

Economic Lessons from History

One event is selected from each major dynasty in China's history to provide important lessons for understanding the present-day Chinese economy. The period of the Republic of China since 1911 is discussed in more detail to provide a historical-institutional setting for the current economic system. A list is provided on what history can teach us about the present-day Chinese economy.

1.1 Introduction

China's economy has become a leader of the world economy. The country has close to 1.4 billion people or almost a fifth of the world population. The national output is the second largest in the world and will exceed that of the United States by 2020. The rate of growth of total output was about 9.5 percent per year up to the world economic recession beginning in 2008 and remained much higher than that of the United States afterwards, making China the most important force driving the world's economic recovery. Hence it is interesting and important to understand how the Chinese economy has evolved and how it functions today.

In this book we apply the theory and method of economics to understand the Chinese economy. We will study the dynamic process of China's economic transformation and growth. What historical forces drove China to a planned economy from the 1950s to the late 1970s? How did the planned economy work? What were the reasons and driving forces for economic reform since 1978? How did such dramatic changes occur after the economic reform? Why was China successful in transforming a planned economy to a market economy? To what extent is the Chinese economy a market economy? How do different

economic institutions in China function today? What economic laws are at work to explain the functioning of various aspects of the Chinese economy? What are the current economic problems? What are the prospects of China's future development?

In this chapter, we will present some important historical facts of China together with interpretations of these facts from the viewpoint of economics. Since the history of China is often described by the dynasties we will select the important facts selected from the major dynasties. At the end of this chapter we will provide a list of important questions about China's history which a student of the Chinese economy should ask in future study. The main part of this chapter discusses what we have learned from history. The last section discusses what we can and should learn from history.

China has the longest living civilization, with a written language that can be traced back to 3000 BC. Throughout Chinese history, we can find examples of economic laws at work, of how people tried to improve their economic well-being or to maximize their satisfaction or profits. We can also find evidence of the market economy at work and of a deep understanding of it on the part of the ancient Chinese. It is the purpose of this chapter to draw several economic lessons from China's history and from some recent historical events that have affected the development of the Chinese economy. In section 1.2 I will select one important event or example from each major dynasty. In section 1.3 a more detailed account will be given for the period between 1911, when the Republic of China was established, and 1949, when the People's Republic of China was founded, because the history of this period is more relevant to the present-day economy. In chapter 2 a historical and institutional account in even greater detail will be provided for the period after 1949, in order to provide a setting for the discussion of economic reform introduced in 1978.

1.2 Significant Events in Major Historical Dynasties

China's history went through different dynasties. The people were ruled by an emperor. In theory the emperor was supposed to have received a mandate from heaven to rule. In practice the rule was established by military conquest, but the ruler was guided by a moral principle to be kind to the people, and could remain in power only if he did not deviate too much from this principle. Each emperor was succeeded by his offspring until some successor failed to perform his job adequately and the throne was seized by someone else in a revolution. Then a new dynasty was established. The historians serving in the court of the ruling dynasty wrote about the virtue of its founder, the successful revolutionary, and the vice of the defeated emperor and the previous dynasty. As a familiar Chinese saying goes, "The winner is the emperor; the loser is the bandit."

1.2.1 *Shang, 1900 BC*

Although recorded Chinese history preceded the Shang period, I will start there. Visitors to a museum containing ancient Chinese art objects will find the beautifully and delicately engraved bronze vessels of this period. They will also find tortoise shells on which there are traces of writing. The shells were used for fortune-telling. After the tortoise shells were

burned they cracked and formed lines that were interpreted for guidance on what would happen and when one should or should not do certain things. The writing on them is a precursor of the Chinese written language in the form of characters. (The fact that the characters of written Chinese are based on the shapes of objects rather than on the sounds of the spoken words, as in European written languages, may explain partly why the Chinese have a different way of thinking, which emphasizes the concrete, in contrast to the European and American tendency to dwell on the abstract and metaphysical.) Such objects show that Chinese civilization was already fairly advanced 4,000 years ago. It will be pointed out later in our study of the Chinese economy that human capital is a very important element for economic development. Human capital means the knowledge and skill possessed by people. The skill that was used by the Chinese people 4,000 years ago to make bronze vessels has been transferred with further improvements through the centuries to current Chinese laborers who make toys and computers. The abundance of skilled labor in China today is an important factor contributing to its rapid development, and so is entrepreneurship, which can be traced back to the training of the mind in ancient Chinese learning and the practices governing human relations in ancient Chinese culture.

