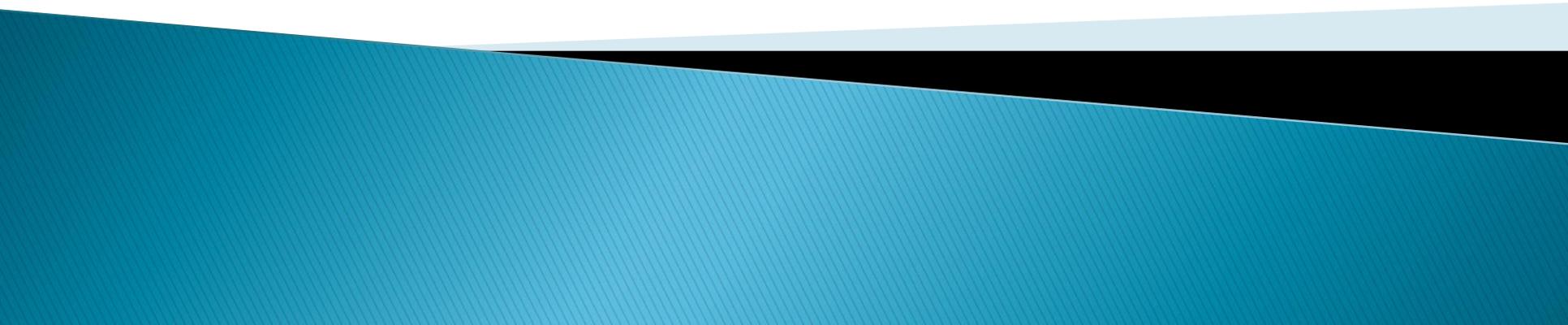


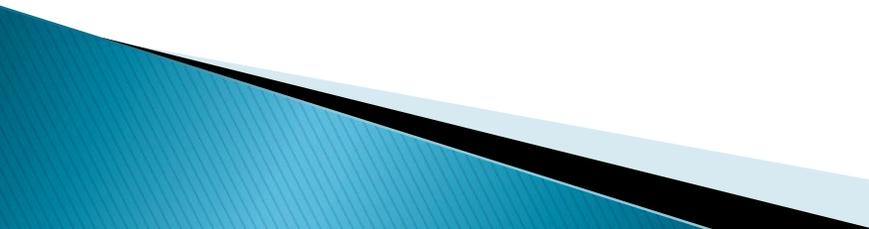
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The Socialist Era, 1949-78



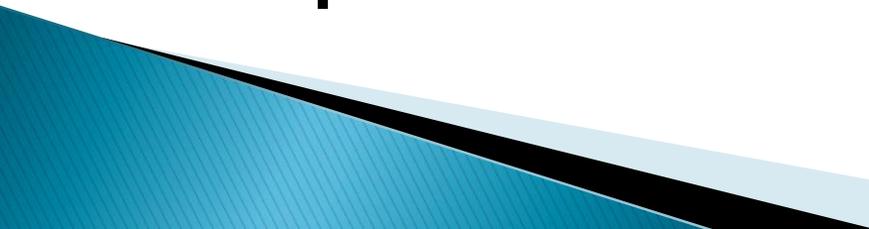
The Socialist Era, 1949-78

- ▶ **The “Big Push” development strategy**
 - ▶ **Command economic system**
 - ▶ **Policy instability**
 - ▶ **Evaluation of strategy**
 - ▶ **Legacies of socialist era**
- 

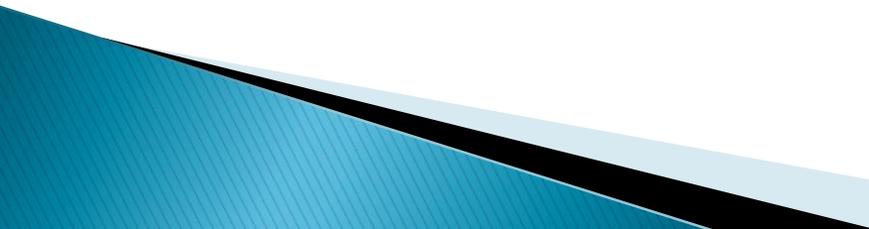
The Socialist Era, 1949-78

- ▶ **With establishment of People's Republic of China (PRC), leaders turned away from traditional economy**
 - ▶ **Aimed to develop socialist, industrial complex through direct government control**
 - ▶ **Focused on capital-intensive industries (metals, machinery, chemicals)**
 - ▶ **Inward-looking, Soviet Union as model**
- 

