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Book review

China's Great Economic Transformation, Loren Brandt, Thomas Rawski, Cambridge University Press (2008)

1. Introduction

There is an old Chinese saying that "A book holds a house of gold." This volume edited by two eminent scholars on China is an impressive achievement and certainly yields a treasure trove of detailed information and thoughtful analysis of the Chinese economy.

Not that there is a dearth of books on China. After all, an economy that has grown at an average rate of about 10%/annum for over two decades, has over a billion people, and has vaulted over others to become the third-largest in the world tends to draw attention. What makes this volume stand out from the crowd is the sheer wealth of material that is brought to bear on different aspects of the growth process and their implications for economic welfare and sustainability of that growth.

China seems to fly against conventional notions of what drives growth—it has an underdeveloped and inefficient financial system, a weak legal framework, dominant state monopolies in many sectors, high levels of corruption, capital controls on inflows and outflows, and the list goes on. Even more strikingly, it had–until recently–registered ever-higher growth rates during this decade while exporting increasingly large amounts of capital, which is the opposite of the standard prescription that developing economies should import capital to increase investment and raise their growth rates.

Has China changed the laws of economics? This is an intriguing question and there are chapters in this book that either directly or indirectly try to frame and address this issue in different ways. For instance, the chapter by Allen, Qian and Qian highlights the deficiencies in the formal financial system. But these authors argue that the informal financial system has done an adequate job of filling in the gaps. Similarly, the chapter on the legal system points out the weaknesses in the formal legal system and suggests that alternative informal institutions have served as a workable substitute.

The Chinese growth experience is a Rorschach test, allowing researchers to project their own prejudices on their interpretations of its growth experience and the reasons for its success. Pro-globalizers and anti-globalizers both see China as conclusive evidence of the validity of their worldviews. But it is indeed an intriguing question whether China is *sui generis* or if there are important generalizable lessons that other low and middle-income countries can take away from its economic success.

Many observers have argued that the Chinese success story stands as a clear repudiation of the so-called Washington Consensus, which is seen as an encapsulation of free-market principles. On the other hand, the statements of Chinese authorities themselves suggest that they see financial development, reform of state enterprises, and better institutions as essential for growth to continue at a rapid pace. Perhaps once again policymakers are proving far more adroit at striking a reasonable balance than academic dogmas that tend to extreme positions. This comes through in a number of chapters, which show that policies implemented by Chinese authorities don't always fit in to conventional categories but somehow seem to deliver the goods. Indeed, despite state control of much of the industrial sector and various other distortions relative to free-market benchmarks, even total factor productivity growth has been mystifyingly strong (see Bosworth and Collins, 2008, for a comparative perspective with India). This book provides a good starting point for thinking about the often-unconventional mechanisms involved in delivering these good economic outcomes.

China's approach to market-oriented reforms, including the political economy aspects of a move towards less state control of the economy, is explored in a number of chapters. The gradualist and incremental approach seems to have worked quite well in terms of moving the economy along the reform path without exposing it to major risks. For instance, tax or social expenditure reforms are sometimes instituted in one or a small set of provinces on a trial basis. Lessons from those experiences are then incorporated into revised policy designs before rolling out those reforms nationally. This is learning by doing at its pragmatic best.

China has also tried to embrace globalization in a calibrated way that permits it to use external forces to push through domestic reforms but without the attendant risks of full opening-up. This set of policies includes active encouragement of inflows of foreign direct investment and associated technology transfers while trying to keep out other more volatile forms of capital; use of trade opening and the ensuing exposure to foreign competition to get domestic firms to increase efficiency; and use of the commitment to liberalize financial services and open up the banking sector to foreign entrants as a deadline to induce domestic banks to make rapid progress on revamping themselves.

As Prasad and Rajan (2006) point out, however, this approach may be less viable now that the economy has become much more complex and market-oriented, making it easier for private agents to unravel limited reforms. Moreover, gradualism in certain reforms such as permitting more exchange rate flexibility, putting in place an alternative monetary policy framework, and capital account liberalization may be infeasible or, in some cases, even counter-productive.