1.2.2 Zhou, 1100 BC

Chinese civilization was advanced during the Zhou period. Major Chinese classics were written during this period. These classical works are still read by some people in China today and by most educated Chinese in the first half of the twentieth century. They include the *Book of Changes (Yiching)*, the *Book of Poems*, and the *Book of Li* (etiquette). The *Book of Changes* is available in many Western bookstores. It was designed for fortune-telling and has been found intriguing by modern mathematicians. The Duke of Zhou, author of the *Book of Li*, was an inspiration to Confucius. At the end of the Zhou dynasty there was the “Spring and Autumn” period, named after a classic of the same title written by Confucius. It was a golden period in the development of Chinese civilization, with diverse schools of thought flourishing. Daoism, for example, advocates inaction, letting nature take its course, and minimum government intervention. Many important ideas about politics, philosophy, and economics can be found in the writings of that period (see Chan 1963).

Confucius’s teaching was only one school of thought at that time, but became dominant in the later part of the Han dynasty. Economists debate today whether the Confucian tradition, which is deeply rooted in Chinese culture, is a positive or a negative factor for the country’s economic development, although no one can deny that it is an important factor. On the positive side, Confucius’s teachings to uphold a high moral standard and to honor one’s commitments are helpful in business transactions. They provide a social order under which a market economy can function. They encourage family ties and trustworthiness among friends, which may form the basis for loyalty in a business enterprise. Confucius valued learning and the acquisition of knowledge, and this may account for the abundance of human capital in China and its neighboring Confucian countries. On the negative side, his thinking is said to promote too much respect for tradition and thus to be a hindrance to progress. The use of personal honor as a safeguard for business commitments might be a poor alternative to a modern legal system – for ethics is considered more important than

law under the Confucian tradition. The negative side of respect for social order and family values is the sacrifice of individual freedom and self-interest. Individualism is taken for granted in many Western societies but is not necessarily considered a virtue in China, where social responsibility for the common good is more highly prized.

1.2.3 Qin, 200 BC

When the Zhou dynasty became weak, many regional rulers took control of their territories. The period is known as the period of Warring States, which followed the “Spring and Autumn” period. There were seven states competing for the throne. Among them was Qin, which finally succeeded in unifying China. The successful first Qin emperor standardized written Chinese and the units of measurement for weight and length. He directed the completion of a large part of the Great Wall to prevent invasion from the north. He was a strong ruler, in fact a dictator, who hated dissenting intellectuals and burned many books and killed dissenting scholars. His tomb in the city of Xian is a great tourist attraction. It is over 1.5 kilometers in diameter and is too large, complicated, and structurally protected for the current Chinese government, even with modern technology, to excavate, except for a small part near its entrance. The excavated soldiers in the entrance, who are supposed to protect the Qin emperor in his grave, are a magnificent example of the arts of the period.

The story of the Qin emperor is significant because 22 centuries later Chairman Mao Zedong of the Chinese Communist Party followed some of his examples. In a famous poem surveying China’s history, Mao referred to the Qin emperor with admiration, but was pleased to hint that he would surpass all ancient heroes. Mao succeeded in unifying China in 1949 – a very difficult and important accomplishment in a tumultuous period that we shall describe later in this chapter. In so doing he provided political stability and national pride for the Chinese people. He was a strong ruler. His government simplified written Chinese (over the objections of many Chinese all over the world) and tried to impose one spoken language all over China. China has essentially one written language but many different spoken dialects that cannot be understood by all. He mistreated and sacrificed numerous intellectuals during the periods of “letting one hundred flowers bloom” in 1957 and the Cultural Revolution of 1966–76, sending them to work in the countryside as laborers. He mobilized the masses to build great projects comparable in scale to the building of the Great Wall, such as the commune system in agriculture created in 1958 under the Great Leap Forward movement. To understand present-day China we have to understand Mao’s influence, and Mao himself was influenced by his study of Chinese history, including in particular the history of the Qin emperor.

1.2.4 Han, 206 BC to 220 AD

The Qin emperor was a strong ruler but his son, who succeeded him, was not able to rule effectively. The dynasty ended soon after his death. The next dynasty, the Han, lasted until 220 AD, including Western Han and Eastern Han. For this dynasty I select a passage written

by the great Chinese historian Sima Qian (family name Sima), who wrote a book of Chinese history, *Records of the Historian*. Young (1996: 138) cites and focuses on the following passage from the chapter entitled “The Biographies of the Money Markets.”

There must be farmers to produce food, men to extract the wealth of mountains and marshes, artisans to produce these things, and merchants to circulate them. There is no need to wait for government orders: each man will play his part, doing his best to get what he desires. So cheap goods will go where they will fetch more, while expensive goods will make men search for cheap ones. When all work willingly at their trade, just as water flows ceaselessly downhill day and night, things will appear unsought and people will produce them without being asked. For clearly this accords with the Way and is in keeping with nature.

