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How Did China Take Off?

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There are two prevailing explanations of what caused China's rate of economic growth to take off. The first view gives the pride of place to globalization. According to this view, Chinese growth started when Deng Xiaoping liberalized trade and foreign investments by setting up special economic zones in the coastal provinces. In this view, China's export-oriented manufacturing, largely foreign-funded, employed millions of rural migrants, boosted their income, and reduced poverty far and wide. The second perspective emphasizes the importance of internal reforms—especially in rural, interior regions—of the agricultural pricing system; land contracting; and the entry of rural businesses known as township and village enterprises.

China's early external reforms are politically important. Special economic zones were ideologically controversial at the time they were introduced and their establishment signaled a triumph of the reformist leaders over conservatives. Also, the inflows of foreign investments were not spontaneous; they required an explicit shift in policies and legal practices. Politically, the 1979 passage of the Law on Chinese–Foreign Equity Joint Ventures, only three years after the Cultural Revolution and committing the Chinese government to the protection of foreign property rights, was pathbreaking.

But the economic contributions of foreign investments do not remotely match those of China's rural industry. At their peak, firms funded by foreign capital employed 18 million people (in 2010). By contrast, at their trough in 1978, township and village enterprises employed 28 million people. Between 1978 and 1988,

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China's poverty headcount declined by 154 million, by far the most impressive record during China's three decades of reforms. The contributions of foreign capital toward China's initial poverty reduction during this period are miniscule. Employment by firms funded by foreign capital was 60,000 in 1985 and 660,000 in 1990. The same two figures for township and village enterprises are 69.8 million and 92.7 million, respectively (National Bureau of Statistics 2011). China's take-off in economic growth starting in the late 1970s and its poverty reduction for the next couple of decades was completely a function of its rural developments and its internal reforms in general.

During the golden era of rural industry in the 1980s, China had none of what are often thought of as the requisite features of the China growth model, like massive state-controlled infrastructural investments and mercantilism. In the 1980s, China had an overvalued exchange rate. Between 1980 and 1990, it had trade deficits every year except 1982, 1983, and 1990. (By contrast, since 1989 China has had trade surpluses every year except 1993.) In the 1980s, the household consumption to GDP ratio stood at over 50 percent, compared with 35 percent in recent years.

To understand how China's economy took off requires an accurate and detailed understanding of its rural development, especially rural industry spearheaded by the rise of township and village enterprises. Many China scholars believe that township and village enterprises have a distinct ownership structure—that they are owned and operated by local governments rather than by private entrepreneurs. That these firms could be so dynamic and efficient, yet government-owned, is often treated as a paradox in the economics literature. This statist view of township and village enterprises, together with the widespread belief that Chinese government has retained tight control of finance, led many scholars to conclude that Chinese growth has defied the conventional wisdom on the importance of private entrepreneurship and financial liberalization for growth.

But my own historical narrative—formulated on the basis of voluminous government and bank documents and data from the 1980s—directly contradicts this heterodox interpretation of Chinese reforms.[1] I will show that township and village enterprises from the inception have been private and that China undertook significant and meaningful financial liberalization at the very start of reforms. Rural private entrepreneurship and financial reforms correlate strongly with some of China's best-known achievements—poverty reduction, fast GDP growth driven by personal consumption (rather than by corporate investments and government spending), and an initial decline of income inequality.

The conventional view of China scholars is right about one point—that today's Chinese financial sector is completely state-controlled. How does one reconcile my reading of the historical evidence on financial reforms with the well-established

[1] The documents include a 22-volume compilation of documents of the central bank, all major state-owned commercial banks, and the rural credit cooperatives between 1982 and 2004. While they are available at libraries at Chinese University in Hong Kong and Harvard, they have not previously been examined by researchers. (Of these, the specific documents I cite are in the reference list.)

current fact of the statist financial controls? The same documentary and data sources provide the answer: China reversed almost all of its financial liberalization sometime around the early to mid 1990s. This financial reversal, despite its monumental effect on the welfare of hundreds of millions of rural Chinese, is almost completely unknown in the West.

My discussion is heavily tilted toward rural China because this is where Chinese growth took off. Developments in rural China also affected China's overall transition to a market economy, not only because in the 1980s the vast majority of the population was rural but also because Chinese capitalism is rural in origin. Reforms in rural China determine the pace and the nature of China's overall transition to a market economy. In the 1980s, it was the rural entrepreneurs who responded quickly to the incipient political and policy flexibility and who started businesses that competed directly with the urban state-owned enterprises. By the same token, reversing rural reforms not only suppressed rural entrepreneurship but also had the effect of slowing down China's overall transition to a market economy. In the 1990s and 2000s, China had no shortage of urban reforms, such as opening to foreign trade and investments; privatization of loss-making small state firms; and housing reforms. Yet China remains one of the most statist economies in the world. This is because the government reversed rural reforms in the 1990s.

The first section of this paper provides an account of how both the initial conditions and the specific reforms led to the rapid emergence of a market economy in rural China. The second section discusses an important institution in rural China—the township and village enterprises. A careful reading of original government documents suggests that contrary to the widespread belief, township and village enterprises may be history's most successful private sector story. The third section discusses financial liberalization and the subsequent reversals. The fourth section offers some speculative comments about how the policy reversals may have affected Chinese growth and the composition of growth.

"Nothing Other than Revolutionary Reforms"

China's rural reforms started in 1978, and their success was huge and instantaneous. Rural per capita income more than doubled between 1978 and 1984, and real rural per capita consumption increased by 51 percent between 1978 and 1983. Rural poverty declined sharply within the first decade of reforms (Riskin 1987).

The success of rural reforms is striking, considering that many economists thought that China's rural reforms were mere "modest" departures from the status quo (Lau, Qian, and Roland 2000). China did not dismantle all planned prices, but moved to a dual-track system in which farmers sold their crops at the market prices after they fulfilled their obligations to the state at state-fixed prices. Land was not privatized; it was contracted out to farmers on long-term leases. State firms were not privatized, but entrepreneurs were allowed to start their own businesses. Hausmann, Pritchett, and Rodrik (2004) emphasize the virtues of relaxing existing restrictions compared with institutional reforms. Deng Xiaoping's agricultural reforms, which they characterized as "humble" in origin, are a prominent example in their framework—evolution, not revolution, in other words.

Deng himself seemed to disagree. In 1984, Deng stated (as quoted in Rural Economy Research Team 1998), "The rural reforms that were carried out in the past few years are nothing other than revolutionary reforms." Which perspective is correct? It depends on what benchmark you use. Western economists benchmark China to what is sometimes called a "Washington consensus" template that includes privatization, deregulation, financial liberalization, rule of law, and democratization. By that standard, Chinese rural reforms were modest. But the benchmark Deng had in mind was the Cultural Revolution, when the life of Chinese private entrepreneurs was, to quote Hobbes, "nasty, brutish, and short." From this dynamic perspective, allowing partial market pricing of agricultural crops, land contracting, and millions of startups by rural entrepreneurs was not modest at all.

