China's Other Path

For all of China's economic achievements, the heyday of its entrepreneurs lies more than 20 years in the past. Renewing that era's rural capitalism would yield more balanced growth and go a long way toward reducing today's trade tensions.

BY YASHENG HUANG

Most people take it for granted that today's rising tensions between the United States and China over trade and the value of the yuan will be resolved (or not) in the corridors of central banks and finance agencies in Beijing and Washington. It is far more likely, however, that the solutions will be found hundreds of miles from Beijing—in the scattered villages and small towns of rural provinces such as Hunan, Sichuan, and Guangxi.

Make no mistake: The onus for the most severe global recession since 1929 lies squarely on the United States, with its lax supervision and excessive leverage in the financial sector. But there is an important background factor: a global economic imbalance in which some countries consume too much and other countries consume too little, and China is the biggest country in the latter category. Any progress it can make in bringing domestic consumption more in line with production will do a great deal to reduce trade tensions with the United States and restore order to the global economy.

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Where should China begin this adjustment process? Many Western economists fix their eyes on Shanghai and other urban export powerhouses. These economists have not seen much point in thinking about the Chinese countryside except as a source of cheap labor for the cities. Visiting Shanghai or Beijing, they are dazzled by impressive new airports and block after block of spanking new skyscrapers—many built with government money—and mistakenly conclude that China's growth is a creation of its strong state. For the most part, these economists don't see rural China as a source of economic dynamism.

They are half right. Rural China today has low levels of income growth and consumption. But it is wrong to assume that the countryside is economically inert. In fact, China's economic resurrection began 30 years ago in some of its most backward places, and for more than a decade tens of millions of private enterprises that blossomed in these remote spots produced a powerful surge of strong and balanced growth. One of the solutions to today's global economic imbalance is to encourage the Chinese leadership to rekindle the same rural entrepreneurial spirit that it all but snuffed out in the 1990s.

One set of statistics illustrates the importance of

Shanghai is the iconic city of China's economic boom, but it is home to only a handful of the country's largest privately owned firms. The city's success is mostly the product of government spending, state-run companies, and investments by foreign-owned firms.

the China that lies beyond the coastal cities. Although they constitute the majority of the population, the 700 million rural Chinese account for less than one-third of China's consumption. In the past 30 years, the growth of the country's gross domestic product (GDP) has averaged almost 10 percent a year. By contrast, rural consumption during the past 20 years has grown only three to five percent annually. That means that a lot of Chinese output has to be consumed elsewhere, mostly overseas.

I said 20 years rather than 30 for a reason. Rural consumption actually grew very rapidly in the 1980s, the first decade of economic reforms, often matching or even surpassing GDP growth. China in that decade witnessed the most impressive consumption gains in the history of the People's Republic.

What is the difference between then and now? Two words: rural entrepreneurship. In the 1980s, in the wake of Chinese leader Deng Xiaoping's 1978 market-freeing reforms, businesses based in the hinterlands were at their most vibrant and China's domestic consumption grew rapidly. That had a twofold effect. First, new jobs and rising incomes were created for the rural Chinese multitude, who were then able to spend even more on goods and services. Second, the growing appetites of rural consumers attracted the attention of entrepreneurs eager to sell to them. The hottest economic action was in the nexus of manufacturing and services—simple processed foods and small manufactured goods that these entrepreneurs could peddle to rural consumers and, more important, their richer urban cousins.

Many of the new businesses sprang up in what economists call the "nontradable" sector, producing goods and services that did not lend themselves to sales in distant markets. Growing China's service sector to a level more in line with international norms—

Far from the spotlight, Sichuan, Anhui, and other rural hotbeds of entrepreneurialism (shaded) pioneered Chinese development in the 1980s.

from its current 40 percent of GDP to something more like 60 percent—would do much to ensure the country's rapid growth while at the same time reduce trade tensions with the United States. But this is easier said than done. One reason why rural commerce prospered in the 1980s is that it was easier then for entrepreneurs from outlying areas to set up shops and stalls in the cities. Today, with strict registration and licensing controls, Chinese cities boast mammoth shopping malls—many of them empty—but they are largely bereft of the small, bustling market fairs that dotted the streets in the 1980s.