This quotation shows that in the Han dynasty at least some part of China had a functioning market economy, with farmers, workers, and merchants engaged in production and trade. The market functioned smoothly without government intervention and according to the law of demand and supply. Each person tried to maximize his self-interest, and the invisible hand was at work to coordinate the economic activities of all. The quotation also suggests that Sima had a deep understanding of the workings of the market economy. What he called “the Way” we now call the law of demand and supply. It might be difficult to find a passage in Adam Smith’s *Wealth of Nations* that provides a clearer and simpler description of a market economy.

1.2.5 Tang, 618–907 AD

Bypassing the dynasties in between, I come to the Tang dynasty. The Chinese have been referred to as the Han people or the Tang people by outsiders. This shows that both were glorious periods of Chinese history. With regard to the Tang dynasty I choose to discuss foreign trade. Although the Han Chinese had traded with foreigners in the north, it was during the Tang dynasty that the Chinese traded with Europeans through the famous Silk Route, which is still traveled today. There was trade between the Chinese and the Romans via this route. There is a memorial site to attract tourists at Dunhuang in Gansu province, where there are cave paintings commissioned by Buddhists as symbols of religious offering. Europeans long ago already desired silk and china from China, but for a long time had to trade through the middlemen in the Middle East. These middlemen also had spice and other goods that the Chinese wanted. The Silk Route reminds us of the importance of foreign trade in economic relations among nations. It marks the beginning of the economic globalization process, though only to a very limited extent by modern standards.

For a long time the Chinese government was not interested in opening China’s door widely because it considered the country self-sufficient. There was little that China desired from the West. Only in recent years has China found itself to be behind in technology and become interested in importing foreign technology and encouraging foreign investment.

1.2.6 Song, 960–1126

China's market economy was fairly well developed in the Song dynasty. In many ways the economy resembled a capitalist system. People with money set up businesses for profit and there were plenty of rich people. Various productive and commercial activities flourished. One can see such activities in a famous Song painting, *Qingming Festival on the River*, depicting the economic scene of Kaifeng in Henan Province during the Qingming (Sweeping of the Graves) Festival in the spring. In the painting there are people engaged in different forms of production and trade, as well as leisure activities. The people appear well-to-do. Although one may claim that in many respects China had a capitalist economy, in a modern sense, in the Song period there was a main ingredient lacking: modern technology based on modern science. An interesting question is why China did not develop modern technology earlier than and independently of the West.

The Chinese knew enough mathematics and had scientific knowledge, including astronomy, that could have served as a basis for the development of technology. They also had some fairly sophisticated technology, which enabled them to build the Great Wall and many impressive palaces and temples and to make the explosives and armaments exhibited, for example, in the Xian museum today. The Chinese invented paper, gunpowder, and the compass. One economic explanation advanced for the failure to develop modern technology in the Song dynasty when the knowledge base appeared sufficient is the lack of economic incentives. China had a large amount of inexpensive labor for production in that period. For a technological innovation used in production to pay off, it must be cheaper to use than labor. In the initial stages of introducing a new technology, the cost is high. The payoff is not sufficient until the product can be mass produced by the new technology for a large market. In an economy with a large amount of inexpensive labor a potential innovator might not envisage a sufficient payoff for the innovation, when the process of invention is costly and its success uncertain. In addition to this lack of economic incentive, intellectuals in traditional Chinese society devoted themselves mainly to the study of Chinese classics in order to pass examinations to become government officials, who had a higher social and economic status than the rest of the population, and this was considered more important than what money alone could offer. Performing a scientific and technological investigation was a lonely activity, even if it might yield some intellectual satisfaction or economic return. One or two technological innovations in an unsuitable economic environment could not have produced an industrial revolution. A study of the reasons why capitalism based on advanced technology did not develop during the Song period would also need to examine the risk of investment in technological innovation at a time when the population had to migrate to the south following invasion from the north. In addition there is the question of the possible sources of financing such investment.

1.2.7 Yuan, 1279

The Yuan dynasty was founded by the Mongolians. It was the first dynasty not ruled by a Han emperor. Hubilie, the grandson of Genghis Khan, founded the dynasty. The territory of the Mongolian Empire extended to a large part of Europe. The Mongolian rulers

assimilated much of Chinese culture and preserved it while they ruled. Through most of Chinese history, Han rulers were not expansionist. A Chinese emperor would welcome tributes from other areas and recognize them as a part of the Chinese sphere of influence, including Vietnam and Korea in the nineteenth century, but very seldom tried to conquer other territories in order to rule them. In keeping with this Chinese historical tradition, the current Chinese government does not appear to have any expansionist intentions. It does consider Taiwan a part of China because the former was historically a part of China. In addition to historical tradition, there are sufficient internal problems, economic and political, to occupy the current government. It has neither the energy, nor the motive, to expand. If it did have the energy and motive, where would it expand? What would the costs and benefits be? As the world's most populous and third largest country, China will gain economic and political influence in the twenty-first century by the natural course of its rapid economic development. It would be self-defeating to rock the boat by engaging in risky military adventures.