The rural reforms did not happen in isolation. They were implemented in conjunction with some broad changes in Chinese politics. The Chinese leadership took deliberate and well-publicized gestures to instill confidence in policy credibility and political stability. In 1979, the Chinese government returned confiscated assets—bank deposits, bonds, gold, and private homes—to former capitalists and landlords. A large number of people imprisoned during the Cultural Revolution for engaging in private commerce were released from jail. (One survey showed that some 10 percent of China's private entrepreneurs were former prisoners.) In 1980, two vice premiers personally brought New Year's greetings to a woman who received the first license to open a business in Beijing. In 1981, the Politburo passed a resolution that made private entrepreneurs—code-named "individual laborers"—eligible for Party membership. In 1984, Wenzhou—a backwater rural county then—released eight peasants-turned-entrepreneurs (arrested in 1982 for graft) and made restitution of their assets. It also published an open apology in local newspapers. In the 1980s, China also introduced village elections (in Huang 2008, I provide more details).

Economists typically think of constraints on government as a source of credibility. The effect of a marginal change—moving from the capricious Cultural Revolution to the more predictable era of Deng Xiaoping—is therefore underestimated. This directional change from complete opposition to private business during the Cultural Revolution to a supportive stance during the Deng era helps resolve a paradox: Why millions of entrepreneurs were willing to invest even though the power of the state was, and still is, absolute. One reason is that in the 1980s entrepreneurs no longer faced automatic risks of being arrested and executed. In the 1980s, China went a long way in establishing security of proprietors even though security of property was far from being achieved. One should never underestimate the incentive effect of not being executed! (By the same token, as the Cultural Revolution fades in memory and the safety of proprietor is taken for granted, the safety of property and the rule of law will increase in their importance for China's future growth.)

Policy and political stability also mattered for the workings of the dual-track price system. Economists praise the dual-track price system because its mechanics are straightforward, but they ignore a precondition for the system to work: peasants had to be confident that the planned targets would not be ratcheted up later. The dual-track price system was neither novel nor Chinese. The Soviet Union tried it many times but failed. The difference is the Chinese leadership committed itself to not ratcheting up the targets and did so credibly. It was the politics of the Deng Xiaoping era, not just the mechanics of the reform, that accounted for the success.

There is another difference with the Soviet Union. Chinese reforms started in the rural areas and China was far more agrarian than the Soviet Union when that country began its own reform program. Rural China has always been more predisposed toward entrepreneurship and capitalism than urban China. Today many of the best private manufacturing firms are not located in Beijing or Shanghai but originated in then-agrarian provinces such as Zhejiang, Hunan, Anhui, and Sichuan.

Rural China's capitalist predispositions arise in part from the nature of agriculture, which is less conducive to planning than industry, and in part from history. The Cultural Revolution was primarily an urban political shock that cleansed urban China of any vestiges of capitalism, but there were still some free market activities in rural China. For the land contracting reforms to work, economic agents need to have some knowledge of residual claims. That knowledge was still extant in rural China but absent in the urban area. The rural readiness for capitalism acted as a multiplier that amplified the effects of policy reforms. This is why many of the reforms that elicited a huge supply response in China and Vietnam completely failed in the more industrialized Soviet Union (and for that matter, in urban China). Contexts and initial conditions provide the necessary complements to policy.

Private Entrepreneurship in Rural China

China's economy took off not just because peasants became more productive in producing grain, but also because reforms created conditions for Chinese peasants to switch to higher value-added activities such as industrial production and service provision. According to one study, four-fifths of the income gains came from improving allocative efficiency (Riskin 1987).

Township and village enterprises played a vital role in this process. They raised rural income, absorbed rural surplus labor, and contributed to a decline in the rural–urban income gap in the 1980s. The value-added produced by these rural businesses increased from 6 percent of GDP in 1978 to 26 percent of GDP in 1996 (Naughton 2007, p. 274). They also injected competition into the Chinese economy. In the 1980s, these rural businesses were the only source of competition to the incumbent state-owned enterprises at a time when foreign firms were still restricted and urban private firms were small. They undermined the monopoly of state-owned enterprises in both product markets and factor markets (in labor and capital). They played "a catalytic role" in China's economic transformation (Naughton 2007, p. 271).

The conventional view on township and village enterprises—laid out in a textbook on the Chinese economy—is that "township and village enterprises had a special distinction during this period [1978–1996] because of their unusual ownership and corporate governance setup. Originating under the rural communes, most township and village enterprises were collectively-owned. . . ." (Naughton 2007, p. 271). Collective ownership means ownership at the lower level of the Chinese political system, such as township and village. This special feature of township and village enterprises, according to Roland (2000), poses a challenge to researchers because, given their public ownership, they are not supposed to perform well. The strong theoretical priors of mainstream economists are that private ownership rights motivate entrepreneurs to invest and to take risks. The stellar performance of the township and village enterprises without this incentive device is puzzling.

Elaborate theories—some backed up by formal mathematical proofs—have been proposed to explain the performance of township and village enterprises as public-sector businesses. For example, Chang and Wang (1994) and Li (1996) argue that township and village enterprises had the advantage of political protection provided by the local governments and that in a biased financial system they had preferential access to capital. Che and Qian (1998) and Roland (2000) develop models of township and village enterprises as an efficient substitute for an economic environment with weak legal institutions. Stiglitz (2006) goes one step further. According to him, the biggest problem in transitional economies is not underdevelopment of the private sector but stealing on the part of the private sector. The hybrid nature of township and village enterprises aligns the interests of the central government with those of the local governments and effectively prevents private stealing of public assets.

These theoretical conceptualizations are all predicated on one important empirical detail—that township and village enterprises are public. Is that claim true?

Many Western scholars believe that township and village enterprises owed their origins to the rural "commune and brigade enterprises" created during the Great Leap Forward (1958–1961) and thus should be viewed as collective institutions. This belief is only partially correct. In 1978, there were about 1.5 million commune and brigade enterprises, but by 1985 there were already 12 million businesses labeled as township and village enterprises (Ministry of Agriculture 2003). Clearly, the vast majority of township and village enterprises had nothing to do with the Great Leap Forward. They were, instead, a product of the rural reforms that began in 1978.

In the records that I studied, the term "township and village enterprise" first appeared in a policy document issued by the State Council—the Chinese cabinet—on March 1, 1984. This landmark document broke new policy grounds. It officially replaced the previous term "commune and brigade enterprise" with "township and village enterprises" precisely because, as the document pointed out, the old term was no longer an accurate description of many of the new enterprises spawned by rural reforms. The second paragraph of this historic document gave the following definition of township and village enterprises (Ministry of Agriculture 1985, p. 450): "Township and village enterprises include enterprises sponsored by townships and villages, the alliance enterprises formed by peasants, other alliance enterprises and individual businesses."

