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## Essay 2

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### SURVIVAL OF THE FITTEST

While attention has focused on Chinese president Jiang Zemin's approval of diversified forms of ownership in his party congress speech, his emphasis on market competition demonstrates a profound commitment to the forces of the marketplace, explains Dali Yang

The constant reference by China's Communist leaders to the doctrine of the survival of the fittest in economic affairs highlights a turning point: China is marching towards the marketplace. According to an estimate by the state commission for economic restructuring, 90% of China's GDP was realised through the marketplace in 1997. Further recognition of the depth of China's reforms came with the European Union's recent decision to cease counting the Chinese economy as a non-market economy.

In his keynote speech to the 15th national congress of the Chinese Communist Party in September 1997, president Jiang Zemin approved diversified forms of ownership, a euphemism for privatisation. While the decision on ownership has been hailed as a breakthrough, it is a belated acknowledgement of existing trends. Since the late 1970s, the non-state sectors, including collective, private, and foreign-funded enterprises, have powered the engines of growth for China. With most state enterprises loss-making, the Chinese state more than ever depends on the non-state sectors to pay taxes, generate employment for an ever-expanding labour force and, indirectly, underwrite the restructuring of the state sector.

While the ownership decision received much publicity, little has been said about Jiang's emphasis, in the same speech, on China's commitment to market competition. He makes more than 50 references to the market in his report and in an ideological sleight of hand, Jiang avers that the market economy is a neutral system that can be both capitalist and socialist. Most importantly, Jiang calls for an open and unified national market that is free from local protectionism and departmental monopolies. The market, Jiang states, should play a fundamental role in resource allocation.

Talk is cheap. Yet economic change in China over the past two decades suggests that its commitment to market competition is more profound than has been recognised in the west. It is hard to imagine that China's reformers did not intend to convert to the market at the start of reforms in the late 1970s. It is even more remarkable that much of the impetus for market competition has actually come from within the bowels of the command economy.

## **Bureaucratic interests and market competition**

When China emerged from the era of Maoism in the late 1970s, it inherited an economy that, like other command economies, was short of consumer goods. Yet, unlike the bureaucratic system of that time in the Soviet Union, the Chinese command economy was fragmented. During several waves of decentralisation, government departments and especially provincial governments had acquired *de facto* property rights over enterprises under their jurisdiction.

The reformist leadership further hardened these property rights through fiscal contracts between the central government and the provinces. The regressive marginal remittance rates of the fiscal contracting arrangements, which lasted until the early 1990s, gave provincial governments strong incentives to promote local economic growth in order to generate new revenue. Taking advantage of the pent-up consumer demand and the virtually guaranteed profit opportunities for industrial investment made available by the gradual price reforms and high tariffs, provincial governments and government departments jumped into an investment race in the 1980s.

The central planning apparatus abetted the investment race by offering cheap credit that carried negative real interest rates. Moreover, it allowed different industrial ministries as well as local governments to enter into the same sectors. For instance, while the ministry of light industry had formal jurisdiction over manufacturers of washing machines, other ministries, including machinery and ordnance, set up their own washing machine factories. Various territorial governments set up their own assembly lines as well. The barriers to entry were gradually removed for other players, including village enterprises and joint ventures between Chinese and overseas investors.

The same story can be told for most other industrial products, including paper, textiles, bicycles, refrigerators, air-conditioners, consumer electronics such as television and VCD (video CD players), motorcycles and automobiles. In the textile industry, for example, the number of enterprises rose from 12,145 in 1978 to 19,681 in 1984 and 48,747 in 1989. In the automotive industry, China has about 120 automotive companies and several hundred more automotive retrofitting plants to share a relatively small domestic market.

While China had only one producer of VCD players in 1995, it now has several hundred. Chinese planners have long complained about industrial duplication, but they have approved new projects to please the various industrial and regional interests. For better or for worse, Chinese industrial bureaucracy has been, until now, an amalgamation of divergent and fragmented interests and has rarely been able to speak with a unified voice.

The rush by local governments to enter various industries, particularly sectors with low barriers to entry such as textiles and light industry, meant that the high profit margins fast disappeared as surplus capacity spread. As new capacity went into production and competition heated up, it was to be expected that local officials would instinctively turn to the kind of bureaucratic protectionism fostered by the former command economy. However, local protectionism and market fragmentation, which rose to a crescendo in the late 1980s, also pointed to the intensification of market penetration and competition.