The Socialist Era, 1949-78

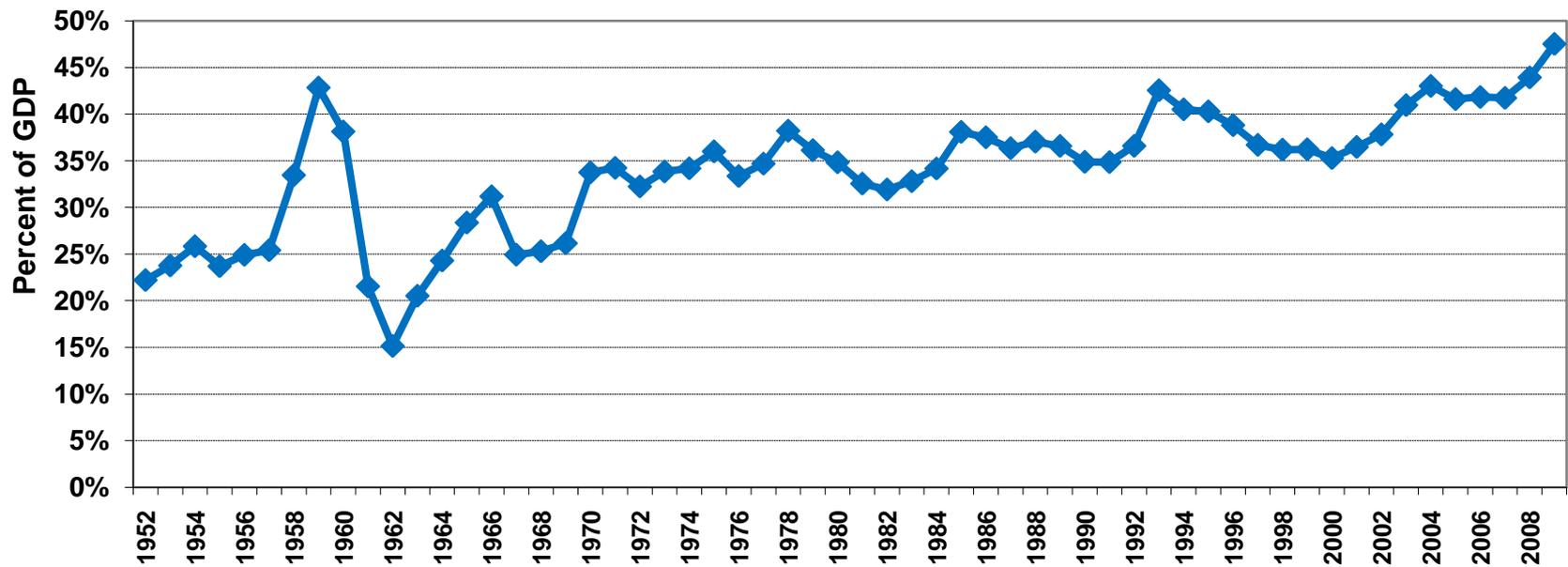
- ▶ **Vision of socialism termed “Big Push” industrialization within *command* economy**
 - ▶ **Command economy subordinated individual decision-making to national strategy**
 - ▶ **Approach varied over the period, generating pattern of economic instability and policy oscillation**
 - ▶ **Since 1979, system gradually dismantled – but no area of current economy has escaped impact of command economy**
- 

“Big-Push” Development Strategy

- ▶ After 1949, rapid industrialization a priority – resources pumped into factory construction**
 - ▶ By 1954, investment rate pushed to 26% of GDP, soared during the Great Leap Forward (GLF), collapsing in its aftermath (see Figure 1)**
 - ▶ Over long-run, investment rates high, rising, but unstable**
 - ▶ 80% of investment in heavy industry, entire new industries created, e.g., fertilizers, motor vehicles**
- 

“Big-Push” Development Strategy

Figure 1 Investment As a Share of GDP



Source: Naughton (2010), *Statistical Yearbook of China*

“Big-Push” Development Strategy

- ▶ **Growth re-started after stagnation of pre-1949 period, Chinese economy took off in 1950s**
 - ▶ **China focused on industries at upper/middle stages of “value chains”– self-reinforcing/self-contained process (steel/iron-ore/coal) – fitted well with inward-looking strategy**
 - ▶ **In contrast, Hong Kong and Taiwan focused on downstream parts of value chains, e.g., finished textiles, light consumer goods – export-oriented – drew on “enclave industrialization” of 1920/30s**
 - ▶ **Only later did Hong Kong and Taiwan move upstream to more technically-demanding/capital-intensive industries**
- 

Different Industrialization Strategies

| | PRC: heavy-industry | Taiwan/Hong Kong: light-industry |
|--------------------------------|---|---|
| Basic strategy | Strategic industries with most upstream and downstream linkages | Begin downstream with consumer goods, work upstream gradually |
| Saving done by | Government, SOEs | Households, private firms, government |
| Investment decisions | Government | Private business, government infrastructure |
| Source of demand growth | Domestic industries, government projects | Foreign/domestic consumer goods markets |
| Household income | Slow growing | Moderate to fast growing |
| Coordination by | Plan | Market, with government steerage |
| Openness to world | Low | High |

“Big-Push” Development Strategy*

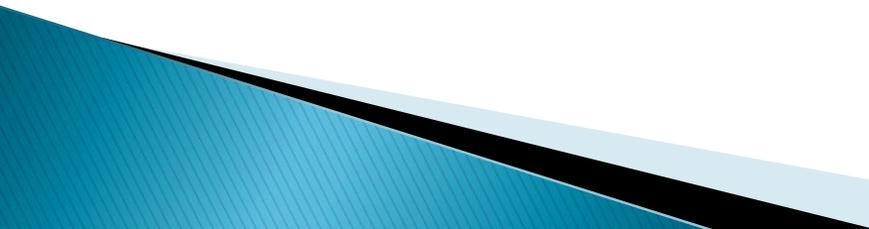
- ▶ **Why did Chinese leaders follow strategy?**
 - (i) To quickly realize independence, believed heavy-industry oriented strategy necessary**
 - (ii) Constraints of international environment – Korean War (1950-53), confrontation with Taiwan, political isolation and economic embargo by Western economies**
 - (iii) Leadership felt industrialization achievable by skipping growth of light industry**