The enterprises sponsored by townships and villages are collectively owned—the kind of firms Western economists assume to represent the universe of all township and village enterprises. The other two categories under the label of "township and village enterprises" are straightforward private businesses or entities. The private township and village enterprises are divided by size. Individual businesses are equivalent to single proprietorships in the West and they typically have an employment of seven people or under. The alliance enterprises (in Chinese, *lianying*) are a 1980s reference to larger private-sector enterprises. They have multiple founders/shareholders (who are usually unrelated by family ties). They employ more than seven people. Over time, references to alliance enterprises were replaced by the term "private-run enterprises" (*siying qiye*) after a major 1987 Politburo document began to explicitly use the term "private-sector firms" (*China Township and Village Enterprise Yearbook* 1989a, p. 138).

This definition of township and village enterprises as including private ownership is consistently applied across the official documents. Here are four excerpts from a sampling of official statements, policy documents, and references. First, a manual prepared by the Shanxi Township and Village Enterprise Management Bureau (1985, p. 1) says that a township and village enterprise "belongs to collective ownership or individual ownership." Second, a 1989 Ministry of Agriculture report to the State Council on the state of township and village enterprise development summarized: "Nowadays a large portion of township and village enterprises comprise individual businesses and alliance enterprises. . . . Currently, individual businesses and alliance enterprises account for a large share of the township and village enterprises in the northwest, southwest, and other economically backward regions" (*China Township and Village Enterprise Yearbook* 1990, p. 4). Third, a 1987 document by Agricultural Bank of China instructed its regional branches not only to lend to enterprises at the township and village level but also to lend to alliance enterprises and household businesses (*China Township and Village Enterprise Yearbook* 1989b, p. 524). Fourth, an analysis in the *China Township and Village Enterprise Yearbook (1978–1987)* states: "Compared with a state-owned enterprise, a township and village enterprise…is a collective-ownership or individual-ownership enterprise with a lot of autonomy and able to make decisions concerning its own fate" (*China Township and Village Enterprise Yearbook* 1989b, p. 3).

The critical distinction between the Chinese official definition of township and village enterprises and the definition widely accepted in the Western economics literature is that the Chinese definition refers to *geography*—enterprises *located* in townships and villages regardless of their ownership. Western economists, mistakenly, assumed that the definition referred to enterprises *owned* by townships and villages.[2] Interestingly, some Chinese bureaucrats have committed the same mistake.

[2] One early study published in English that got this question right is by Bryd and Lin (1990), a joint research project by the World Bank and Chinese academics. It identified township and village enterprises

Wan Li, a foremost reformer and the vice premier in charge of agriculture in the 1980s, remarked in 1984, "[Some officials] only include the original collectively owned enterprises of townships and villages started by the masses as township and village enterprises, but do not include those businesses later established by peasants on their own or those alliance enterprises financed from pooled capital as township and village enterprises" in the definition of township and village enterprises (as quoted in *China Township and Village Enterprise Yearbook* 1991 p. 128).

The absolute majority of township and village enterprises, from the very beginning, were in fact private rather than public. In 1985, according to Ministry of Agriculture data, there were over 12 million township and village enterprises, of which 10.5 million were private. By contrast, there were only 1.57 million collective township and village enterprises in the same year. In 1978, the number of legally registered private township and village enterprises was zero; by 1985, this number had grown to 10 million strong. China's township and village enterprises are probably one of history's most remarkable private sector success stories.

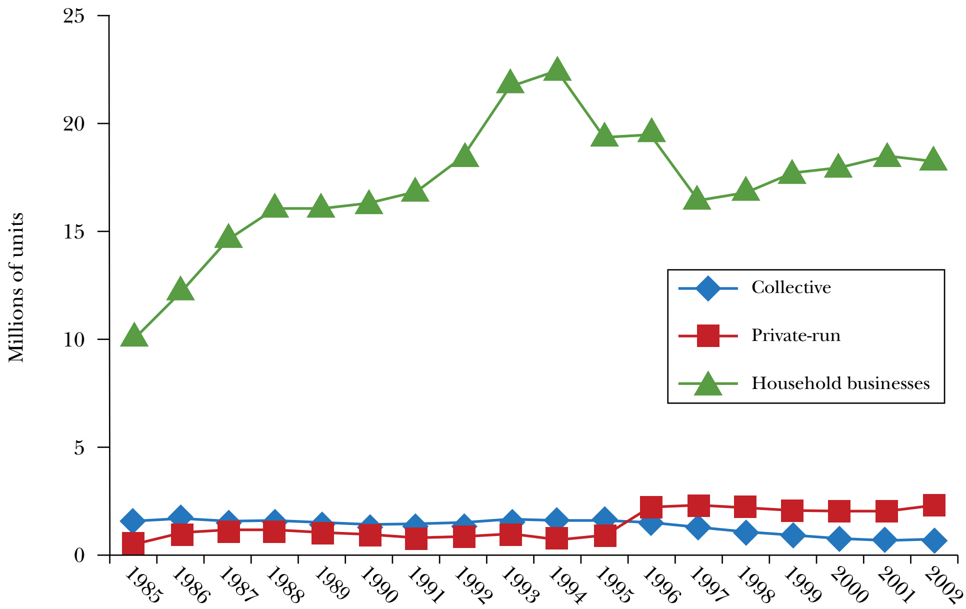
Figure 1 is a graphical representation of the development of township and village enterprises over time based on Ministry of Agriculture data. (The Ministry of Agriculture data are more detailed than those provided by the National Bureau of Statistics because they are broken down by more detailed ownership categories. The two sources are consistent with each other.) In 1985, this data began to divide township and village enterprises into three categories: 1) collective, 2) privately-run, and 3) household businesses. The latter two categories are private, but differ in the size of their employment.

The growth of township and village enterprises occurred almost entirely on the private spectrum of township and village enterprises. The number of collective township and village enterprises was highest in 1986 and 1993, but then declined substantially throughout the rest of the 1990s. Meanwhile, the number of household businesses rose sharply throughout the 1980s as did the number of privately-run enterprises in the 1990s.

It is almost certain that these official figures of collective firms overstate the size of the public ownership of township and village enterprises, especially for the 1980s. The reason is that in the 1980s the Chinese government supported private sector development through political statements and financial opening, but it had not developed a legal framework for private entrepreneurs to register their businesses as explicitly private. Many private entrepreneurs therefore registered their businesses under the collective township and village enterprises. (One of the most famous examples of these "red-hat firms" is Wanxiang, which was founded by Lu Guanqiao. Wanxiang is now China's leading automobile component supplier, and it has an operation in Illinois.) This changed in 1994 when China's Company Law went into effect. Newly established private firms began to be explicitly registered as private and those previously registered as collective were converted into privately

as covering both public and private sectors. But this study had no apparent effect on the modeling work of economists that treated township and village enterprises as run by local government.