China is, after all, a continent-sized economy characterised by territorial divisions; it has 31

provincial units (average population about 41 million), nearly 600 cities, more than 2,000 counties, and nearly 50,000 town and township governments. With porous internal borders and a central government seeking to promote internal trade, the logical outcome of 2,000-plus localities each seeking to keep the local market to itself, while also selling outside its locality, is market competition. No local government has a monopoly on production, and factories in each locality face external competition. As this market competition intensifies, a growing number of local governments have joined the bandwagon of consolidation and cooperation. This is to promote mergers in sectors suffering from excess capacity and to shed unprofitable enterprises that are failing to compete in the marketplace.

### **A competition based economic philosophy**

The central government bureaucrats at first did not like the emergence of new players in economic competition. Yet, by the late 1980s, China's traditional planning tools - central control over investment and material balancing - were growing increasingly irrelevant as enterprises turned to market pricing. They bought and sold on the market which diminished the power of state planning agencies. These agencies thus desperately sought to find new justification for their continued existence. The state planning commission, the core of the planning agencies, found a new mission and identity in east Asian-style industrial policies.

The design and implementation of these industrial policies in China have been haphazard at best. Instead, the central government has had to address the declining performance of state-owned bank credits and other props to these flailing organisations.

While the state sought to use industrial policies to lead the market, it has had to respond to and live with market forces. The spread of market forces led more and more members of the governing elite, by learning and attrition, to appreciate the virtues of market competition. This was exacerbated when Chinese producers, particularly in consumer electronics and home appliances, began to win back the domestic market that had been lost to foreign producers.

By 1993, the Chinese leadership had begun to embrace an economic philosophy that made market competition the driving force of economic progress. The state is to harness market forces, not to supplant them. Monopolies of any kind stifle economic innovation.

More specifically, the Chinese government recognises that most consumer products industries, such as textiles, consumer electronics and home appliances, are already competitive industries plagued by excess capacity in the domestic market. In recognition of the growing competitiveness of these industries, the Chinese government has slashed tariffs on their products. It has reduced these tariffs far more rapidly than it has cut tariffs for less competitive products such as automotives.

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Nevertheless, while high tariffs are still used to protect internationally uncompetitive sectors such as automotives, a programme of disciplined liberalisation has been formulated and put into practice. China has steadily reduced tariffs for automotive imports - which remain high, however - and warned domestic producers that they have only a limited window of opportunity to shape up and meet the challenges of fully fledged international competition. Government officials and industry leaders believe further liberalisation is inevitable.

Even in sectors in which the state wants to retain control, competition is to be introduced. As president Jiang summarised in his report to the congress, China should not let one government department or ministry monopolise a particular industry. This is already the case in most sectors that are conventionally considered natural monopolies. In air transport, nearly three dozen airlines were created in the early 1990s. Ticket price control was finally lifted in October 1997, unleashing a wave of discounted fares. Airlines must also contend with other modes of transport (especially rail and bus) that have seen significant improvement in service. New companies have been set up in other industries such as petroleum extraction and processing, power generation, banking and financial services.

The most striking development in the adoption of the competition philosophy has been in telecommunications operations. The central government has refused to allow foreign operators in (though complex deals have been struck to allow foreign investment), but has steadily allowed new domestic operators to set up business to compete with the ministry of posts and telecommunications. While China Unicom, a company backed by three other ministries, has only been able to offer extremely limited competition in local and long-distance telephony, there is now vigorous competition in other services, including cellular telephony, paging and a variety of value-added services. Competition has improved service quality, brought prices down sharply and stimulated demand. By late 1997, China had over 40 million pager subscribers and 13 million cellular phone users, making it one of the world's largest markets in these services.

China's commitment to the competition ethos has been so profound that even the large state power corporations are contemplating selling power to consumers via the state-owned power grid. Inside sources have revealed that electric utilities can be deregulated and that power generators may be separated from the power grid. Chinese industry officials will be watching the experiment in this industry in the US intently because the China Power Corporation, recently formed to phase out the ministry of electric power, will own the power grid, thus theoretically opening up the possibility for deregulation of the power industry in China.