*** See Lin et al., Ch.2**

“Big-Push” Development Strategy

- ▶ **Soviet Union actually had extensive debate in 1920s about development path:**
 - (i) Nikolai Bukharin pushed for market mechanism, and agricultural development to create demand for light-industry**
 - (ii) Yevgeni Preobrazhensky argued for “hyper-industrialization” – although purged by Stalin in 1927, ideas were part of 1929 5-Year Plan**
- ▶ **China stipulated strategy without much debate – included in its first 5-Year Plan in 1953-57**

“Big-Push” Development Strategy

- ▶ **Key characteristics of heavy industry for a developing country: long construction cycle; need to import equipment; large scale of investment**
 - ▶ **In conflict with China’s economy reality in 1953:**
 - (i) Scarce capital and high interest rates**
 - (ii) Lack of foreign exchange, weak exchange rate, and low export capacity**
 - (iii) Low economic surplus – difficult to get funds**
- 

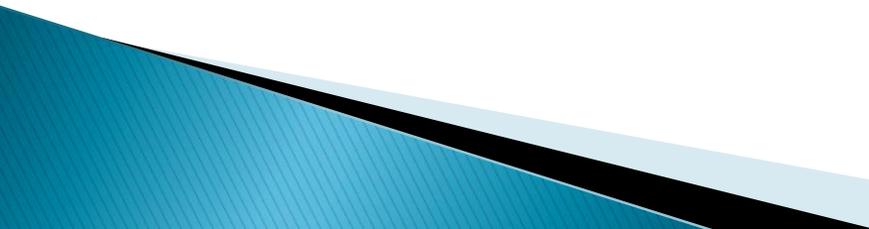
“Big-Push” Development Strategy

- ▶ Cost of industrialization had to be decreased artificially, and resource availability improved:**
 - (i) Low-interest rate policy**
 - (ii) Interfered with exchange rate to ensure key equipment could be imported**
 - (iii) Policy of low nominal wages and low prices for energy and raw materials**
 - (iv) Policy of low prices for agricultural products and other essential goods – to maintain social stability**
- 

Command Economic System

- ▶ **Adopted Soviet system, main features being:**
 - (i) Factories/transportation/communications owned by government; land owned/managed by collectives**
 - (ii) Central planning – production targets for firms, direct allocation of resources, price signals less significant in terms of rationing function**
 - (iii) Government controlled price system, setting relative prices to channel resources to itself and industrialization**
 - (iv) Control of economy reinforced through the Party – controlled managerial paths**
- 

Command Economic System

- ▶ Features characterized Stalinist system, but China altered them to fit Maoist ideology, and accommodate poorer Chinese economy
 - ▶ Intentionally set relative prices to benefit industry, and state-owned enterprises (SOEs)
 - ▶ 1953, compulsory procurement of grain at low fixed prices set by state grain monopoly
 - ▶ While distorting agriculture's terms of trade, mobility of farmers restricted
- 

Command Economic System

- ▶ **Government revenues based on SOEs – able to finance “Big Push” industrialization**
- ▶ **Specific decisions made through “material balance planning” – i.e., supplies allocated based on sources and uses of goods, no role for prices**
- ▶ **Control of labor exercised through *nomenklatura* system (list of urban jobs) – career paths dictated by the Party**
- ▶ **Passive financial system (state monopoly banking), designed to accommodate plan – did not influence resource allocation**
- ▶ **Households able to allocate their own budgets among a limited supply of consumer goods**

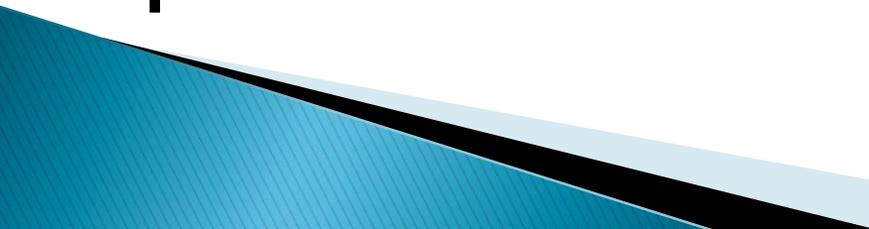
Command Economic System

- ▶ **SOEs had little authority to adjust labor force, and retained no profits, but Chinese system less centralized than Soviet Union**

Less decision-making at top/bottom, more by local officials; small firms more important; transportation/communications less controlled; fewer goods allocated by central planners (600 in China vs. 60,000 in Soviet Union)