Most people associate entrepreneurship with people like Bill Gates: lone heroes who start out humble—often, apparently, in garages—and grow big companies by pioneering breakthrough technologies. But in much of the developing world, this narrative is simply irrelevant. For one thing, poor countries don't have many garages, because they don't have many cars. What they do have is a lot of poor people who will not soon be either big producers or big consumers of high technology. The issue is how to grow income and create jobs, and when it comes to that, nothing beats the low-end service sector that is the domain of rural entrepreneurs.

It is not an exaggeration to say that the modern history of entrepreneurship in China has been written by its rural people. They single-handedly created the miracle growth of the 1980s and early '90s at a time when the ideological risks of venturing into commerce and the market economy were still substantial. As recently as the mid-1990s, rural entrepreneurs accounted for 30 to 50 percent of private-sector activity in *urban* China. Today, their share is far smaller, as they have given ground to a new group of entrepreneurs in technology, retail, and real estate. But rural business ventures still have a huge potential to create employment and income opportunities, and because the developed economies have yet to recover from the economic crisis of 2008–09, this is one of the toughest policy challenges now facing the Chinese leadership.

One of my favorite success stories out of the many that could be told about the 1980s is that of a man named Nian Guangjiu. In 1982, Nian made it big by selling a product with a distinct flavor and a brand name to match: Idiot's Seeds, which are fried, salted sunflower seeds that Chinese consume as a snack food. This is a classic nontradable good—produced for Chinese tastes and appetites and sold on domestic markets. Nian, a farmer in the impoverished eastern agricultural province of Anhui, "the Appalachia of China," held a rather low opinion of himself, which is reflected in the name he gave his snacks. (The name was not always helpful. When he proposed to set up a scholarship fund at a local school, the teachers balked at the idea of bestowing an "Idiot's scholarship" on students.) But by 1986 he was selling his sunflower seeds in many of the biggest cities in China, reaping profits large enough to put his company in the top 10 percent of private businesses in the country.

Many of China's leading manufacturing firms are based in backward rural provinces such as Guangdong and Hunan. The first indigenously designed automobile to reach Western markets, for example, will probably come not from Shanghai but from the agricultural hinterland of Nian's Anhui Province, home of Chery Automobile, which builds small cars for the domestic market. China's largest food-processing and agribusiness firm, the Hope Group, is based in the interior province of Sichuan, the country's biggest producer of rice, wheat, and other crops. The four brothers who founded the business, originally as a purveyor of quail eggs, held highly prized permits that allowed them to live in urban areas, but they went to rural Sichuan in search of greater economic freedom.

Of all of China's provinces, Zhejiang is the true center of entrepreneurial activity. It was a rural backwater in the 1970s, with 32.2 million of its 37.5 million people living in the countryside at the end of the decade. Today, it boasts the nation's most successful e-commerce business, Alibaba, and its largest auto component supplier, Wanxiang. Located south of Shanghai, it is home to no less than half of China's largest private-sector firms. Because its growth is powered by a large number of micro entrepreneurs, a bigger portion of the benefits flow to local residents, creating more consumption bang for each buck of GDP growth. Over the past 20 years, Zhejiang has devoted a larger share of its GDP to consumption than have neighboring coastal provinces.

The experience of Zhejiang and other outlying provinces shows how important it is to invest in the social capital base of a country. I have found in my research that the first generation of rural entrepreneurs were far better educated than their non-entrepreneurial peers. In the China of the 1970s, a junior or senior high school education was still considered a luxury, but many of those early entrepreneurs had that level of schooling. During the 1960s and '70s, Mao Zedong pursued disastrous economic and political policies, but his government mobilized huge resources to improve rural literacy and health. While these investments did not foster economic growth at the time, they did in the 1980s, when Deng Xiaoping moved the country toward a market economy.

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Contrast China with India, the other major rising power in the developing world. As early as 1965, China boasted better basic education and longer life expectancy for its citizens. This is probably the foremost reason why so many Chinese in the countryside turned to entrepreneurship in the 1980s while very few rural Indians do so, even today. Academic research shows that human capital, not physical capital, is always the more critical enabling factor in economic growth. This is China's true advantage over India, not the length of its highways.