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### **Market competition as strategic leverage**

The Chinese government has also fashioned a strategy to use competition from domestic firms for leverage over multinationals. The goal is to benefit domestic consumers and especially to lower the costs of government procurement. In consumer products, the government has supported the fight by Lucky, China's last remaining photographic products company, to retain a slice of the domestic market from multinationals such as Kodak and Fuji. In telecommunications equipment, support for domestic producers has not only translated into lower prices but also substantial improvement in the competitiveness of domestic producers. As late as 1995, China still imported 30% of the telecom network equipment. In 1996, however, Chinese companies (including joint ventures) produced 90% of the newly installed telecom equipment. Government officials suggest that the presence of domestic competition based on lower costs has kept equipment prices substantially lower than would have been the case had China relied on imports. This has saved China hundreds of millions of dollars in procurement costs, as it has expanded its telecommunications network to form the second largest in the world by 1997.

Competition has speeded up the introduction of technology in the Chinese market. In cellular telecommunications, for example, services have made the transition to digital GSM (global standard for mobile communications). Trial CDMA (code division multiple access) networks have been set up and are competing to make the technology viable in the Chinese market. Chinese switching equipment producers such as Shanghai Bell and China Great Dragon Telecommunication Group have also begun to clinch some export orders for telephone exchanges.

### **Failure to cartelise**

The growing appreciation of the virtues of market competition in China does not mean that the market faces no enemies. From time to time, bureaucrats have sought to bend the market in one way or another. In the late 1980s, "commodity wars" (such as blockades to prevent the sale of raw materials to other areas) and other forms of local protectionism caused many to worry about market segmentation. While the commodity wars have receded following price liberalisation and changing supply-demand conditions, two recent developments are worthy of attention: efforts to organise price cartels and a rush to merge existing enterprises into conglomerates or enterprise groups.

With escalating competition in most products and declining prices, the bureaucrats in Beijing routinely receive calls for help from state companies that have found it hard to survive the intensifying competition. Research on products ranging from television sets to microwave ovens to steel, suggests that officials in industrial ministries have sought to

moderate these pressures through price agreements among producers.

Such agreements have rarely held, however, because of lack of effective enforcement mechanisms and the temptation for some producers to defect and seek market share. Over time, it appears that producers have come to accept the reality of competition. At a November meeting of microwave oven producers organised by the Chinese Microwave Oven (Producers) Association, manufacturers ganged up on Galanz, a Guangdong-based microwave oven maker, and accused it of having competed unfairly in the industry by sharply lowering prices. The most conciliatory move made by participants was an agreement for quality improvement and against dumping below production costs.

Even when some industrial ministries longed for more central control, the central government has refused to coordinate efforts to cartelise various industrial sectors. This leaves the individual ministries little leverage because of the proliferation of domestic producers and growing international competition in foreign trade. Indeed, officials in industrial ministries routinely rail against the customs administration and the ministry of foreign trade and complain that the Chinese state has been ineffective in controlling its borders and limiting the surge of imports such as steel.

### **The push for conglomerates**

Another worrisome trend is the government's campaign to create large conglomerates and enterprise groups through mergers and acquisitions. According to the China News Service, the state sector was projected to record nearly 3,000 mergers, acquisitions and bankruptcies in 1997, involving more than 415 billion yuan (\$50 billion) and 5.6 million workers. The pace of mergers has accelerated in automobiles, airlines, petrochemicals, steel and foreign trade.

On the surface, this merger movement is an attempt to emulate the *chaebols* and *keiretsus* of Korea and Japan. Yet, like the great merger movement that occurred in the United States in the early 20th century, the Chinese merger movement is fundamentally a response to the pressures of economic competition. As enterprise performance declines, the costs of owning an enterprise rise, making government departments and local governments more willing to get rid of under-performing assets. In consequence, the Chinese government has decided to focus its attention on the largest 1,000 companies and to deregulate the small and medium sized ones. Government officials hope that mergers will help foster companies with the scale economies to survive the competitive environment. To stimulate restructuring, the central government has offered interest reductions and other preferential policies (totalling 30 billion yuan in 1997 and 40 billion yuan in 1998) to those companies that take over debt-laden enterprises.

Provincial governments have also offered various incentives, such as preferential tax treatment, to promote mergers so that locally based enterprises would survive the growing competition. Government officials and firm managers repeatedly refer to their goal to create enterprises that will join the list of the top 500 global companies. In a sense, while the government is willing to abandon most small and medium enterprises to the whims of the market, they are in the meantime strengthening their ties with a very select group of large companies. The model for Chinese industry leaders has been South Korea, through which the Chinese leadership obviously hoped to find an alternative to both the planned and the unfettered market.