1.2.8 Ming, 1415

Imperial rule was returned to the Han Chinese in the Ming dynasty. During this period, China began extensive overseas exploration. Chinese ships traveled to southeast and south Asia, and through the Indian Ocean to the Persian Gulf and the coast of east Africa. Menzies (2003) claims that a Chinese fleet led by Zheng He, a eunuch and confidant of the emperor, reached America 70 years before Columbus and circumnavigated the globe a century before Magellan, although such claims are debated by scholars. A large number of Chinese migrated to Taiwan from Fujian province across the Taiwan Strait. Taiwan became a part of China until 1895, when China was defeated in the Sino-Japanese War and surrendered the island to Japan. In 1945, when Japan was defeated at the end of the Second World War, it returned Taiwan to China. Today, there is the possibility of an explosive disagreement between the government of the People's Republic of China and the government of the Republic of China in Taiwan concerning the political status of Taiwan. The PRC government is not interested in the expansion of Chinese territory, but it considers Taiwan a part of China. The situation could be volatile because the PRC government has not given up the possible use of force to settle this disagreement, in addition to which the majority of the people in Taiwan appear not to favor becoming a part of the PRC. The existing stability of their relationship is due to both governments' recognizing that an armed conflict would do neither side any good.

1.2.9 Qing, 1760–1911

The Manchurians took over China and became rulers of the Qing dynasty. After early periods of prosperity and strength, the dynasty became very weak as the rulers in the 1800s were incompetent. The dynasty still considered itself the center of the world, as some Chinese had, while the Western world had advanced a great deal economically, scientifically, technologically, and militarily. The British Empire was expanding. The British were

interested in increasing trade with China, mainly to buy Chinese tea and silk. The Chinese were not much interested in what the British had to offer. However, one important item offered by the British was opium. To prevent the import of opium, China engaged in the Opium War of 1840 with the British, and was defeated. In the Treaty of Nanking, signed in 1842 after the war, the Chinese agreed to cede Hong Kong to the British, to open other ports, to let British ships enter Chinese rivers, and to allow the British extra-territorial rights on Chinese territory (including the jurisdiction of British consulates over British citizens in China). Since the Treaty of Nanking, many other unequal treaties have been signed, conceding territory and similar rights to other countries, including Germany, France, and Japan. These treaties created great resentment among the Chinese people against their weak and incompetent rulers and the foreign imperial powers that had succeeded in forcing concessions out of them. Nationalism became a strong force in Chinese society. This sentiment persists today in spite of the great progress China has made. An example of this was the mass uproar over the bombing of the Chinese embassy in Serbia in 1999, which the Chinese viewed as reminiscent of mistreatment suffered after the defeat in the Opium War. This sentiment also explains why there was such a great celebration in China before and on July 1, 1997, when Hong Kong was returned by the British to China, for it symbolized the end of foreign domination and the achievement of Chinese independence.

1.3 The Republic of China, 1911–

Because space and its relevance are limited I have omitted much of the interesting and exciting Qing period and mentioned only the weak and incompetent Qing government and the Opium War. Historians would find equally interesting material in other dynasties that is missing in our discussion. The main point with regard to the Qing period was that the people were unhappy and eager to modernize China, to make it economically and militarily strong and free from foreign domination. Most leaders agreed that China should learn modern science and technology and should improve its political system. There were disagreements as to how to achieve this goal. Some officials in the Qing government proposed drastic reforms under the leadership of a young emperor in 1898, but their attempts at reform were defeated by the Empress Dowager. Others advocated revolution to overthrow the Qing government. For an excellent source on Chinese history from 1869 to 1933, the reader should refer to *The Annals of Mr. Liang Yansun of Sanshui* (1939). Parts of its contents are available in English in Au (1999), and <http://loki.stockton.edu/~gilmorew/consorti/1beasia.htm> is a website containing brief descriptions of all the historical dynasties of China as well as details on the Republic of China and the People's Republic of China.