Figure 1
Number of Township and Village Enterprises by Three Ownership Categories: Collective, Private-run, and Household Businesses, 1985–2002
(millions of units)

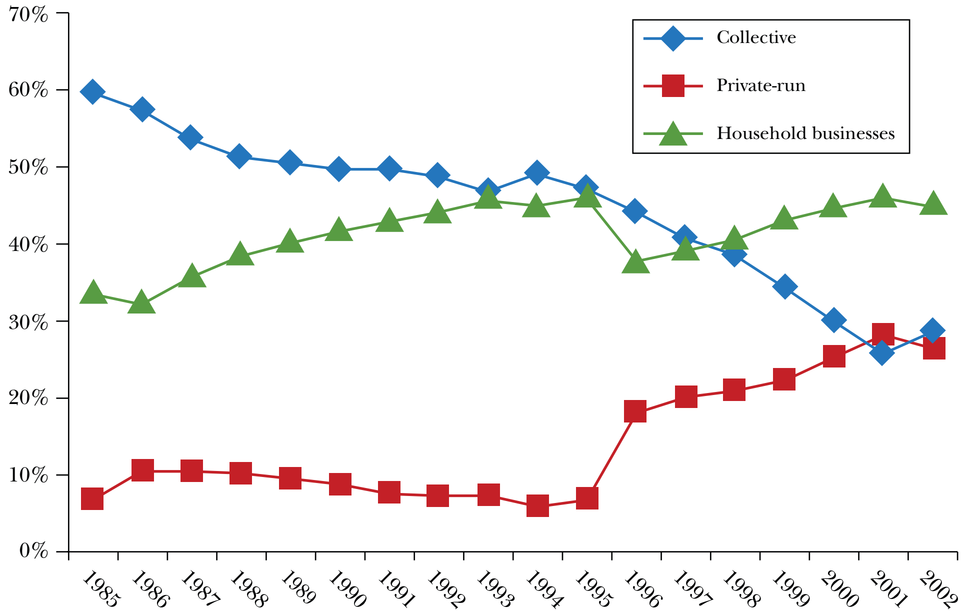


Notes: Data are from Ministry of Agriculture (2003).

registered entities. This change appears in Figures 1 and 2. After 1994, there was a sharp increase in the number and employment of privately-run township and village enterprises and a corresponding decrease in collective township and village enterprises. Some scholars mistook this development as privatization of collective township and village enterprises. In reality, it was a clarification of titles.

As shown in Figure 2, collective township and village enterprises were larger in terms of employment in the mid 1980s. In 1985, the collective enterprises accounted for 59 percent of overall employment in township and village enterprises. Keep in mind that the collective enterprises were founded in the late 1950s and had had 30 years of operation whereas the private township and village enterprises were new entrants in the 1980s. Even with their late start, by 1989, the share of employment by private township and village enterprises matched that of collective township and village enterprises, and the employment share of collective township and village enterprises declined throughout the reform era (except for a brief interval between 1992 and 1994). Other measures show the same dynamism among private township and village enterprises. In 1989, private township and village enterprises claimed 58 percent of the after-tax profits and 45 percent of the total wage bill of all township and village enterprises. In short, the growth miracle

Figure 2
Employment Shares of Township and Village Enterprises by Ownership Categories: Collective, Private-run, and Household Businesses, 1987–2002



Notes: Data are from Ministry of Agriculture (2003).

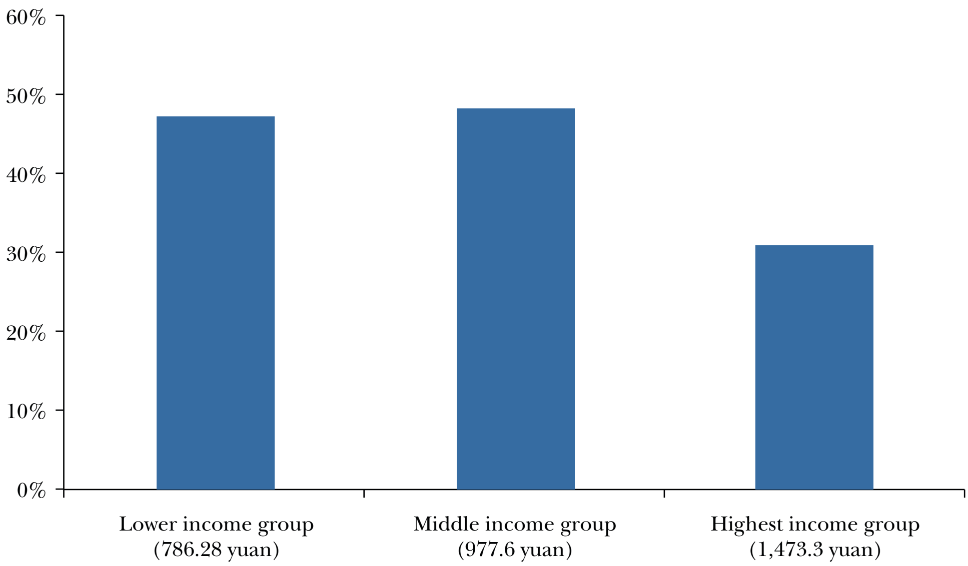
of the township and village enterprises took place almost entirely in the private sector, not in the collective sector.

Data on output tells a similar story about the importance of private township and village enterprises. In 1987, private township and village enterprises produced 32 percent of the gross output value of the township and village enterprise sector.[3] However, this aggregate measure misses an important detail that has substantial policy implications—that private township and village enterprises prospered in poor provinces whereas collective ones tended to prevail in richer and less-industrialized provinces.

Figures 3 and 4 divide China's 29 provinces into three groups based on their per capita GDP and rural shares of population, respectively (with the middle group comprising nine provinces). The graphs are based on data for 1987. In Figure 1, the ten provinces in the top tier of per capita GDP—averaging 1,473 yuan per person—have the lowest private share of the gross output value of the township and village enterprises compared with the provinces in the lower income tiers. (Gross output value includes both industry and service sectors.) On average for the provinces in

[3] The unweighted average of the private township and village enterprises' share of the value of gross output across the provinces of China in 1987 is 40 percent.