Even before the Korean financial crisis in late 1997, there was little doubt that China's effort to create conglomerates would turn out differently from the Korean model. In Korea, about a half dozen *chaebols*, including Samsung, Hyundai, Daewoo and LG Group, dominate the economy. These expansion-oriented *chaebols* turbo-charged the economy but also magnified the downside risks. In contrast, China's continental size and sprawling bureaucratic system make such business concentration highly unlikely. The ironic outcome of each government ministry and local government promoting a list of elite companies is that there will still be hundreds of companies on such priority lists.

The improved access to credit which is being accorded the conglomerates would still have happened under market conditions, as struggling state banks seek to limit credit risk and narrow their bets to the strongest companies. Also, in the light of the many levels of access to the Chinese system, it is unlikely that China will acquire the sort of impenetrable business networks that have made the Japanese market so inaccessible to foreign competition.

The financial crisis that has brought the Korean economy down on its knees has cast doubt on China's new-found model for development. Both within the Chinese government and in the Chinese press, critics of the push for conglomerates have emphasised that such a campaign may lead the Chinese economy down a risky road. It is all the more remarkable that a leading critic of the merger mania has come from the state planning commission's own research outfit. There is no magic formula for restructuring China's corporate structure. China must be open to alternatives other than the Korean model of cosy government-*chaebol* ties. Government-promoted mergers may temporarily create big companies, but the merged companies have to compete in the marketplace to survive and thrive.

### **China and the world economy**

In the past few years, there has been a major debate in China on whether the huge influx of foreign capital and the presence of deep-pocketed multinationals have been marginalising Chinese producers and even consigning them to oblivion. By 1997, more than 200 of the world's 500 largest companies had entered the Chinese market. The concern about foreign competition prompted Chinese producers to use nationalistic sentiments to sell their goods. In strategic industries such as telecommunications, the Chinese government has insisted on entering joint ventures with foreign investors in order to secure a foothold in the respective industries and gain access to technology (Motorola is a major exception).

What ultimately turned the debate around was the competitiveness of Chinese producers. While China has maintained its traditional strengths in low-end products such as textiles and bicycles, it has also rapidly gained ground in televisions, refrigerators, air conditioners, digital telephone exchanges and VCD players. Through sustaining an impressive succession of innovative and profitable products, Chinese producers have, in the past few years, consistently gained market share domestically and have become major exporters.

One of the most dramatic turnarounds occurred in personal computers. In 1995, foreign players such as AST, Compaq and IBM still accounted for 65% of the 1.4 million PCs sold in China. By 1996, Chinese producers led by Legend and Great Wall had caught up. In the first half of 1997, PC sales in China reached nearly 1.4 million units and domestic producers

accounted for 800,000 units. This constitutes nearly 60% of PC sales. While China remains largely dependent on imported processors, it is now a major producer of computer motherboards. Chinese product cycles have also gained in efficiency by becoming increasingly synchronised and integrated with international technological developments.

It is the competitiveness of Chinese producers that has convinced Chinese leaders as well as planners to embrace more and not less competition. They now argue that it is unrealistic to have Chinese partners holding majority shares in all joint ventures. In certain high-tech areas in which China has driven a hard bargain with multinationals, the Chinese government has recently given unprecedented concessions to companies such as Motorola to set up solely owned enterprises.

Only on the basis of China's growing competitiveness has the Chinese leadership been able to respond to international demands for greater openness with steady cuts in its tariff levels. As late as 1995, China's general tariff rates were still at 35%. In the third quarter of 1997, during the Asian financial crisis, president Jiang committed China to reducing its tariff levels from the current 17% to 10% by 2005. In an interesting reversal of fortune, the central government, as well as some local governments such as Shanghai, has quietly started to encourage Chinese enterprises to invest overseas; particularly in South Africa and southeast Asia. Shanghai plans to offer preferential policies for enterprises that invest or purchase enterprises in South Africa.

It is misleading to judge China's reforms on whether mass privatisation will occur or not. Instead, it is best to evaluate China's reform programme in terms of how it expresses the Chinese leadership's attitudes towards market forces. While much of the market revolution did not happen by design, and sometimes occurred in spite of government efforts, the march of the market has convinced more and more Chinese leaders to jump on the bandwagon of competition and harness market forces to improve economic performance.

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