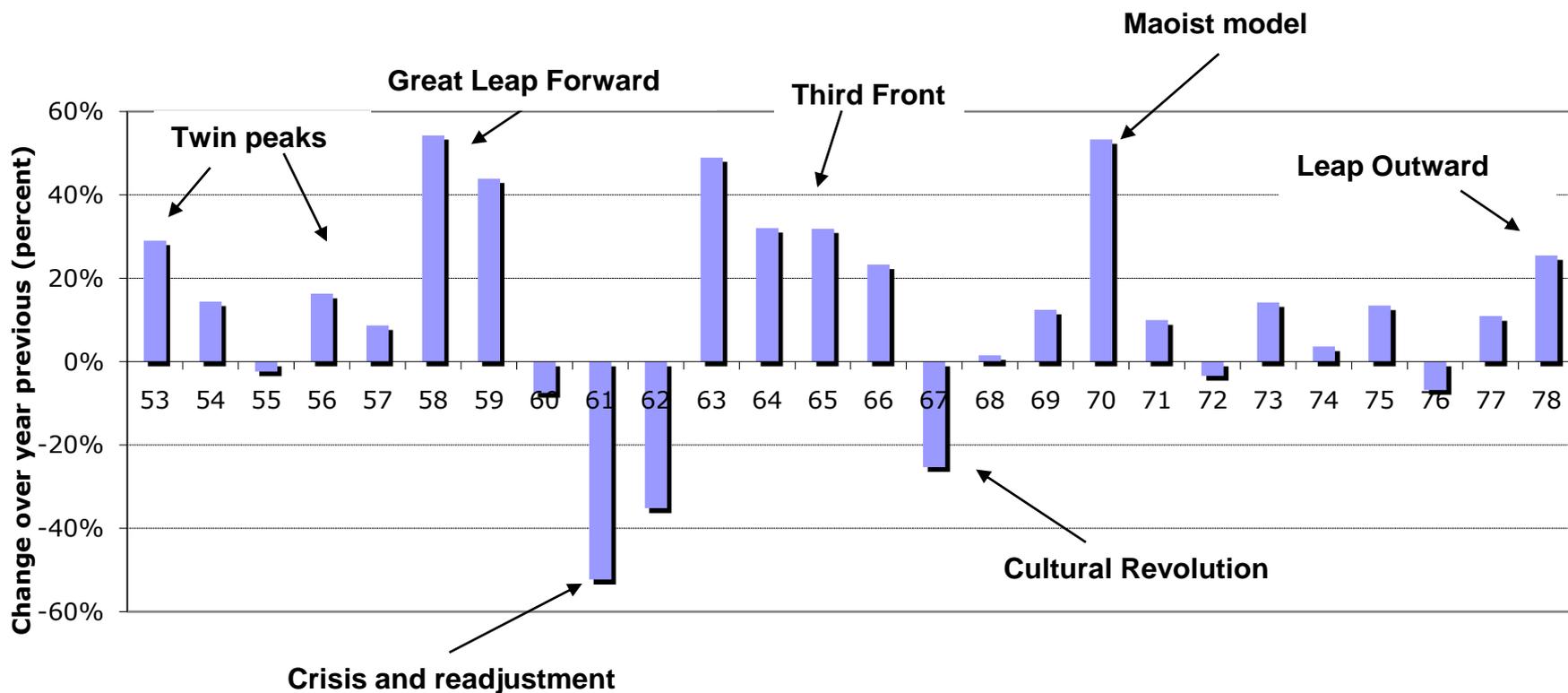
- ▶ **Ideological and social control much tighter – migration restricted; school leavers sent to countryside in Cultural Revolution; firms could not fire workers**

Policy Instability

- ▶ **In some periods, policy emphasis unique to Maoist model, at other times Soviet-like, and then at times pragmatic**
 - ▶ **Shifts in policy often due to political conflict – investment data show five periods when investment exceeded 20% of GDP (see Figure 2)**
 - ▶ **Each “leap” corresponds to period of political mobilization/institutional change – followed by period of retrenchment**
- 

Policy Instability

Figure 2: Growth of Investment in the Socialist Era, 1949-1978



Source: Naughton (2007), *Statistical Yearbook of China*

Policy Instability

- ▶ 1953 and 1956 - Twin Peaks of First 5-year Plan:
 - (i) 1953 investment ramped up – 156 projects imported from Soviet Union/Eastern Europe, built inland or in Northeast – curtailed due to inflationary threat
 - (ii) 1955-56 – criticism from Mao resulted in collectivization of agriculture; private ownership of industry removed; investment growth accelerated
 - (iii) Soviet model in place by 1956 – China a fully “socialist” economy

Policy Instability

- ▶ Retrenchment – “Hundred Flowers” of 1956-57:
 - (i) 1956 – Nikita Krushchev denounced Stalin – socialist countries have right to determine own path
 - (ii) Chinese leaders relaxed political environment, focused on problems due to rapid change, e.g., stagnation of agricultural output; wage inflation
 - (iii) 1956 Party Congress – reforms discussed, including use of market mechanism – open political discussion through “Hundred Flowers” movement, eventually undermined by Mao.