In 1911, the revolutionaries succeeded in overthrowing the Qing dynasty. The Republic of China was established, with Sun Yat-sen serving as its first temporary President. Sun did not have sufficient military power and had to turn over the presidency after only four months to Yuan Shih-kai, a former Qing official who did have military power. Three years later Yuan tried to make himself emperor but failed. The presidency of China changed hands several times between 1916 and 1927, while new premiers and their cabinet

members were appointed over a dozen times under an unstable parliamentary system. While political instability was occurring in the government in Beijing there was a separate government in the South. Sun Yat-sen did not support the government in Beijing and tried to be the leader of the government in the South, but managed it only intermittently. The Northern and Southern governments had to share control with different factions, including strong governors of important provinces and warlords who controlled different territories. There were several serious attempts to negotiate a settlement between the Northern and the Southern governments and unify China, but all efforts failed.

In the early 1920s Sun Yat-sen led the Kuomintang (or the Nationalist Party) and solicited the support of members of the Chinese Communist Party to unify China. The well-known Huangpo Military Academy was established with Chiang Kai-shek as its President and Zhou Enlai of the Communist Party serving as director of the political department. In 1925 Sun died. Soon afterwards, Chiang led a northern military expedition, eventually reaching Beijing in 1928. China was nominally unified under Chiang, but his control of China was weak and Japan soon took over Manchuria, the northeastern provinces of China. During the northern expedition Chiang fell out with the Communists and had many of them killed in Shanghai. He accepted the surrender of a number of warlords in exchange for their retaining political and military power in their territories as officials under his government. Chiang's remaining task was to extinguish the Communists. He pursued them through several thousand miles in 1933 until they finally escaped to and settled in the city of Yanan. The escape is known as the Long March. Only 2,000 of the original over 10,000 Communists survived.

In 1930, Japan began to invade China, starting by taking over Manchuria and establishing Manchukuo under its control. Many Chinese people wanted to fight the Japanese, but Chiang thought that the Communists were the worse enemy. He wanted to annihilate the Communists first before fighting the Japanese. In 1934, one of his generals captured him while he was in Xian and forced him to make peace with the Communists and fight the Japanese together. The Sino-Japanese War officially began in 1937. The Japanese rapidly took over much of the coastal area of China, while the Chiang government was moved to the wartime capital of Chungking, now called Chongqing. The Second World War started in Asia as Japan attacked Pearl Harbor in December 1941, only to be defeated in August 1945. Chiang was the war hero and the Chinese people rejoiced in the victory.

In the first half of the twentieth century, while China was going through revolutions, political instability, and wars, the economy continued to function and develop. It was essentially a market economy as it had been since at least the Han dynasty. Most of the national output consisted of agricultural products produced by family farms, and the majority of the population were peasants. An excellent study of the Chinese farm economy by a professor at the University of Nanking, John L. Buck (1930), is based on surveying 2,866 farms in 17 localities of China in the 1920s, including a total farm area of 21,000 acres and a rural population of approximately 17,000 persons. It provides information on the economics of the farm business, including capital investment, receipts, expenses and profits, farm ownership and tenancy, labor cost and efficiency, demographic characteristics of farm families, food consumption, and the standard of living. According to Buck, writing in 1930:

... farm land is generally worked by owners, although approximately one-fifth is farmed by tenants and another one-fifth by part owners The production from the farm business in China and in the United States is remarkably equal in quantity per unit of land In the United States the chief means has been the use of capital as well as labor; in China it has been the use of labor, for the most part human labor, and with very little capital The Chinese farmer has by the trial and error method arrived at many sound and practicable conclusions for his situation. His crops are often suited to the soil, and his cropping systems follow the general principle of rotation remarkably well The small size of business and the crowded population led necessarily to a standard of living that is low when compared to the standard of the western farmer Diet, while remarkable in containing many of the elements needed for health and strength, lacks variety mainly in fruits and vegetables, particularly in North China. The direct utilization of grains and to a certain extent of soybeans, however, is probably a more economical procedure than the western way of using so much food largely through animals. (Buck 1930: 423–5)

Along with agriculture, handicraft industry and trade were parts of the traditional Chinese market economy. After the Western impact, modern industries and financial institutions began to emerge. Factories producing consumer goods such as textiles, wool and leather products, toys, tobacco and paper products were operating by 1920, if not before, especially in Shanghai, Tianjin, and other coastal cities. The governments in power did succeed in building infrastructure to some extent, including railroads, highways, and seaports. Telephone lines and a telegraph network were built. Electric power supplies became available in major cities. In addition to the old-fashioned banks, new commercial banks were established and functioned as modern banks in taking deposits and extending loans for business working capital and investment. By 1920, the Bank of China and the Bank of Communications were the two largest banks that issued currency, while numerous commercial banks existed in various cities. There was a stock market in Shanghai trading actively in the 1930s. Private life insurance companies were operating. The education system improved, through government effort and private initiative, with help from foreign friends, including missionaries. Private universities coexisted with state universities sponsored by the central government and provincial governments.

