Diamond of sustained growth | china

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Global Perspectives on Enterprise Systems

Professor George D. Smith China’s Shaky Path Ahead

According to *The Diamond of Sustained Growth* by Smith, Sylla and Wright, there are four essential components in growing and sustaining a growing economy: a stable government focused on economic growth, a strong financial system, vibrant entrepreneurship and sophisticated managerial ability. Each of these blocks not only promotes economic growth, but feeds into the next component to create a strong foundation to support growth. In fact, these four blocks are so fundamental to each other that they can be seen as a cycle (see Figure 1) that must continually be evaluated and fed to sustain growth.

To begin growing an economy, a country must first have a political system that is geared to enabling economic growth. According to Smith, the government “ must be able to unify an economically relevant territory, establish order and protect the lives, liberty and property of its citizens through an impartial rule of law” while providing public goods (like national security) and ensuring that markets are regulated so that competition is fair and honest.[1]It is important to note that a government that promotes economic growth does not necessarily mean a democratic, capitalistic government. In fact, many Asian countries that experienced the Miracle of Growth either had dictatorial regimes (South Korea, Taiwan, China, Indonesia), periods of military rule (Thailand) or systems with limited freedoms dominated by one political movement (Singapore, Malaysia).[2]

The next block corner in the diamond of growth is an effective financial system. Financial systems (which include banks, capital markets and corporations) provide a platform for both public and private entities to transfer funds from areas of surplus to projects that may lack in funding. They also provide liquidity and leverage to projects that seek funds. However, for the financial system to be effective, it relies on the government being able to provide the means to fund projects through efficient and fair taxation and sound public credit, which relies on sound monetary and fiscal discipline.

Once there are the needed funds and the means of transferring them, there need to be people to use them. This is where entrepreneurship comes into place. Economies rely on entrepreneurship to introduce new products and services, production processes (or improvements on all the previously listed) while opening new markets and creating new combinations of land, labor and capital to create new businesses and ways of making money and growing the economy. However, if the government doesn’t provide sufficient security and legal foundation for securing intellectual property rights, entrepreneurs cannot survive over the long term and their incentives to innovate will weaken. Furthermore, the if the financial sector is inefficient, the cost of investing in new projects will increase until it reaches a point in which it is too high and investors no longer have incentives to invest (unless the government is willing to step in and fill the gap with new taxation and issuance of public debt).

Finally, once the new companies are put in place, there must be the managerial capability to keep the companies alive and thriving. As companies grow, they grow increasingly reliant on sophisticated methods of coordination and control. Being able to manage these sorts of methods is key in realizing economies of scale and scope – as costs come down, society benefits. It also allows companies to better plan for the future; to more readily adjust to changing market conditions; to compete more effectively; to invest in new, innovative projects to continue the entrepreneurship cycle; and to reduce or abandon investments in projects that are no longer productive or profitable. However, managerial skills often need to be taught and require a highly specialized labor force – which requires the government to invest in education. 1

Having laid down the appropriate groundwork in determining what factors are needed for growth, we can now apply the Diamond to China’s growth. Therefore, to evaluate China’s growth potential in the next five decades, we must first look at its political (and therefore governmental) history in the past five decades – to see how China has progressed and whether or not it can continue to move in its current direction.

It is only within the last hundred or so years that China moved from a dynastic monarchy to make strides toward a more “ modern” government – though the transition has been anything but smooth. Chinese history is riddled with civil unrest and war; the last 50 years are no exception. During the 1930s, China actually had an economy that was growing modestly but compared to other countries, it was significant economic growth. Following the Great Depression in the 1930s, China’s share of world trade and its ratio of foreign trade to GDP levels would take over 60 years to repair.[3]

In 1949, with the end of the Chinese Civil War and the mass evacuation of the Kuomintang to Taiwan, the Communist Party of China took power in the Chinese government and Chairman Mao Zedong declared the birth of the People's Republic of China (PRC). In 1958, Mao implemented his " Great Leap Forward" campaign. His goal was to transform China from a country that was largely dependent on agriculture and an agrarian society into a communist society through heavy industrialization and collectivization. Multiple farmers worked on one piece of land, much like an enterprise, and those that were left without a job turned to making steel in their own backyards.[4]

Initially, the growth that came from the Great Leap Forward looked quite promising – with iron production increasing 45% in 1958 alone and 30% over the two years following. However, iron production rates plummeted in 1961 and were not able to recover to previous levels until 1964. As Mao insisted on continuing the production of steel in backyard steel furnaces despite low returns, peasants and farmers began to cut down forests in an attempt to fuel the furnace. " Homes were pulled down to make fertilizer, to build canteens, to relocate villagers, to straighten roads, to make place for a better future beckoning ahead or simply to punish their owners." As famine spread because of the implementation of collective agriculture, and caused the deaths of 30 to 40 million Chinese people, the government began to repeal their policies on the practice and aided the gradual de-collectivization of farms.[5][6]The purges during the Cultural Revolution, which sought to purge anything that had to do with capitalism and traditional and cultural elements from Chinese society, followed the Great Leap Forward. Often, victims were intellectuals who were sent to labor camps and those that survived fled the country. The entire Chinese education system, and subsequently the economy, came to a halt. Anyone who knew how to start and run a business was dead or gone.[7]