Policy Instability

▶ The Great Leap Forward - 1958-60:

- (i) Mid-1957, Mao attacked liberal critics – 800,000 intellectuals condemned, reforms to economic system in atmosphere of radicalism
- (ii) GLF often seen as Mao developing version of socialism different to Soviet model – basic outcome was large increase in rate of resource-transfer from agriculture to industry
- (iii) Did have some “innovative” elements

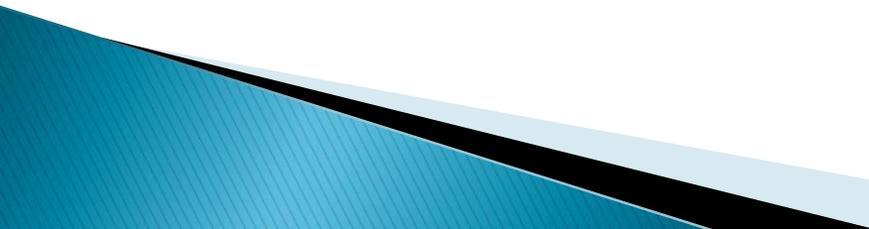
Policy Instability

- ▶ **Communes established in countryside – mobilized labor for construction, development of rural industries, provision of social services**
 - ▶ **Monetary rewards rejected, SOE bonuses eliminated, rural free markets shut down**
 - ▶ **Decentralization of economic decision-making**
 - ▶ **“Walking on two legs” technology policy – simple technologies to be combined with advanced industrial technology**
- 

Policy Instability

- ▶ **During 1958, ideological atmosphere became more extreme, and leadership got good economic news, e.g., strong harvest**
 - ▶ **Leadership reduced supply of resources to agriculture, and increased grain procurement**
 - ▶ **Millions of workers drawn out of agriculture to work in rural industries, e.g., “backyard steel mills”**
 - ▶ **Leaders believed crop yields could be tripled**
- 

Policy Instability

- ▶ **Party silenced critics of GLF and did not heed warnings from peasants of agricultural disaster**
 - ▶ **State-sector employment surged in 1960, and grain procurement grew – local and regional food shortages developed as harvests and stocks declined**
 - ▶ **China faced full-blown famine in 1960, at same time major rift with Soviet Union after Krushchev withdrew advisers**
- 

Policy Instability

- ▶ **Famine dominated rural areas, especially inland provinces such as Sichuan, Guizhou and Anhui (see Figure 3)**
 - ▶ **State continued grain procurement**
 - ▶ **Official population data indicate by end of 1961, 25-30 million famine-related deaths – largest famine of 20th century (see Lin and Yang, 2000)**
 - ▶ **Began to recede by end of 1962**
- 

Policy Instability

▶ Retrenchment - Crisis/“Readjustment”-1961-63 :

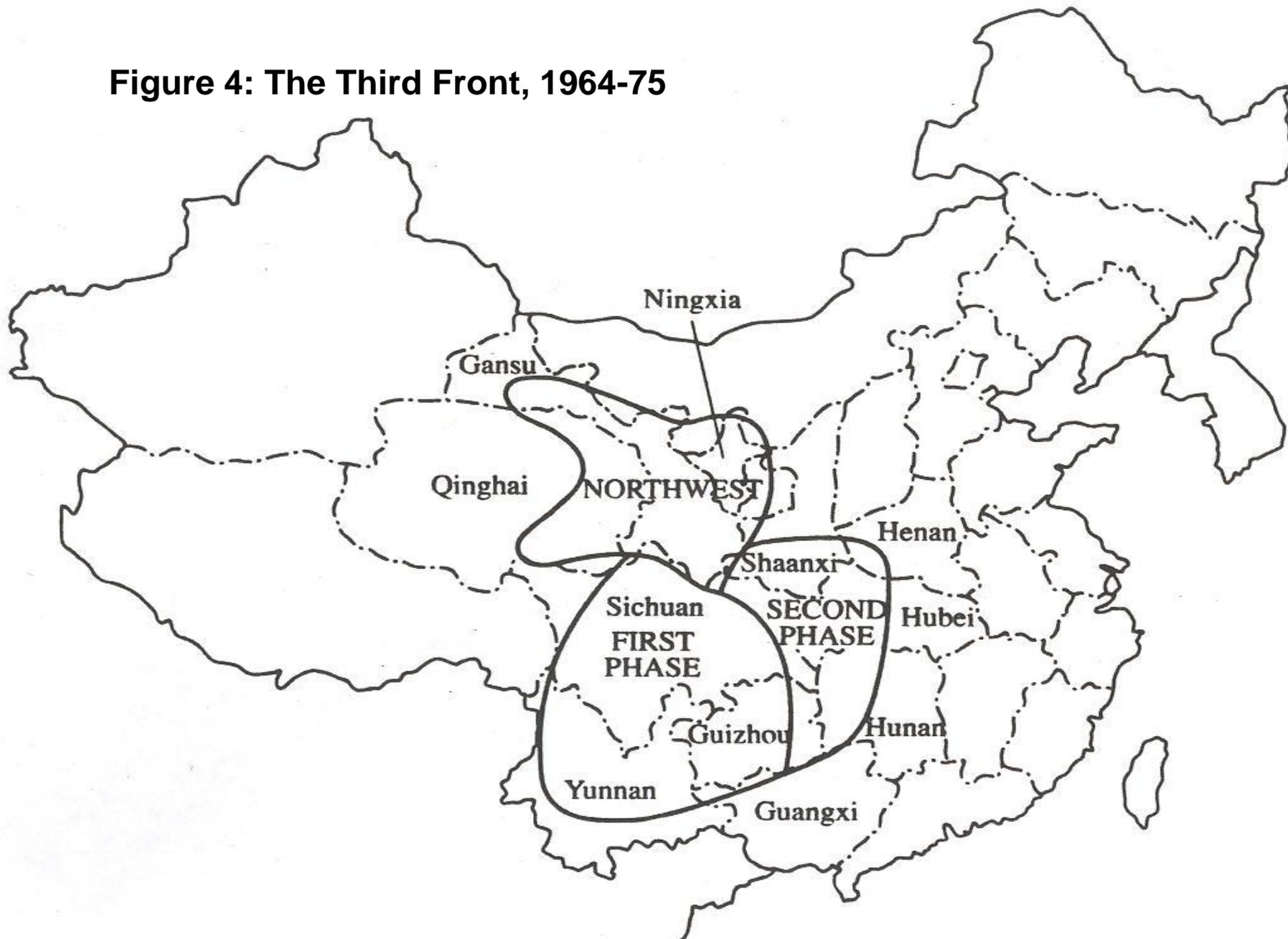
- (i) 1961, leadership cut investment, 20 million workers returned to countryside
 - (ii) Communes restructured – agricultural production by smaller groups of households; rural industry cut back
 - (iii) Recentralization of economy, rationing imposed
 - (iv) 1963 – drafts of new 5-Year Plan implied turn away from “Big-Push” industrialization, and attempt to restore living standards
- 