Figure 3
Private Shares of the Gross Output Value of Township and Village Enterprises for Three Groups of Provinces Based on their per Capita GDP, 1987
(provincial averages)



Notes: Data are from Ministry of Agriculture (2003). Twenty-nine provinces are divided into three groups based on their per capita GDP. The middle group has nine provinces. The figures in parentheses on the horizontal axis refer to the average per capita GDP in that income group.

the top income tier, private township and village enterprises produced 31 percent of the gross output value for the entire sector, compared with 47 and 48 percent for the other two income tiers.

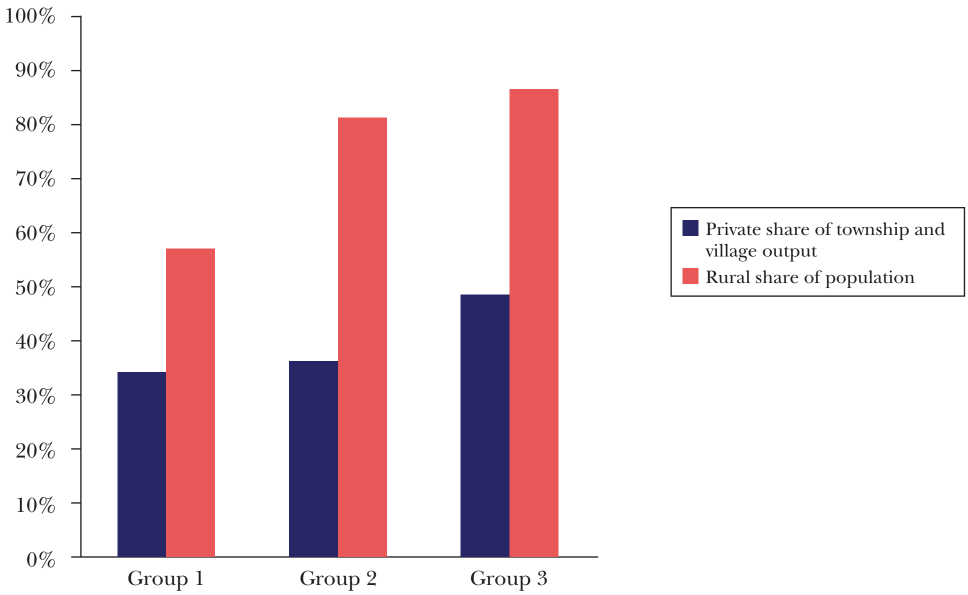
The highest private share of township and village enterprise output is found in the province of Hebei, at 70.4 percent. In 1987, 85 percent of Hebei's population was rural. By contrast, Shanghai had the lowest private share of the township and village enterprise output, only 6 percent, meaning there is an extraordinary range between provinces in private shares of township and village enterprise output. The three regions with the lowest private shares of the township and village enterprise output are all cities: Shanghai (6 percent), Beijing (10.9 percent), and Tianjin (12.2 percent).[4] The contrast between Hebei on the one hand and Shanghai, Beijing, and Tianjin on the other illustrates the two sides in the development of Chinese capitalism: capitalism is rural and socialism is urban. Figure 4 further illustrates this divide. The ten provinces with the highest share of rural population (86.5 percent) averaged 49 percent in private share of total township and village enterprise output. For the ten provinces

[4] Chinese cities are an administrative concept, not an economic one. Cities also have rural population under their administration. In 1987, 34 percent of Shanghai's population was rural.

Figure 4

Private Shares of the Gross Output Value of Township and Village Enterprise for Three Groups of Provinces based on their Rural Shares of Population, 1987

(provincial averages)



Notes: Data are from Ministry of Agriculture (2003). Twenty-nine provinces are divided into three groups based on their shares of rural population. The middle group has nine provinces.

with the lowest share of rural population (57.2 percent), the figure is 34.6 percent. There are other factors influencing private shares of township and village enterprise output, and the correlations are not perfect but fairly substantial. Across 29 provinces, the two-way correlation between per capita GDP and private shares of township and village enterprise output is about −0.71; for rural population shares it is 0.49.

One of the undisputed achievements of Chinese reforms is a sharp reduction of poverty. In China, as in all developing countries, poverty is concentrated in underdeveloped rural regions. For this reason, it is important to focus on the economic and business developments in the poor provinces in order to understand how China reduced its poverty. In the poor provinces, it was private entrepreneurship, not government-run township and village enterprises, that contributed to the bulk of output production. In aggregate, the scale of population affected by private township and village enterprises was massive.

As of 1987, private township and village enterprises already contributed about half of the output of the township and village enterprise sector in eight provinces, home to 260 million rural Chinese (30 percent of China's rural population). In another 15 provinces, the rural private sector produced between 30 to 50 percent of the township and village enterprise output value. These 15 provinces accounted for an additional 427.8 million rural Chinese (about 50 percent of the rural population). Within a single decade of reforms, private township and village enterprises went from essentially nonexistent to contributing a substantial share of nonagricultural output in provinces with close to 80 percent of the rural Chinese population. It would not be an overstatement to say that rural private entrepreneurship played an instrumental role in China's impressive record of poverty reduction.

Financial Reforms and Reversals

An influential finance paper sought to explain why China can grow without financial liberalization by identifying informal finance as a key source of capital for private entrepreneurs (Allen, Qian, and Qian 2005). Informal finance and formal finance are, according to this view, substitutes. To evaluate this claim requires some contextual knowledge. Unlike other developing countries, China and other centrally planned economies categorically banned underground finance. Unlicensed deposit-taking or loan-making could be considered a capital crime. Thus, in China, that informal finance is allowed to operate at all is, *ipso facto,* evidence of financial liberalization rather than evidence of financial controls. It is unsurprising that informal finance is most vibrant during the most liberal period of Chinese reforms (such as in the 1980s) rather than in the Maoist period of the 1970s, and it is most vibrant in those regions of China with liberal economic policies (such as Wenzhou or Zhejiang province). After all, informal financiers are themselves private entrepreneurs. Formal finance and informal finance are substitutes only if government policies suppress or discriminate against the private sector. Otherwise they are complements.

Based on the data of the early 2000s, Allen, Qian, and Qian (2005) are correct that the private sector lacked access to formal finance, but they are wrong in believing that this was a permanent feature of Chinese reforms. In fact, China implemented far-reaching financial liberalization at the very start of rural reforms, a fact that is basically unknown outside of China despite its monumental significance. The reason for this lack of knowledge is that in the early 1990s, China reversed these reforms. The view that China challenges the standard view of economics by growing without financial liberalization is due to an observation bias: much of the economic research was done during the reversal period since the early 1990s rather than during the liberal period of the 1980s.

Rural financial reforms in the 1980s had three main components: First, the authorities began to delegate control rights of an important rural financial institution—the rural credit cooperatives—to its depositor-members, who, nominally, were the true shareholders. Second, entry of entrepreneurs into financial intermediation was permitted, even encouraged. Third, as a cumulative result of these aforementioned reforms, access to credit for rural private entrepreneurs was eased considerably.