A bird's-eye view of the Chinese economy can be found in the estimates of gross domestic product in 1933 and 1952 by industrial origin in table 1.1.

What lessons can be learned from briefly reviewing the history of the first three decades of the Republic of China? First, in spite of political instability, economic activities carried on and economic development took place between 1911 and 1937. Modern economic institutions evolved naturally in a market economy. The resourcefulness of the Chinese people and their desire and energy to make a better living were sufficient to improve the economy once they were given some freedom and the opportunity to do so. In short, modernization was taking place. China had a market economy that functioned well, although it was still a poor country except for some coastal cities. Economic progress would have been more rapid if there had been internal political stability and no war with Japan. Some observers have remarked that Japan attacked China in 1937 because it was witnessing the progress made in the latter and could not wait any longer. This explains why China was capable of returning to a market economy after economic reform started in 1978 and why, once the Chinese people were given some economic freedom, economic development has been so

Table 1.1 Chinese domestic product by origin, in constant 1933 and 1952 prices

Sector	Net value added in			
	(1933 yuan billions)		(1952 yuan billions)	
	1933	1952	1933	1952
1. Agriculture	18.76	18.39	33.86	34.19
2. Factories	0.64	1.09	3.33	6.45
a. Producer goods	0.16	0.46	0.84	3.15
b. Consumer goods	0.47	0.63	2.48	3.30
3. Handicrafts	2.04	2.14	4.41	4.72
a. Identified portion	1.24	0.66	2.67	1.45
b. Others	0.80	1.48	1.74	3.26
4. Mining	0.21	0.63	0.50	1.47
5. Utilities	0.13	0.31	0.14	0.31
6. Construction	0.34	0.60	1.03	1.83
7. Modern transportation and communications	0.43	0.83	1.09	2.10
8. Old-fashioned transportation	1.20	1.20	2.61	2.65
9. Trade	2.71	2.88	8.19	9.66
a. Trading stores and restaurants	1.75	1.97	6.12	7.66
b. Peddlers	0.96	0.91	2.07	2.00
10. Government administration	0.82	1.84	1.43	3.27
11. Finance	0.21	0.80	0.35	1.31
12. Personal services	0.34	0.34	0.55	0.55
13. Residential rents	1.03	1.17	2.00	2.28
14. Work brigades		0.28		0.62
Net domestic product	28.86	32.50	59.49	71.41
Depreciation	1.02	1.33	2.19	3.26
Gross domestic product	29.88	33.83	61.68	74.67

Source: *T. C. Liu and K. C. Yeh, The Economy of the Chinese Mainland, vol. 1. Santa Monica, CA: Rand Corporation, 1963, table 8.*

rapid since 1978. In some respects, including the institutional structure and functioning of the commercial banks and of many industrial enterprises, the current state has not yet reached the high point achieved in the 1930s because it is difficult to abolish the economic institutions and change bureaucratic behavior established under central planning.

A second lesson to learn from studying the events of the first half of the twentieth century in China is the difficulty of establishing democratic institutions there. Sun Yatsen hoped to establish the Republic of China based on the “three principles of the people,” including nationalism, democracy, and the people’s welfare. He was inspired by

the three “peoples” – of the people, for the people, and by the people – in Lincoln’s Gettysburg Address. The Republic of China in those years had a parliamentary system with upper and lower houses, although the representatives were selected by provincial and local governments and were not publicly elected. Even such a parliamentary system was not functioning when the presidency changed hands frequently depending on the results of power struggles among political and military leaders. Different parts of China were controlled by different leaders and they did not agree on the person to serve as the president.

Before 1911, China had been ruled by an emperor. The people by tradition respected his authority. They had no idea how to select a leader for the country. Neither had they the desire to do so. If events turned out to be unfavorable, the majority would resign themselves to the situation and merely pray for things to get better. On rare occasions, a small group would rise up to take control and establish a new dynasty. It was under such a tradition that Sun and others wished to establish a democratic republic. Their lack of experience in exercising the responsibilities of a democracy should not be construed to mean that the Chinese people did not treasure freedom, including freedom to choose their work, their residence, and their family size; to associate; and to express themselves. In fact they largely had such freedoms throughout Chinese history, but having freedoms and having a democratic government are not the same thing. The Chinese were not familiar with modern democratic institutions. Looking back, historians can question whether attempting to establish a democratic republic was the best course for China in 1911. Other alternatives included promoting reform in the Qing dynasty and establishing a new dynasty with a Han emperor and a parliamentary system. Today, China’s political structure is expected to change, to keep up with its economic structure. Historical tradition will play an important role in shaping the form that the future government will take.