Policy Instability

▶ Launch of Third Front – 1964-66:

- (i) Due to China's isolation, and US involvement in Vietnam, Mao shifted strategy in 1964 – pushed for “Third Front”
- (ii) Construction program focused on inland provinces (see Figure 4) – objective to create industrial base for strategic independence
- (iii) Aimed to build entire industrial structure, i.e., steel, transport, industrial equipment (Naughton, 1988)
- (iv) Re-established “Big-Push” – halted by Cultural Revolution

Figure 4: The Third Front, 1964-75



Source: Naughton (2007), Naughton (1988)

Policy Instability

▶ Retrenchment-The Cultural Revolution-1967-69:

- (i) Mao encouraged students, Red Guards, to overthrow Communist Party leadership – subject to criticism and dismissal, e.g., Deng Xiaoping
- (ii) Substantial disruption and factional conflict
- (iii) Had relatively little long-run effect on economy – guiding policies reinstated quickly in 1969, focus being back on Third Front

Policy Instability

▶ The Maoist Model – New Leap in 1970:

Model a distinctive variant of Soviet model:

- (i) Militarization of economy**
 - (ii) Decentralization of economy**
 - (iii) Relative autarky practiced**
 - (iv) Absence of incentives, and few markets**
 - (v) Labor mobility ceased, no migration**
- 

Policy Instability

▶ Retrenchment-Consolidation/Drift-1972-76:

- (i) Industrial growth began to exceed agricultural growth again – too many resources tied up in construction
- (ii) 1971, Lin Biao purged, and rapprochement with US – President Nixon visited in 1972
- (iii) Premier Zhou Enlai introduced more moderate course – investment cut back, economy opened up to equipment imports
- (iv) Deng Xiaoping returned to power in 1974, but ejected again in 1976 – economic policy-making paralyzed

Policy Instability

- ▶ Leap Outward – 1978 and End of Maoism:
 - (i) Mao Zedong died September 1976 – new leader, Hua Guofeng focused on new investment plan – based on Chinese oil export earnings
 - (ii) By 1978, clear China could not pay for industrial construction contracts, leap-outward strategy collapsed – basically no oil reserves
 - (iii) December 1978, “third plenum” saw return of Deng Xiaoping as leader – new economic policies adopted heralding reform era

Evaluation of Socialist Era*

- ▶ **Socialist strategy resulted in:**
 - **distorted product and factor prices**
 - **centrally-planned resource allocation**
 - **micro-management**
- ▶ **Lin, Cai and Li (1996) describe this as the “trinity of the traditional economic system” (see Figure 5)**
- ▶ **Economic performance net result of system**