The second factor behind rural China's economic takeoff was a series of policy reforms by the government. The West's biggest misconception about China is that its growth has been the product of globalization. In fact, domestic liberalization has played a far more important role. Economists use this term loosely to describe the changes Deng Xiaoping began in 1978. In particular, Deng got localization right.

In the 1980s, rural China, then home to more

Jack Ma's Internet company, Alibaba Group, is one of many big private firms based in Zhejiang Province, which was a rural backwater in the 1970s.

than 80 percent of the Chinese population, was a hotbed of reform, notably financial liberalization. Private finance was allowed, and some informal finance was legalized, enabling private businesses to get short-term loans and raise equity capital outside official channels. Around the same time that Muhammad Yunus launched his microfinance revolution in Bangladesh, China began to roll out its own version of this financial innovation. Entrepreneurship flourished in places such as Zhejiang Province rather than in many of the urban centers for a very simple reason: Rural China has always been freer than urban China, and it was quick to seize on the new opportunities.

Since 2000, China has become a global export powerhouse and the biggest recipient of foreign direct investment among developing countries. These are laudable achievements, but the reduction of poverty trumps them both, and so far nothing has matched Deng's rural reforms in accomplishing this. It is often noted that China has reduced poverty by 200 million people in the last 30 years, but it is rarely recognized that more than half of the reduction occurred during the first few years of rural reform, as a careful analysis by economists Martin Ravallion and Shaohua Chen of the World Bank shows.

In smaller countries, foreign trade can have a huge impact, but for a continental country such as China, the most important forces come from within. In the early 1980s, reforms were pioneered by two interior provinces, one, Anhui, virtually unknown to Westerners, the other, Sichuan, best known for its association with spicy food. In both provinces, peasants themselves started reforms, and the biggest contribution of the political leadership both in the provinces and in Beijing was that it allowed the peasants to figure out what to do and how to do it. The experiences of these two provinces are case studies of how entrepreneurs everywhere succeed—they need freedom, and they need confidence in the stability of policies.

One important byproduct of reform was the township and village enterprises. TVEs are famous in China for powering the rural industrialization in the 1980s and early '90s that reduced poverty and raised productivity levels. The vast majority of them were run by private entrepreneurs—makers of cement, fertilizer, and many other products. In contrast to the arrangement in other countries, where high-value-added manufacturing operations are concentrated in a few urban centers, in China, people created and worked for TVEs with manufacturing operations in far-flung rural areas. The income of these Chinese increased quickly as they transitioned from low-value-added agriculture to higher-value-added industrial and service-sector work without having to endure the typically traumatic process of migrating to the unfamiliar and often hostile city centers.

China in the 1980s was a hopeful place for the rural majority. But what happened in the 1990s? Let us revisit Nian Guangjiu, the sunflower seeds merchant. In September 1989 he was arrested on the charge of embezzling state property, an accusation so outrageous—after all, he owned his own company—that a higher court overturned the verdict. The same court nonetheless dispatched him to jail, albeit for the crime of "hooliganism," sentencing him to three years in prison for having had immoral relationships with 10 women. (Upon hearing the verdict, Nian reportedly commented, "No, 12.")

Nian's fate signified a new economic and political order for China's rural entrepreneurs. After the trauma of the Tiananmen Square crackdown in 1989, China's conservative leadership tightened controls on the private sector. Credit dried up, and because rural China had the larger private sector it was disproportionately affected. This crackdown eased beginning in 1993, but the leadership then began to shift its policy emphasis away from rural areas. The new pro-urban bias, a classic scourge of many developing countries, intensified. One consequence was a sharp reduction of financial resources flowing into rural China. Many of the unofficial financial operations that had supplied critical start-up funding to rural entrepreneurs were shut down, and the non-standard forms of finance they had relied upon (such as loans from extended-family members and informal groups) were criminalized. Some individuals were sent to jail for pooling capital to start their own businesses. My research shows that the percentage of rural households able to get access to credit fell by more than half from the 1980s to the '90s, and that fixed-asset investment in rural areas slowed drastically in the 1990s.