In 1985, rural credit cooperatives accounted for 76.8 percent of all agricultural loans and 47.8 percent of all loans extended to township and village enterprises. They also intermediated and disbursed many of the loans originating from Agricultural Bank of China (China Finance Association 1986, p. II–19). Rural credit cooperatives were first established in 1951 as genuinely private financial institutions. Their members elected the officers and determined the lending priorities and criteria of their own branches. But in the 1960s and 1970s, as central planning took hold in China, a state bank, Agricultural Bank of China, and local governments took control of rural credit cooperatives.

Reform of rural credit cooperatives was one of the first acts of the reformist leaders. And unlike the much better-known household responsibility reforms, which were initiated by a group of Chinese peasants on their own in Anhui province, the financial reforms were launched by the central government. As early as 1980, the Politburo tasked a finance leadership group specifically to reform the rural credit cooperative system. The plan formulated by this group was to restore three founding principles of rural credit cooperatives. These are "organizational reliance on the members, managerial democracy, and operational flexibility."

This 1980 policy document, cited numerous times by later policy documents, is remarkable in several ways. First, it clarifies an issue of timing. Financial reforms occurred at the very outset of China's growth process as a deliberate political and policy decision. They were exogenous to—or at least concurrent with—China's economic takeoff. This detail on the timing of financial reforms directly contradicts a common claim among economists who study China—that, to the extent that China has implemented institutional reforms, they are endogenous with growth. Second, only four years after the Cultural Revolution, this document directly and explicitly singled out "government control" as the most serious problem afflicting rural credit cooperatives. This framing of government control as a problem set the tone for the reforms of rural finance for the rest of the decade.

In 1983, Agricultural Bank of China shifted from micro controls of rural credit cooperatives to indirect macro management. Agricultural Bank of China imposed a reserve requirement equivalent to 30 percent of the rural credit cooperative's deposit base and rural credit cooperatives could lend the rest on their own (Agricultural Bank of China [1983] 1985). By 1985, 80 percent of the rural credit cooperatives in the country had adopted reforms along this line (Agricultural Bank of China [1985] 1986, p. 34). In 1988, Agricultural Bank of China began to implement governance reforms. Article 11 of the employment regulations of rural credit cooperatives drafted by Agricultural Bank of China called for selection of rural credit cooperative branch managers through "democratic election" at shareholder meetings (Agricultural Bank of China 1988b, p. 200). To safeguard the function of these elections, the same document explicitly banned a widespread practice in Chinese bureaucracy—rotating the heads of departments across regions.

The authorities also liberalized entry. Informal finance emerged not because of porous bans but because of deliberate and proactive policy encouragements.

These two statements from the 1980s are quite telling. First, here is Chen Muhua (1987): "In addition to the capital provided by the state banks and rural credit cooperatives, there are now various kinds of businesses with deposit-taking and lending operations. Non-governmental capital mobilization and non-governmental rural cooperatives have emerged. The various methods of financial mobilization have made a positive contribution to local economic development." Second, here is Han Lei (1984, p. 51): "Rural areas need state-owned banks and credit cooperatives for finance but at the same time, under bank supervision, we need to allow the existence of private free lending and borrowing."

These are not two liberal academic economists advocating reforms. Chen Muhua and Han Lei were, respectively, the Governor of the People's Bank of China (PBoC)—China's central bank—and the Chairman of Agricultural Bank of China, arguably the most important state-owned bank in China in the 1980s, given the pioneering rural reforms. Several bank documents from that era justified informal finance on competitive grounds—that they competed with and therefore helped improve the state-owned banks. (The bank documents in the 1990s made the same factual observation on competition but drew exactly the opposite normative and policy implications.)

Western academics who did research in the 1990s record informal finance primarily in liberal and richer regions of the country, such as Wenzhou and Fujian (Tsai 2002). Bank documents in the 1980s record informal finance activities across many economically heterogeneous regions, such as Guizhou (China's poorest province), Guangxi (poor and populated by ethnic minorities), and Jilin (a conservative stronghold of state-owned enterprises). A 1987 report by the Jilin's Branch of the People's Bank of China (p. 151) shows that 69 percent of rural households had access to informal finance and 81 percent of informal loans were used to finance production. A better predictor of informal finance is not geography, but liberal policies. That informal finance was present in many parts of the country is evidence that policies were liberal nationwide.

The nongovernment financial institutions that Governor Chen and Chairman Han referred to are the "rural cooperative foundations." Rural cooperative foundations were local savings and loan institutions similar to rural credit cooperatives except that their shareholders exercised real control rights. Although the People's Bank of China never formally acknowledged rural cooperative foundations as a legitimate financial institution, it tacitly permitted their operation. The Ministry of Agriculture provided the political cover by giving rural cooperative foundations a formal status. Rural cooperative foundations competed directly with rural credit cooperatives and Agricultural Bank of China on both deposit and lending businesses. The scale of the rural cooperative foundations was massive. As of 1990, the rural cooperative foundations operated in 38 percent of Chinese rural townships (Rural Work Leadership Team of Fujian Communist Party Committee 1997). In Wenzhou, by the end of the 1980s, rural cooperative foundations began to approach Agricultural Bank of China in both loan size and network reach (*Wenzhou Financial History* 1995, p. 152, 225).

In the 1980s, rural households also had substantial access to formal credit in addition to the new availability of informal finance. Bank documents from the era consistently called for easing of credit access for private entrepreneurs. Fixed interest rates are a barrier to private access to capital because they lead to scarcity and credit rationing. Another barrier is requiring fixed assets as collateral. In 1984, Agricultural Bank of China permitted floating interest rates and waived collateral requirements for household businesses, and then in 1988 extended the same policies to larger private-run enterprises (Agricultural Bank of China [1984] 1986, p. 364; Agricultural Bank of China 1988a).

On all three fronts—reforms of rural credit cooperatives, entry liberalization, and credit access, bank documents reveal evidence of explicit, direct, and complete policy reversals in the early 1990s. The 1988 ban on rotating rural credit cooperative managers was rescinded in 1992 (Agricultural Bank of China 1992b). Rotation is a mockery of democracy as it nullifies any elections in the rotated regions. (Imagine rotating the governor of Massachusetts to Maine.) The control rights of rural credit cooperatives were recentralized. The three principles cited often in the 1980s documents—"organizational reliance on the members, managerial democracy, and operational flexibility"—completely disappeared in the 1990s. The bank documents now emphasized the "cooperative" nature of rural credit cooperatives, which in the Chinese parlance means in a state of transition from private to public ownership. After 1996, even the implied autonomy associated with "cooperative" was dropped. In 1999, Shi Jiliang (1999), a vice governor of the central bank defined rural credit cooperatives explicitly as "local government financial institutions." In March 1998, the People's Bank of China ([1998] 1999) formally assumed operational controls of rural credit cooperatives, including personnel appointments, screening of candidates, account examinations, and the termination of appointments. The micromanagement of rural credit cooperatives, still nominally owned by their members, was numbingly detailed. A 1995 Agricultural Bank of China document instructed its officers to examine the filing systems and to inspect the computer software used in rural credit cooperatives (Agricultural Bank of China 1995). The management of rural credit cooperatives had completely returned to their *status quo* during the central planning era.