While Mao’s ultimate goal for the Great Leap Forward had been economic growth, the years of the Great Leap Forward (1958-1961) saw the decrease in China’s economic strength. This period of time was the only time between 1953 and 1985 in which China’s economy actually began to *shrink* . According to political economist Dwight Perkins stated that “ enormous amounts of investment produced only modest increase in production or none at all. … In short, the Great Leap was a very expensive disaster.” Because of his “ misleadership” during the Great Leap Forward, Mao stepped down as the Chairman of the PRC in 1959. In comparison to its neighbors, China’s economic performance was very poor. Upon the death of Mao Zedong, the Communist Party of China sought to correct market inefficiencies and malinvestments by implemented market-oriented reforms in an attempt to salvage a failing economy. [4]

Considering the economic turmoil that the Great Leap Forward had wreaked on China, when Deng Xiaoping came into power, he had what most people would consider an impossible task in revitalizing the Chinese economy. The government, and therefore the economy of China, at the time were in no position for any sort of growth. Though his policies faced a lot of opposition, they were highly successful in building China’s wealth. His set of economic reforms, æ”¹é©å¼€æ”¾, which can be translated to “ Change Reform, Open Up” was started in 1978 and sought to open up China to the world.

Deng's economic reforms were carried out in two stages. The first stage aided in the decollectivization of agriculture, opening up China to foreign investment and permission for entrepreneurs to start businesses (though most industries were still largely state owned). The second stage saw the privatization and contracting out of the bulk of state-owned industry and lifting price controls, protectionist policies and regulations. During this time, the private sector grew remarkably, accounting for as much as 70% of Chinese DCP by 2005. From 1978 until the present, there was an unprecedented growth boom, with the economy increasing by 9. 5% a year. [8]China officially became the largest Asian economy, surpassing Japan, in 2010 and second largest in the world after the United States. By 2025, it is expected that it will be the world's largest economy.[9]

With the success of Deng's " Change Reform, Open Up" policies, there have been many changes in Chinese society. Large-scale government planning programs alongside market characteristics have reduced poverty, while incomes and income inequality have increased, leading to a backlash led by the New Left. However, given how far the country has come, as a whole, in the last 50 years and its continued dedication to growth and expanding the Chinese economy, it is highly likely that China will continue to grow, though not as quickly as it has in the last 20 years.

From a managerial standpoint, China has invested billions of yuan in educating the masses. In 2012-2013 alone, China's national education budget was ï¿¥388. 39 billion. All citizens must attend school for at least 9 years (elementary and middle school). In 1985, the government abolished tax-funded higher education and instead required university applicants to compete for scholarships based on merit, insuring that the best of the best had access to higher education. With the openings of several private institutes of higher education, the number of PhD holders increased five-fold in a mere 10 years. In 2003 alone, the Chinese government supported 1, 552 institutions of higher learning and 725, 000 professors and 11 million students. Chinese spending on education has grown by 20% per year since 1999, and as many as 1. 5 million science and engineering students graduated from Chinese universities in 2006. Though Chinese universities have relatively high graduation rates, only 4% of the China's middle school graduates are actually admitted to college. China, instead, has developed other ways of meeting the demand for education by offering " non-formal" education. Many of these schools have courses in industry, services, business and agriculture. The goal of such programs, as with any education program, is to raise the cultural, scientific and general education levels of workers on the job.

Though many students get at least a cursory knowledge of business in school, entrepreneurship education is very seldom taught in China's universities. It is still a new concept and practice. Currently, very few people hold academic entrepreneurship titles in China and fewer have actual entrepreneurial experience. Up until 1991, when the first MBA program opened up on mainland China, there was very little emphasis on private business. Furthermore, traditional Chinese cultures, still heavily influenced by Confucian values like obedience, respect for authority and emotional control, all contradict typical entrepreneurial values, which make it extremely difficult for entrepreneurs to break out from a very traditional society. Recent research emphasizes the significant impact that good entrepreneurship education can make towards entrepreneurial success and the promotion of entrepreneurial culture.[10]

If China can somehow weave entrepreneurship education into the system of education that it already has, it may become a key advantage for China's growth. In many developed countries, entrepreneurship is still seen as an add-on to existing business and management courses. In China, where entrepreneurship education is still very much in its infancy, Chinese universities have a real opportunity to construct programs that include input not only from typical business school academic areas such as finance as marketing, but also from the social sciences such as psychology and sociology which are extremely important in successful management teams.

