AEDE/IS 539
The Socialist Era, 1949-78
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- 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

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“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
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
Figure 3: Post-GLF Famine

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 Bao 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
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
Endowment of economy

Economic system

Heavy-industry-oriented development strategy
Agrarian economy with scarce capital

Distorted macro environment: suppression of interest and exchange rates, input prices, wages and agricultural prices
Centrally-planned resource allocation
Micro-management via SOEs and communes

Distorted industrial structure
Low degree of efficiency, incentives suppressed
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

Light industry

Heavy industry

P = \frac{p_h}{p_L}

0 x_0 x_2 x_1 D

y_0 y_1 y_2
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