In the 1990s, the authorities mounted a ferocious attempt to wipe out informal finance. Several private financial entrepreneurs were arrested and punished severely. One, an illiterate woman in Zhejiang, was executed. (She committed the alleged fraud in 1986 but was executed only when the macro policy changed, in 1991. Incidentally, another Zhejiang woman, Wu Ying, was given a commuted death sentence in 2012 for "illegal capital mobilization.")

The most direct target was rural cooperative foundations. In 1993, rural cooperative foundations were stripped of their deposit-taking businesses and were ordered to transfer their deposits to rural credit cooperatives (State Council [1993] 1994, p. 7). The following year, the authorities restricted the lending operations of rural cooperative foundations to low-margin agricultural production and forbade establishment of new branches and lending to urban residents (Rural Work Leadership Team of Fujian Communist Party Committee 1997).

The official language on competition changed from laudatory to derogatory. A 1996 document described rural cooperative foundations as "competing viciously" with state-owned banks. Instead of welcoming the competition as Governor Chen Muhua did in 1986, this decree ordered a complete takeover of all rural cooperative foundations by rural credit cooperatives, which, as pointed out before, were themselves being recentralized. Then in 1998, in a decree issued by the State Council and signed by none other than the premier himself, rural cooperative foundations and all forms of informal finance were categorically declared illegal. The decree criminalized not only the informal finance itself but also any failures by officials to refer the informal financial operations to public security bureaus (State Council 1998).

The private sector's access to formal finance was sharply curtailed. In the 1980s, rural credit cooperatives and rural cooperative foundations were important sources of funding for nonfarm entrepreneurship in rural China. In the 1990s, rural cooperative foundations were abolished and rural credit cooperatives were ordered to redirect their lending focus to agriculture. High floors were set for agricultural lending in the total loan program of rural credit cooperatives (usually above 40 percent). This is an implicit discrimination against rural private entrepreneurs who started businesses *to get out of agriculture*. Another implicit discrimination was the order to direct lending to production rather than investment. In a 1996 State Council document, fixed-asset loans were capped at 30 percent of all rural credit cooperative loans. Private entrepreneurs, by definition, were new entrants and needed loans to finance construction of new facilities.

The lending criteria were tightened substantially for private borrowers (despite clear evidence that it was urban state-owned enterprises, not rural entrepreneurs, that defaulted on loans). In 1992, Agricultural Bank of China required rural credit cooperatives to collect deposits from private entrepreneurs for a "risk guarantee fund" as an eligibility criterion (Agricultural Bank of China 1992a). In the 1980s, rural credit cooperatives used floating and higher interest rates to mitigate against default risks. Both evidence and theory suggest that this approach can be productive because it is able to distinguish between good and bad borrowers. Potentially productive borrowers can generate returns to pay for the higher interest costs. The 1992 policy required an upfront payment, and it biased lending to the incumbent businesses at the expense of new entrepreneurial entrants.

In the 1980s, the Agricultural Bank of China and rural credit cooperatives waived collateral requirements under certain conditions. In the 1990s, collateral requirements were reinstated and tightened. The most common form of assets in rural China—land for private farming and private housing structures—was purposely excluded as collateralizable assets. This raised the threshold for loan eligibility substantially (see Rural Work Leadership Team 1997). Even all these measures were deemed inadequate. In 1994, Agricultural Bank of China required rural credit cooperatives to issue loans to private entrepreneurs only after two signatures were secured, one from the loan officer and the other from the head of the rural credit cooperative at the next higher level. For example, a loan in a township had to be approved at the county level (Agricultural Bank of China 1994).

Along with these financial controls, the governance of rural credit cooperatives deteriorated as rural credit cooperatives essentially became cashiers of local governments rather than serving the needs of their nominal shareholders. Here is a catalog of egregious lending practices compiled by the People's Bank of China (2001): making loans to peasants in the form of goods rather than money and forcing peasants to sell the goods to buyers designated by rural credit cooperatives; expropriating the share capital contributions of the members of the rural credit cooperatives when extending loans; collecting taxes and fees from peasants when making loans; making loans to township and village governments to finance their tax bills to higher-level governments; forcing peasants to purchase shares of rural credit cooperatives and deducting their share contributions from their loans; financing government office construction and purchasing luxurious sedans while operating at a loss.

The health of rural finance deteriorated massively. The bank documents reveal that while rural credit cooperatives carried some nonperforming loans on their books in the 1980s, almost all of these nonperforming loans resulted from lending during the Cultural Revolution when rural credit cooperatives extended consumption loans to indigent households. Nonperforming loans increased in the 1990s *after* financial controls were instituted. In 1994, 31.4 percent of the loan assets of the rural credit cooperatives were nonperforming, and in 1996 nonperforming loans increased to 38 percent, according to Dai Xianglong (1997), the Governor of the People's Bank of China. The shareholder equity of the rural credit cooperatives was reported to be 63.2 billion yuan in 1995, 54.8 billion yuan in 1996, 31 billion yuan in 1997, 15.1 billion yuan in 1998, and –8.5 billion yuan in 1999 (China Finance Association 1997, p. 452; 2000). Within a single decade of policy reversals, an institution that had played an important role in China's economic takeoff became technically insolvent.

Conclusion

This concluding section addresses four issues. First, why did China reverse its rural financial reforms? Second, is the claim that China initially opened and then subsequently closed its rural finance supported by quantitative as well as documentary evidence? Third, did the policy reversals in rural China matter for real economic outcomes? Fourth, did the policy reversals affect China's pace of transition to a market economy?

The rural policy reversals coincided closely in timing with the assumption of power by a new group of leaders in the aftermath of the 1989 Tiananmen crackdown. In the 1980s, the leader in charge of the economy—Zhao Ziyang—pioneered rural reforms in Sichuan, but he fell from power in 1989. Between 1989 and 2002, China was led by a group of urban technocrats who made their political career in the most urban and statist region of China—Shanghai (Huang and Qian 2010). The urban technocrats launched massive infrastructure projects that required classic mobilization of financial resources. They reduced the credit allocation to rural China and stamped out informal finance—mostly in rural China—in order to fund these big-push projects. The instability of 1989 also prompted the leadership in the 1990s to strengthen the controls by the Communist Party across the board and to discontinue the incipient political reforms introduced by Zhao Ziyang. Rural China bore the brunt of this reversal because political reforms went farthest in rural China.