Third, by examining Chinese history before 1949, we realize how difficult it was for Mao Zedong to unify the country and why he received so much credit in China for having done so. Unification was important for establishing social order and to enable the government to direct the modernization of China – serious mistakes in government policies before 1978 notwithstanding. Unification makes China strong among nations and restores the pride of the Chinese people. Nationalism is a very important force in guiding China’s policies for political and economic development at present, and it will remain so in the future.

Soon after the end of the Second World War in 1945, the Chiang Kai-shek government became unpopular. Government officials who were with Chiang in the wartime capital of Chungking (Chongqing) came back to the coastal area to take over the government of these territories. Having suffered through the war, many abused their power and extracted money from the people in the process of regaining control from the Japanese. Chiang failed to discipline them. Civil war with the Communists started and the government financed the war essentially by printing more money, as it did not yet have a sound tax base. That led to inflation, and inflation was unpopular. As the civil war intensified, the government printed even more money. The inflation rate increased accordingly. Hyperinflation occurred in 1948–9. The government introduced a policy to force people to surrender their gold, foreign currency, and precious metal holdings in exchange for paper money that soon became

almost worthless. This policy created more resentment. People failing to obey were caught and executed in public in Shanghai. Government popularity hit an all-time low in early 1949. The Chiang government finally fell and moved to Taiwan, and the People's Republic of China was established on October 1, 1949. Mao declared in Tiananmen Square that the Chinese people had finally risen! In view of the confusion, chaos, and humiliation suffered by the Chinese people since the Opium War of 1840, the majority truly rejoiced with Mao as he declared the establishment of the People's Republic of China. However, many were skeptical of the ideology and tactics of the new government.

1.4 Summary of Historical Lessons

In this brief review of very selective historical events, I hope to draw the following lessons relevant for understanding the present-day Chinese economy.

First, human capital embedded in the people through cultural tradition is an important factor for the functioning of the economy and for economic development. The Chinese cultural tradition dates back at least to the Shang dynasty some 4,000 years ago. There is evidence of skilled labor in the many Shang dynasty art objects displayed in museums.

Second, the particular characteristics of a culture affect economic behavior, as exemplified by the tradition of Confucianism that originated in the late Zhou period about 2,500 years ago. The ethics of hard work, respect for scholarship, honesty and trustworthiness in human relationships, emphasis on family and social order, and the high value attached to the common good as compared with individual rights, all have effects on the economic behavior of individuals and institutions.

Third, the character and behavior of one political leader can have a great influence on the economic life of the Chinese people, as demonstrated by the great influence of the emperor Qin in 200 BC. Recent examples are Mao Zedong and Deng Xiaoping, to whom we shall return later in this book.

Fourth, China has long had a market economy, the operation of which was well understood and well articulated by the great historian Sima Qian in the Han dynasty some 2,000 years ago.

Fifth, foreign trade is an important component of economic activity and was practiced by the Chinese years ago. It flourished in the Tang dynasty, as evidenced by the Silk Route. Its importance to China today will be discussed in chapter 17 below.

Sixth, China had a fairly mature form of capitalism in the Song dynasty some thousand years ago, but did not have advanced technology. Economists can speculate on the reasons for China not developing economically useful technology when knowledge of mathematics and science was available. The importance of technology for economic development should be emphasized.

Seventh, the Yuan dynasty was ruled by Mongolians and had more territory than any other Chinese dynasty. Whether China has a desire to expand its territory today is an interesting question. In answering this question, an economist will consider not only China's past behavior but also the costs and benefits of expansionism.

Eighth, exploration across the seas was a stimulus for economic development not only in European history but also in the Ming period in China. The migration of Chinese to Taiwan was a result. This is one origin of the PRC government's claim that Taiwan was a part of China, and of its disagreement with the government of the Republic of China in Taiwan on the sovereignty issue. However, economic cooperation has taken place between the two sides of the Taiwan Strait, and investment from Taiwan to the mainland has contributed to the latter's development.

Ninth, the weakness of the Qing dynasty at the crucial time of the expansion of world imperial capitalism explains much of the economic history of China in the last century and a half. Through one military defeat and unequal treaty after another since the Opium War in 1840, the Chinese developed mixed feelings of envy (for the military might) and hostility (because of the aggression) towards foreign imperial powers. This sentiment is still an important factor affecting China's diplomatic and thus political and economic relations with the outside world.

