanding reach of the European Union's bureaucracy is more likely to improve than to impair it. But in China the prospect that a mixed system involving both government intervention and private capitalism will enhance economic performance may be brighter. Unlike Europe, China's economic system is moving away from the heavy hand of centralized state planning toward a system marked by greater openness, competitiveness, and flexibility.

POSTAUDIT

With few exceptions, the main points are as valid now as when the article was published in 2002. Some exceptions are that the growth of the market-oriented private sector has been even more rapid than the essay anticipated (the private sector accounted for 60 percent of China's GDP in 2006) and that improvement in corporate governance has probably been somewhat less than envisaged.