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This was virtually the same moment when many Western economists were forming their basic conceptions of China. They saw it aggressively courting foreign direct investment in the coastal cities as it rapidly built new highways and other infrastructure. In 1999, China ended a 13-year stalemate with the United States by making almost all the concessions necessary to win membership in the World Trade Organization. The conclusion was obvious: Globalization had arrived in China, and it was rapidly enriching the country.

But many observers failed to ask a basic question: "Where did the government of such a low-income country get the money to finance all this impressive urban infrastructure?" The answer: rural China. In the 1990s, as skyscrapers sprang up in Beijing and Shanghai, the rate of rural income growth went down. Low income growth then led to low consumption growth. Household consumption fluctuated between 40 and 45 percent of GDP throughout the 1990s but then began a decline in 2000, from 46 percent to today's 35 percent. (In most other countries, consumption usually averages between 60 and 70 percent of GDP.) This was the beginning of the economic imbalances that put production far ahead of consumption—facilitated, one should add, by demand created by excessive American consumption fueled by credit bubbles. The trade tensions with the United States and all the charges and countercharges about currency manipulation are basically the result of this startlingly low consumption/production ratio.

How did rural Chinese fare in the 1990s? Not very well. Their income growth rate fell sharply, from seven to eight percent annually in the 1980s to around four percent in the 1990s. At the same time, surcharges by the state on basic education and health care services rose, increasing economic pressures on families and reducing their ability to buy goods and services.

One avenue of material improvement remained open to rural Chinese: migrating to the coastal cities to work in factories. Many took this route. There is no question that the pay in urban centers was much better than it was on farms back home. But the flood of workers depressed wages in the cities. In Guangdong Province, average pay for migrant workers increased at only about one-third the rate that GDP did. Slow wage growth meant that Chinese migrant workers, unlike middle-class urbanites elsewhere in the world, were not able to consume much of what they produced. But the excess production had to find a market. China became an export-driven economy as a result.

It is rare in the economic arena to have one policy instrument that can solve multiple problems, but just such a tool lies within the grasp of China's leaders. To reduce its reliance on exports, to achieve more equitable growth, and to increase its efficiency, they need to rethink their policies toward the rural economy. China's policy elites are still in the grip of the traditional groupthink view that people from the countryside are fit only to contribute labor, not product and process innovations that we customarily associate with entrepreneurship.

In *The Other Path: The Invisible Revolution in the Third World* (1989), the seminal book that inspired the title of this essay, Peruvian economist Hernando de Soto showed the power of land and asset reforms in unleashing grassroots entrepreneurship in developing countries. In China, there is some encouraging evidence that the leadership group that came to power with President Hu Jintao in 2003 is finally beginning to show an appreciation of these forces. Some old policies are being repudiated. Modest land and financial reforms have been introduced, and at the just-concluded National People's Congress there was discussion of further lifting the residential restrictions that inhibit people's mobility in rural China. These changes point in the right direction, but they must be implemented on a larger scale if China is to repeat the growth miracle of the 1980s. The most convincing evidence that things are beginning to change is that manufacturers in coastal areas of Guangdong Province have begun to experience upward pressure on wages. That matters because it indicates that they now have to compete for workers with rural businesses in the interior, which seem to be reviving. This bodes well for China's efforts to rebalance its economy and move quickly toward a growth model powered by domestic income and consumption.

For the United States, it would be far more productive to help China with this transition than to berate it for its exchange-rate policies. This kind of change is not alien to China in the wake of Deng Xiaoping's reforms, and there is much that it can learn from the American experience creating the Small Business Administration and various credit-guarantee programs for entrepreneurs. Instead of making a case for freedom and individual choice on the grounds of human and political rights, which can be culturally contentious and divisive, the United States can frame the discussion in economic terms, highlighting its own considerable success at fostering a free and supportive environment for entrepreneurs. The United States has a deep and substantial interest in seeing China succeed in this transition, as do many millions of ordinary Chinese and all of those whose lives are tied to the global economic order. ■