*** See Lin et al. Ch.3**

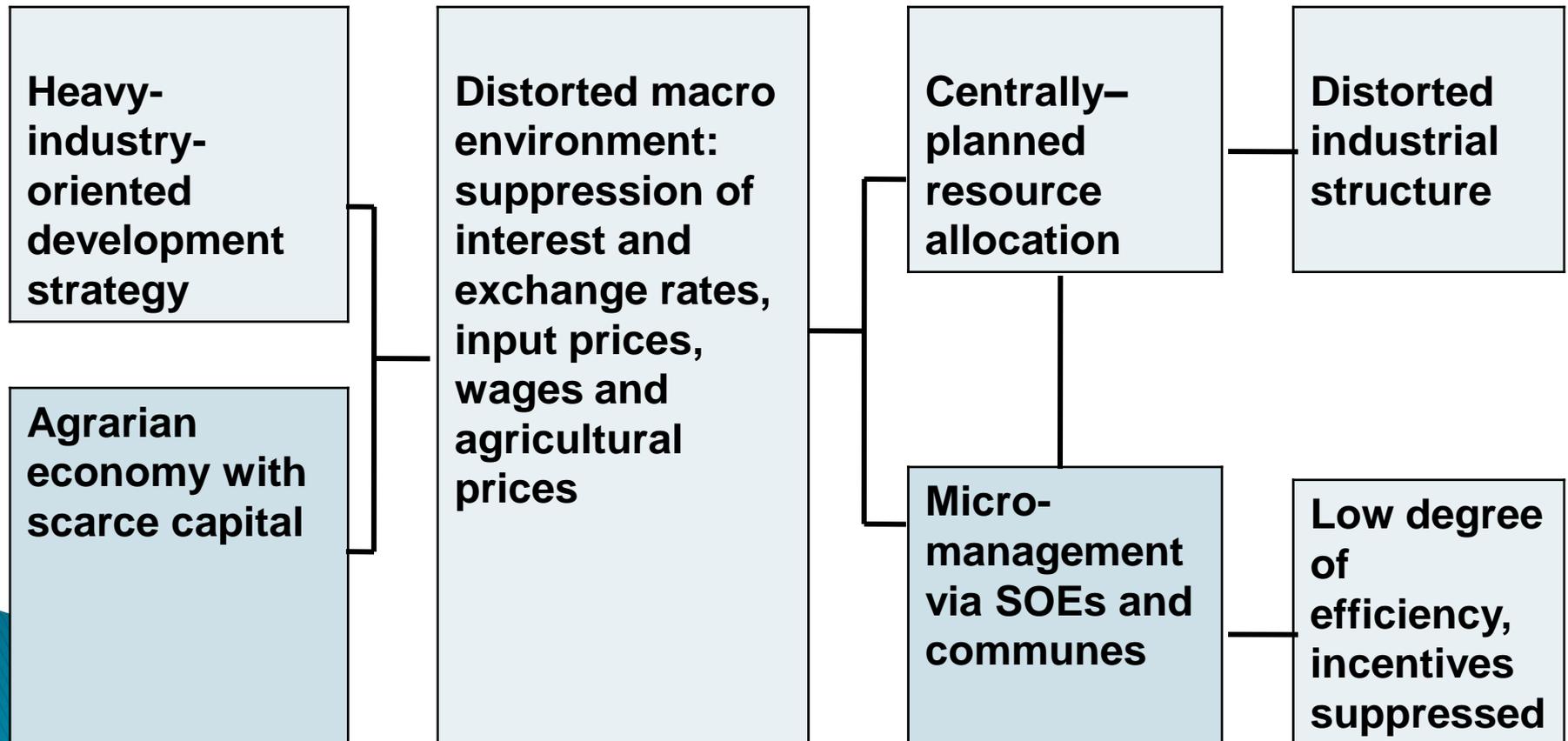
Figure 5: Socialist Economic System

Development strategy

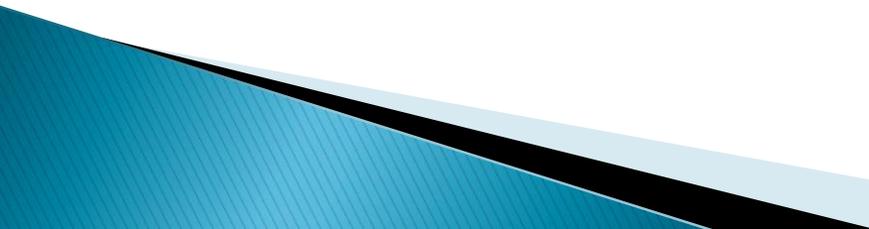
Economic system

Economic performance

Endowment of economy



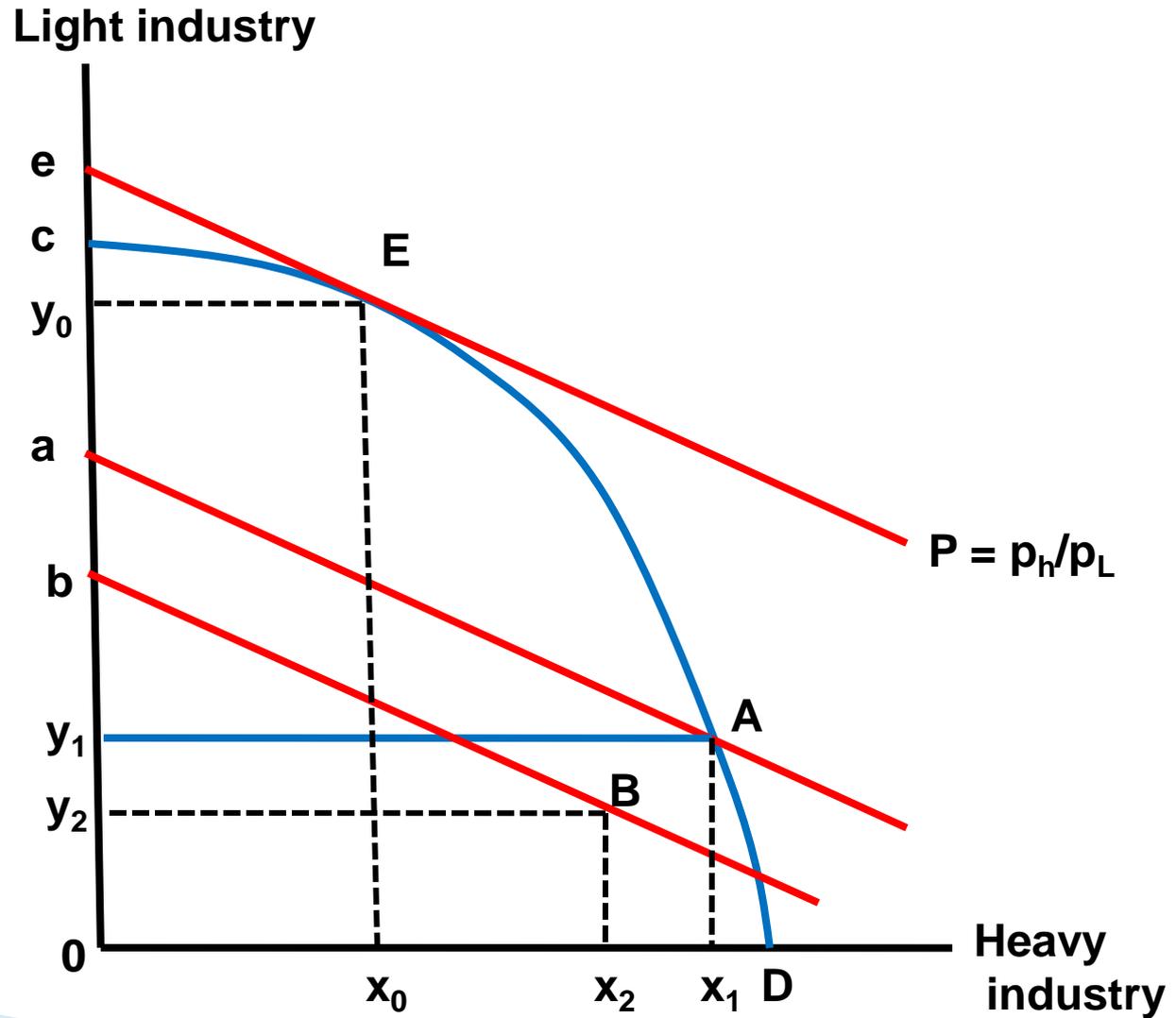
Evaluation of Socialist Era

- ▶ **1952-78, China's GNP increased by 6% (Lin et al., (2003))**
 - ▶ **Industry's share of GNP rose from 19% to 49%, while agriculture's share fell from 58% to 33%**
 - ▶ **With such a high growth rate, why did it fail to achieve economic modernization?**
 - **distorted market structure under "Big-Push"**
 - **lack of incentives and low efficiency**
- 

Evaluation of Socialist Era

- ▶ **Structure inconsistent with China's comparative advantage determined by factor endowments – impeding development and standards of living**
- ▶ **Consequences of distortion:**
 - (i) **Economic growth rate depressed – if markets had been allowed to function, labor-intensive industries would have been competitive (see Figure 6)**

Figure 6: Socialist Strategy and Production Inefficiency



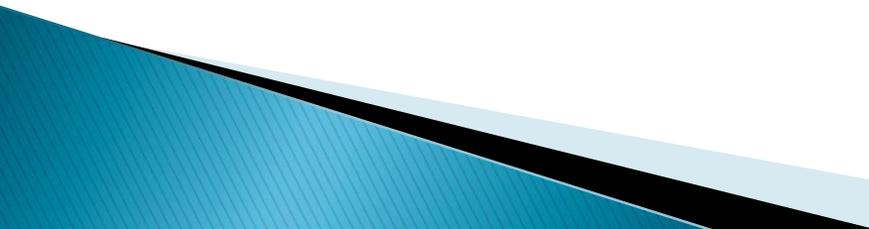
Evaluation of Socialist Era

- undistorted relative prices, $P=p_H/p_L$, results in production mix at E on cEAD, with GDP at e, with $0y_0$ of light industry, and $0x_0$ of heavy industry
- allocation of capital to heavy industry by planning depressed light industry, i.e., y_1AD , with $0y_1$ of light industry and $0x_1$ of heavy
- evaluated at non-distorted prices P , static loss of GDP of ea (measured in terms of light industry)
