Lecture Notes – Friday, 23 February 2001

What happens to economies after the implosion of communism?

1. Change to bartering system
2. Massive shutdowns
3. Collapse of trade

CIA most likely overestimated the strength of the USSR to keep funding high. This way the CIA was safe.

Advantages in the beginning

Let’s examine what advantages Russia and China when they started their respective transitions to capitalism:

<table>
<thead>
<tr>
<th>Russia in 1991</th>
<th>China in 1978</th>
</tr>
</thead>
<tbody>
<tr>
<td>Lots of natural resources</td>
<td>More decentralized – smaller factories</td>
</tr>
<tr>
<td>More educated</td>
<td>Homogenous population (actually a country)</td>
</tr>
<tr>
<td>High technology</td>
<td>Willingness to accept outside help</td>
</tr>
<tr>
<td>Much richer</td>
<td>Gov’t could make, take, and enforce decisions</td>
</tr>
<tr>
<td>Lots of infrastructure</td>
<td>Had strategy</td>
</tr>
<tr>
<td></td>
<td>Didn’t have communism for so long</td>
</tr>
</tbody>
</table>

These lists seem to indicated that the USSR was going to do much better. However, we now see that China is in fact doing significantly better. This argues that soft advantages (which the Chinese had) are more important than the hard ones (which the Russians had) during transition.

Chaos and creativity

In the 1400s, China was a very technologically advanced country. They were on the cusp of the industrial revolution and it seemed that they would rule the world in the next few centuries. However, by the 19th century, Europe ruled the world. What happened? There was a deliberate turning in by the emperor. He felt that all this creativity was threatening to the country. China turned its back on technology and withdrew from the world.

Russia during the time 1850 to 1900 was probably the most creative (highest concentration of geniuses) nation in the history of the world. They had the most brilliant writers, composers, and scientists. During this time, though, Russia was a dying nation with lots of chaos. The point is that chaos is needed for creativity. Inventions don’t come from order (thing GE vs. XEROX). The question is where is the right balance between chaos and order?

China’s strategy in 1978

In the beginning:
1. Started in agriculture – they solved the property rights problem and ownership.
2. Transition started with a plan (not a government collapse).
3. The big advantage was the communism was short-lived (~20 years). People still knew how to be farmers. This provided a big incentive that turned into an enormous success.

In communism, services are not counted as part of Material Product (like GDP). When you switch to the capitalistic GDP accounting, these services get counted. You get rapid growth and expansion becomes easy.

China made special economic zones where they reformed small areas fast. The first one was across the border from Hong Kong. This allowed the Hong Kongians (?) to set up shop in China, allowing the mainland to make Hong Kong rich (not the other way around). China also imported off-shore management into these zones.

China undervalued the currency to drive up exports (which is the fear of many nations if China joins the WTO). This was the hallmark of their export-led strategy.

China’s growth

China experienced 9% growth in the 1980s (pretty damn good). In the 1990s, China claimed to have similar growth but we don’t really believe them. For example, in 1998, China claimed an 8% growth in the middle of the Asian crisis when all its neighbors were burning. This is unlikely for several reasons:

1. Electricity consumption was up only 2.7% – inconsistent with large growth.
2. Chinese exports were stagnant – an export-led economy cannot grow without a growth in exports.
3. Hong Kong was at –5% growth – this is incompatible with 12% across the border (which it would have to be to get 8% average across the nation).
4. Reserve bank went broke.
5. Inflation went from 8% to –3%.
6. Agriculture growth was close to zero – this would mean that urban growth would have to be 40% to get 8% overall (highly unlikely).

It’s not that they were lying. It’s just that nobody knew what was going on (and there may have been some degree of overestimation). The Chinese probably also underestimated inflation.

China was probably growing around 5-6% in the 1990s, which is still phenomenal. It is important to keep in mind, though, that what counts in the world is per capita income and not total GDP. This is why India has a much larger economy than The Netherlands but The Netherlands is a world player but India is not.

Problems for China going forward

1. There is a potential for large unemployment:
   a. State-owned enterprises – if they are privatized, lots of people will be fired. Many factories will also have to be closed because they were misplaced originally by Mao for military reasons.
2. Financial problems
   a. Privatization will cause the government to lose their revenue stream.
   b. Money will have to be poured into rural investments to provide the infrastructure needed for effective free-market agriculture. This money would most likely be drained from urban areas.
   c. Lots of money will also be needed infrastructure in the western part of China. The government has to expand the boom away from the coast.
   d. Many of the state-owned enterprises are already money-losing meaning that there will tons of pressure on the banking system because so many bad loans have been made.
3. Almost every foreign investment in China is a joint venture (the government required it). However, there is no successful example of a joint venture (even in the western world). Already, many of these ventures are failing. What will happen to them?
4. Regional economic warlords will try to grab some power.
5. Environment (lots of pollution in China).

One thing that is for certain is that no matter what, China *will not* break-up into regional factions. It is a very stable society that has remained intact for over 2000 years (!).