Tenth, the early history of the Republic of China established in 1911 demonstrates at least three points. First, the resourcefulness and energy of the Chinese people were sufficient to develop and maintain the functioning of a market economy even when there was much internal political instability. Second, to establish a democratic republic in China is a difficult task given the cultural tradition of the Chinese people. Like all people, the Chinese treasure freedom, but the majority have not learned how to assume the responsibility of citizenship under a democratic government. Third, national unity was a very important goal and nationalism is an important force behind China's economic and political policies.

1.5 What History Can Reveal about the Chinese Economy

Up to this point we have discussed what we have learned about economics from studying Chinese history. In this section we will discuss what we can learn about the present-day Chinese economy from the study of history. This is a broad subject. Only a list of questions to be learned from history will be listed. Each question can serve as a topic of research for the interested reader.

Seven questions have been raised and discussed in Lin (1992) including:

1. How traditional agriculture and light industry were developed, which have affected these productive activities today.
2. How private ownership of land was developed in the period of the Warring States while farmers had used the land belonging to the kings during the previous Zhou dynasty.
3. How the family system was formed and how family members worked together, which affect the Chinese economy today.
4. How commerce and trade were developed, including international trade. The development of commerce includes different forms of money, the development of industry alongside with the expansion of trade, the relation between rural and urban economies, commercial organizations, forms of communications and finance, government industrial enterprises, and government commercial policy, all of these being relevant today.

5. How the governments throughout history exercised their role in economic activities, including the employment of labor for infrastructure building, such as the Great Wall and the Grand Canal, and the provision of loans to poor farmers in certain periods.
6. How the morality and value systems were formed and how they affect the working attitude and habit of present-day Chinese workers.
7. The system of economic incentives and social welfare that existed in Chinese history.

In addition I would like to raise the following questions for consideration:

1. How the political system of China today is affected by its historical tradition and how the development of democracy is affected by China's history. In the annual report of the Chinese Premier to the National People's Congress, the progress towards a democratic government has been an important topic. Is China ready for democracy? If so, based on China's historical tradition, what form of democracy is most suitable?
2. How the legal system today is affected by historical tradition, including the legal system established in the ROC and practiced to a large extent in Taiwan today. How the legal system introduced since the beginning of economic reform in 1978 affects the traditional use of guanxi in business transactions.
3. Does economic planning practiced before and after economic reform beginning in 1978 have a historical basis, such as the building of the Great Wall and the Grand Canal?
4. How is today's family system affected by China's history, including childbirth, the relation between parents and young children, marriage, and the relation between retired parents and their children.
5. In Lin (1992), historical periods of prosperity and recession were mainly explained by political factors, with good government administration at the beginning of a new dynasty, but we need to consider economic factors, including the effect of government policies such as taxation policy on national output.
6. What were the state enterprises in Chinese history?
7. What were the banking and financial institutions? How were private enterprises encouraged or discouraged?
8. Were there historical precedents to the present-day emphasis on getting rich and being wealthy?

We can understand the present-day Chinese economy better by considering these questions in terms of China's historical tradition.

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Questions

- 1 It is said that human capital is more important than physical capital for economic development. Give a meaningful interpretation of this statement. Provide an illustration with reference to a particular economy.
- 2 Is Confucianism a positive or negative factor in China's economic development? Explain your answer.
- 3 It is sometimes said that China is ruled by men and not by law. Give examples of two Chinese rulers to illustrate this statement.
- 4 Using the language of modern economics, rewrite the paragraph from Sima quoted in section 1.2.4.
- 5 What was the volume of foreign trade as a percentage of China's gross domestic product in 1978? In the most recent year? The answer can be found in the *China Statistical Yearbook*.
- 6 China is said to have had a capitalist economy in the Song dynasty. How would you define a capitalist economy? What historical evidence should be found in order to support or refute this statement?
- 7 What is the level of military expenditure in China as a fraction of GDP? What is the level in the United States? How would an economist determine what the right amount is?
- 8 What were the economic gains from the overseas exploration occurring in the Ming dynasty?
- 9 In the later parts of the Qing dynasty, China was in need of political changes for the purposes of modernization. Name three alternative courses that China could have taken. Which one was taken? Which one would you prefer and why?
- 10 Why was it difficult for China to adopt a democratic form of government in the first half of the twentieth century? Are the difficulties today more or less serious, and why?

- 11 Describe the Chinese economy in the 1930s briefly, in terms of its various productive sectors and their relative importance. What modern economic institutions existed?
- 12 What lessons can one learn from studying the history of China from 1911 to 1949 for the purposes of understanding the current economy?
- 13 Name three questions concerning the Chinese economy today and explain what kind of historical facts that you need to find in order to understand each.
- 14 Choose one question from 13 and find some historical facts to understand it.
- 15 Write an essay to answer one of the questions stated in section 1.5.