There is quantitative—not just documentary—evidence for the financial reform/reversal story as laid out in this paper. Examining a large rural household dataset conducted by the Ministry of Agriculture between 1986 and 2002, in Qian and Huang (2012), my coauthor and I found that credit access by rural households declined sharply between the 1980s and the 1990s. Specifically, during the 1986–1991 period, close to 30 percent of rural households reported receiving either formal or informal credit. This ratio declined to 10 percent between 1995 and 2002. We found that, controlling for a variety of household characteristics, the political status of households—such as having a Communist Party member—had no effect on credit access in the 1980s but a substantial and positive effect in the 1990s. As credit access was reduced, political power became more important in credit allocation. Another finding is that in the 1990s fewer loans went to households who ran nonfarm businesses as compared with the 1980s. The policy changes shown in the documentary examination had a real and substantial effect.

One can easily counter the claim that rural financial policy reversals have inhibited economic growth by pointing out that China's GDP has continued to grow strongly since the early 1990s. But it seems the rural financial policy reversals affect the composition of the growth rather than the growth itself. One clear difference between the 1980s and the 1990s lies in the growth rates of rural household income. Although there are data complications (mostly having to do with how rural migrant labor income is measured), the overall trend is clear. Between 1978 and 1988, growth of real rural household income per capita averaged more than 10 percent a year, exceeding the GDP growth. Between 1989 and 2002, the growth slowed down to 4 percent a year, less than half of the GDP growth. In fact for several years in the late 1990s, there was no nominal growth of rural household income at all. All the growth came from deflation. (Since 2003, rural household income growth recovered to about 7 percent per year.)

It would be surprising if this slowdown in rural household income on the part of some 70 percent of the population did not affect China's growth patterns. In the 1980s, household consumption to GDP ratio was around 50 percent. This ratio began to decline in the early 1990s, and now it is only around 35 percent, probably the lowest for any major economy. In the 1990s, Chinese growth became increasingly driven by the state-controlled investments and then since 2000 by net exports. This is in sharp contrast to the 1980s, when China was investing at a level comparable to other East Asian economies and its trade accounts consistently produced a deficit. A reasonable hypothesis is that reduced growth of rural household income led to a slowdown of rural household consumption and this income effect is in addition to and possibly more important than the changes in household savings behavior.

My account is heavily tilted toward developments in rural China. One may argue that this rural focus, while important to a story of how China initially took off, is less relevant to China today. Rapid industrialization has reduced the rural share of population from 80 percent in the 1980s to around 50 percent today. Also one may argue that the negative effects of rural policy reversals are more than offset by the urban reforms since the early 1990s, such as opening to foreign direct investments, privatization of urban state-owned enterprises, and restructuring of the banking system. On the basis of these reforms, some economists have pronounced that China has already succeeded in transitioning to a market economy and its major challenge today is economic development rather than reforms (Qian 1999; Naughton 2007).

My account does not support this optimistic assessment of Chinese reforms. A key insight here rests on some fundamental differences between rural and urban China. Chinese capitalism is rural in origin, and rural capitalism is highly entrepreneurial in a Schumpeterian sense. Urban China, by contrast, is far more state-controlled. The urban reforms since the early 1990s have led to the rise of a politically-connected, rent-seeking private sector (the most prominent example of which is the real estate private firms), whereas the reversals of rural reforms have been at the expense of a more arm's-length, entrepreneurial type of private sector. The effects of rural policy reversals go beyond rural China; they may have slowed down the overall pace of market transition.

Those who argued that China has completed its market transition cite rising and high shares of private output as evidence. For example, an OECD study shows that private firms accounted for 52.3 percent of industrial value-added in 2003, up from 27.9 percent in 1998 and, most likely, from zero percent in 1978 (Dougherty and Herd 2005). Estimates like this tend to overstate the true size of China's private sector. First, the definition of private sector is complex. The OECD study includes "legal-person" shareholding firms in its definition of private firms. In reality, many of these firms are affiliates or subsidiaries of state-owned enterprises and should be classified as state-owned enterprises. A more realistic estimate is that the private share of industrial value added in 1998 was 18 percent in 1998 and 28 percent in 2003 (Huang 2008).

The fact that the output share of the private sector has grown is not disputed. The issue is whether the size of private sector output is a reliable indicator of economic transition. Here an example from the Soviet Union is illustrative. No one accuses Leonid Brezhnev of being pro-market, but under his leadership, private plots contributed as much as half of agricultural household income in the Soviet Union (Gregory and Stuart 1981, p. 230). This occurred because private farming was so much more efficient than state farming, so its contribution to income was disproportionate to the inputs allocated to it. Private plots only accounted for 1.4 percent of cultivable land in the Soviet Union (Hewett 1988, p. 117).

This Soviet example shows that input, not output, is a more reliable measure of private-sector policies. Output measures of transition conflate two effects: an efficiency effect and a policy effect. Because private firms are more efficient, their output share can rise even if the policy environment is fixed or adverse. In 1990, the post-Tiananmen leadership cracked down on the private sector, and yet the output share of the private sector still increased. By one input-based measure, fixed asset investments, China's private sector development was not linear. Between 1981 and 1989, the private share of fixed asset investments averaged around 21 percent. Between 1993 and 2001, the share declined sharply to 13 percent (for details, see Huang 2008).

The rural policy reversals directly contributed to this development. In the 1980s, almost all of the private fixed asset investments were rural, and the net effect of rural policy reversals was to reduce the growth of the private sector from a much larger, initial rural base of capitalism. The private sector did grow, especially since 2000, but that growth was off a far smaller urban base.

To understand the two sides of China's growth story—its steep poverty reduction on account of fast personal income growth, and the statist orientation of its economy today—it is important to get the rural story right. China's takeoff began with rural entrepreneurship and substantial liberalization, but for political reasons, its leadership in the 1990s chose to reverse or discontinue much of the reform package that proved so promising. Financial reforms were completely reversed and land contracting reforms did not deepen. One reform that survived—village elections—was weakened considerably by the fact that the Chinese Communist Party tightened its direct controls of villages. Only village directors are subject to elections; village Party secretaries, who have real power, are not.

Between 1978 and 2012, it has taken China more years to "reform" the central planning system than it took for it to establish and operate that system from 1949 to 1978. Under a broad definition of private sector, China's private fixed-asset investment share was around 34 percent in 2005. This is less than the same ratio in India—of Indira Gandhi, not of Manmohan Singh, that is. In 1983, the comparable Indian ratio was 58 percent (World Bank 1989). China has moved from central-planning to what might be called a commanding-heights economy. This is progress, but China is far from completing its transition to a market economy.

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