- with reduction in production, if some GDP goes to investment every period, then growth potential of economy reduced, i.e., end up at B, producing $0y_2$ and $0x_2$

Evaluation of Socialist Era

- (ii) Transfer of labor to non-agricultural sector slowed down – economic growth failed to provide sufficient employment, and restrained exit of labor from agriculture**
 - (iii) Living standards improved little – resources focused on production of capital products, little focus on consumer goods**
 - (iv) Inward-looking nature of economy reinforced – labor-intensive sectors with export-potential failed to develop**
- 

Evaluation of Socialist Era

- ▶ **Inefficiency of system driven by:**
 - (i) Resource allocation by central planning resulted in surplus/shortages, depending on bargaining power of sector**
 - (ii) Lack of competition – little incentive to improve efficiency/product quality**
 - (iii) Suppression of incentive to work**
- 

Legacies of Socialist Era

- ▶ **Policy instability resulted in dissatisfaction with standard socialist system – reformers aware of potential alternatives at end of 1970s**
- ▶ **Scarce resources pushed into heavy industry and used very inefficiently – consumption and services neglected, and retail sector shrank**
- ▶ **Investment in basic human capital fairly substantial – life expectancy grew, and literacy rates good**
- ▶ **System more decentralized/less entrenched than in Soviet Union, and Chinese leaders did not want to be left behind other East Asian economies**