One large obstacle that China faces is the emigration of highly skilled workers to countries like the United States where they can get better jobs and higher pay. China must come up with a way to retain its educated and skilled workforce if it wants any hope of promoting entrepreneurship in China. China's Premier, Le Keqiang, has pledged more policies to encourage entrepreneurial activity and support start-up business across China. However, it is still widely seen as a place where there is no real protection for intellectual property rights – and therefore, there is very little incentive for entrepreneurs to stay in China if their ideas can be stolen with no risk of punishment. Even though China has a pretty comprehensive set of intellectual property protection laws but the government does little to actually protect IPR. All indications show that this situation will continue at least for the foreseeable future.[11]

However, despite IPR problems, if there is any solid indicator of China's economic success through entrepreneurship, simply take a look at the number of billionaires coming out of China. In 2013, there were a reported 168 billionaires in the 2013 Forbes China Rich List, up 44% from 113 billionaires in 2012.[12]Out of the list, China's ten richest *internet* entrepreneurs are worth a combined $56. 7 billion.[13]

Many Chinese entrepreneurs, unfortunately, do not make it to billionaire status if they make it at all. Securing adequate funding for projects is extremely difficult in China, so many entrepreneurs turn to private lending to finance their projects. Oftentimes, it is the only source of financing that they can access. Because private entities are not allowed to run banks, commercial loans can only be obtained by state-owned banks. Because state-owned enterprises are controlled by the government, they are sometimes more driven by political incentives than market incentives. Unsurprisingly, the people who run private enterprises are on the bottom of the banks' lending list because state-owned enterprises are always given higher priority no matter how bad their balance sheets look. The financial platforms that are available are insufficient and prejudiced – leading to an inability to get surplus funds to projects that actually have growth potential.

Further strengthening the government's banking monopoly, laws also bar inter-company lending, so companies cannot lend to each other. Lastly, the tradition of borrowing money from friends and neighbors to get through hard times has deep roots in Chinese society, with the importance of " keeping face". These combined factors have led some Chinese entrepreneurs to seek private financing despite the risks and punishments they may face if they are caught.

Traditionally, individual loans are made based on personal relationships. However, since China’s banking system does not allocate capital fairly, a huge “ shadow” capital market has emerged where the enormous demand from desperate private enterprises is met by the supply of money from ordinary people seeking a better return on their investment than the below-inflation rates offered by banks. Business owners who need capital can get credit from friends of friends, and even from total strangers, through loan matchmaking agencies. Because this “ shadow” loan market is unregulated, risks abound. Borrowers might undertake very risky projects or simply take the money and disappear. Using borrowed money to speculate on stocks and futures is not uncommon; one person even raised money to run casinos, despite the fact that gambling is illegal in China.

Private lenders, on the other hand, are generally left in the dark, under the impression that their hard-earned money has been locked in at “ guaranteed” high yield rates, when they may have nothing more than a handwritten IOU. Lacking awareness of the risks, lenders usually invest far more than they can afford to lose. When a bubble bursts, many may lose all they have, and the borrowers are always blamed, because there is no clear line separating legal private lending and illegal fundraising.

It is this information asymmetry between the borrowers and lenders that causes so many credit crises in private lending. Under normal circumstances, banks mitigate this asymmetry by acting as profit-driven intermediaries with their expertise in diversification and risk control. When banks cannot provide this service, problems begin to appear. The implicit costs of investing in entrepreneurial activities are simply too much, when compared with the risk that is associated with them, and not worth the time. Entrepreneurs are therefore left with very few choices to get the proper funding, since the government looks out for the government before entrepreneurs; and everyday investors are wary of investing too much money.[14]

However, there has been progress made in terms of creating a stronger private financial system. In July of 2013, China's State Council published ten guidelines for financial market restructuring[15]. The ninth guideline specifically deals with the legalization of privately-run banks and the regulation of private lending markets. Hopefully, this will make getting the proper funding for entrepreneurial ventures simpler and push more people with entrepreneurial spirit to offer new and innovative products, services and processes to the market to help sustain growth.

Though the current government is stable (in terms of ideologies as well as transfers of power), there is still much work ahead for China to fully realize the Diamond of Sustained Growth. Firstly, the financial system must be revamped so that private funding is no longer illegal and entrepreneurs have access to the money they need. Secondly, China has to be stricter about enforcing IPR laws so that entrepreneurs are incentivized to stay. China should also provide some sort of subsidy or incentive plan to make China into a start-up incubator. And lastly, China needs to better educate its population about entrepreneurship so that people can, not only start a business, but also keep it alive. Judging by the success of its current entrepreneurs; the progress that China has made in the last 50 years over incredible odds; current trends and indicators; and the fact that the government has taken active positions in making China a more entrepreneur-friendly country, if China can overcome the few obstacles outlined in this paper, it certainly has the potential to continue to grow much as it has in the last few decades.

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[12]http://www. forbes. com/sites/russellflannery/2013/10/21/inside-the-2013-forbes-china-400-a-record-168-billionaires/

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[15]http://www. gov. cn/zwgk/2013-07/05/content_2440894. htm