Before one gets swept away with the enviable growth performance, it is also useful to reflect on what negative consequences the growth model has wrought in terms of long-term welfare and efficiency. Justin Lin (2008), for instance, has described the Chinese approach as a Comparative Advantage Defying strategy of industrial development, which has delivered many benefits but created its own problems. Subsidies to capital, land and energy have made investment the prime driver of growth; a significant portion of this investment is financed through an inefficient financial intermediation system and may not be productive. This growth strategy and its collateral costs like severe environmental degradation are explored in various chapters. Moreover, households save a large fraction of their disposable income (on average, nearly 25%) and get low or even negative rates of return on their savings from a repressed financial

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system (Chamon and Prasad, forthcoming). This represents a huge but hidden welfare cost of the growth model. The Chinese face a big challenge in rebalancing growth to make it more welfare-enhancing and sustainable (Blanchard and Giavazzi, 2006). This book describes many of these challenges but appropriately puts them into the context of the tremendous progress that has been made in improving standards of living and reducing poverty. After all, no matter how it is achieved, double-digit growth rates over an extended period solve far more problems than they create.

The interplay between economics and politics is of course fascinating in a country like China, which has had little political freedom but where the legitimacy of the Chinese Communist Party increasingly comes from its ability to deliver a rapidly rising standard of living to its masses. The political economy dimensions of various policies and structural changes in the economy are nicely woven through a number of chapters in the book. Interestingly, the front cover of the book shows a picture of a Chinese farmer framed against the impressive backdrop of a glittering skyline. But the skyline is that of Hong Kong rather than mainland China. Perhaps this is how the editors want to subtly convey the complex economic and political web that is flexible enough to accommodate many extremes.

One noteworthy feature of the book is that it blends together top–down analysis with a careful examination of data at different levels of disaggregation, including microeconomic firm-level and household-level data. Case studies of particular industries lend color to the big picture (there is a particularly interesting one on the evolution of the beer industry in Chapter 15), while the analysis of income inequality and spatial disparities in development hint at the complex challenges on the social stability front even if overall growth stays strong.

The book also has an impressive amount of data in the form of charts and tables. Chinese data tend to be rather dodgy in many respects, both because of weaknesses in data collection procedures and because of incentives facing officials reporting the data. For instance, it has long been the case that the sum of all provinces' GDP is considerably higher than national GDP. During the 1990s, there were questions about whether GDP growth was being overstated in the official figures to make the economy look in better shape than it was; in the mid-2000s, the view of many experts was that the official numbers may be understating growth to avoid perceptions of overheating. The authors of various chapters in this book are conversant with the subtleties of the data issues in their respective subject areas. Hence, the reader is presented with cleaned-up and more reliable data, along with critical perspectives on specific data series.

While the book is massive and covers a lot of ground, there are many interesting topics that inevitably get less attention than they deserve. This no doubt came down to a matter of editorial choice, but I was surprised to note that, with so much attention focused on China's exchange rate regime and the massive buildup of foreign exchange reserves in recent years, the discussion of those topics is mostly limited to a couple of brief sections in two chapters. A more detailed analysis of the implications of China's mix of external policies that have resulted in current and capital account surpluses and consequent accumulation of reserves would have helped round out the discussion of how China's domestic and external economic policies have shaped the nature of its engagement with the world economy. I would also have liked to see more discussion of monetary policy, which is intimately connected with financial market issues and also ties in to the broader subject of macroeconomic stability (see Prasad, forthcoming).

But these are quibbles reflecting my prejudices. After all, the Chinese growth experience presents a vast canvas for researchers to paint on and no single book can do justice to it all. The bottom line is that this book admirably achieves its editors' objective of providing "… a rich tapestry of information and analysis that expands the foundation on which future research can be built." This volume is indeed destined to become part of the essential collection of reference and source materials for scholars as well as students of the Chinese economy.

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