

Harvard on China Podcast, China's Great Gamble, with Barry Naughton

James Evans: Welcome to the Harvard on China podcast. I'm James Evans at the Fairbank Center for Chinese Studies. Today, I'm talking to the esteemed economist Barry Naughton about President Xi Jinping's consolidation of power, China's push to become a global technology leader, and what Naughton calls China's great gamble.

Professor Naughton is the So Kwanlok Chair of Chinese International Affairs at the University of California, San Diego. Most recently, he's published an updated 2018 version of the authoritative textbook *The Chinese Economy: Transitions and Growth* from The MIT Press, which is also now available in Chinese.

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Barry Naughton, welcome to the Harvard on China podcast.

Barry Naughton: Thanks. It's great to be here.

James Evans: Your talk at the Fairbank Center this week is called China's Great Gamble. So what is it? What is China's great gamble?

Barry Naughton: Well, the great gamble is the enormous effort that China is taking right now to invest in high technology, invest in infrastructure, invest in urban reconstruction, all these things taking place in order to prevent the economy from slowing down and hoping to essentially skip a stage and launch China directly into a modern economy.

James Evans: If China's gamble is about trying to continue growth, and we've seen anything from 10% to 6% growth over the last 10, 20 years. We have a professor here at MIT, Yasheng Huang, and he describes China's economic growth as currently coming from investment and labor rather than, say, productivity. But he also says that the investment as a percentage of GDP is incredibly high already, the labor force is not expanding as much, China is having more of an aging population, for example, and so China's future growth will necessarily have to come from increased productivity, whether that's technology advancements or a degree of political reform that allows for more open economy. Do you agree with that assessment?

Barry Naughton: Yes, I think that's basically right. What I would add to that is to say that when we look backwards at this incredible 30 years of miraculous growth, we see that all of the factors were in line to produce this very high-speed growth. And from about 2010, these factors have essentially disappeared. Labor force growth has slowed to zero. Migration from the countryside to the cities has slowed to almost zero. Traditional industrialization in terms of steel and cement and

household appliances has slowed way down. Many of the simple forces that produce growth are coming to an end.

Now, we've seen that before. We've seen it in Japan. We've seen it in Korea. We've seen it in other growth miracles. Most of those countries accepted that when the slower growth period came, the government would step back and allow an increasingly middle-income society to make its own choices. China has done exactly the opposite. Rather than stepping back, they've stepped up and said, "Actually, we're going to invest more in these kind of transformative technologies, more in infrastructure construction, more in a whole range of things," even though the investment rate is already very, very high.

What people, I think, haven't fully taken account of yet is that the overall magnitude of this effort really is unprecedented in history. What they're trying to do is quite remarkable. It's quite unusual, because it means a middle-income country leaping to the global frontier in lots of technological areas. In some of these areas, China will do just fine, but in many others it might be a leap too far. Also, there are a whole range of macroeconomic and institutional risks associated with this effort. I think this is something we're just beginning to come to terms with.

James Evans: You just mentioned about the state even expanding its rate of investment. Does that mean that we'll start to see the state crowding the market out even more in the near future?

Barry Naughton: Well, it's hard to say. I would say at this point, no, because essentially so much money is available for many of these newly emerging sectors that right now there's plenty of room for both state actor and private actors. In fact, the private actors right now feel extremely enthusiastic. After all, there's a lot of technological excitement and there's a lot of government subsidy money available.

There's a kind of a bubble going on in areas like artificial intelligence and networking and robotics. It's a great field to be in, but that means that there's excess entry being induced. There are lots of companies that are starting up that are actually never going to succeed. There's a real danger that if this surge of activity is not managed well, that it'll end up creating significantly negative reactions in the Chinese economy.

James Evans: One thing you mentioned, as well, was about the slowdown of industries like steel, more traditional heavy industry. In the news in the last few weeks has been President Trump's announcement of trade tariffs on things like Chinese steel. If steel is a declining industry in China, does that mean that not only are these tariffs probably poor economics, but they'll hurt China even less than was originally intended because of the slowdown in that industry?

Barry Naughton: I think that's certainly true for the steel tariffs. No question about that. The question, certainly, the Chinese are trying to grapple with, but to a certain extent Americans as well, the American stock market, is what is the Trump administration trying to get from China? Nobody can really get a consistent story.

I think that the Chinese policymakers like Liu He, who's the single most influential voice, would be quite willing to deal in some sense with the Trump administration, not so much because they agree with Trump's goals, but because for them it's much more important to maintain this dramatic technological transformation, and if in order to smooth relations with the United States to have to reduce exports of steel or running shoes or things like that, then it certainly will contemplate that. They have a long-term game plan, and they're just trying to figure out, I think, at this point what the Trump administration is trying to do.

James Evans: Actually, it's interesting that you talk about the long term. A number of people's observations of China is, as an autocratic state, it is necessarily looking at the long term to a far greater degree than, say, the United States is as a democracy. Do you think of it as apparent?

Barry Naughton: Well, I'm not sure I would make it into a rule of the differences between autocracies and democracies, although it certainly seems like that from today's news. Certainly, Xi Jinping is an unusual character in that he has a set of long-range objectives that he is really clearly very much committed to, and that are clearly tied up with his individual prestige and what he considers Chinese prestige to be.

I was just in Beijing the last couple of weeks, and the news coming out of the National People's Congress was quite sharp. Of course, everybody knows about the elimination of the term limits for Xi as president, but the other thing that was quite surprising was the degree to which the government and party reorganization is clearly designed to make an autocratic system more efficient. It creates these functional channels for commands to go from the leader down to the different departments. You see a system that is adapting itself to this very clear set of long-range objectives, and I think that's very unusual and somewhat troubling. We also see a set of changes in the state-owned enterprise and financial system that can also be interpreted as ways to allow the market to function, but more importantly, to allow these transformative impulses to be sent from the government through to these different market actors.

James Evans: I guess, for many people, state-owned enterprises is really a key indicator of the Chinese economy, and there's been calls for their reform really for quite some time. Do you think that this is going to be something to keep your eyes on in the near future?

Barry Naughton: I think it's very important to keep our eyes on it. It's also important to maybe step away from the idea of reform because, of course, when we talk about reform, especially economic reform, we typically think in terms of changes that cause the government to step back and allow market forces stronger play. I think what we're seeing right now with Chinese state enterprises is a very contradictory set of policies that, on the one hand, give them more freedom, especially financial freedom, but on the other hand, increase party control very dramatically, and also give state enterprises targets that are unrelated to just economic efficiency. In other words, they have to absorb new technologies, they have to become technology leaders, they have to contribute in some cases to the anti-poverty drive. They're being asked to do more things. They're being asked to be instruments of the party and the government.

I think from a reform perspective, it is very contradictory. You can't really call them reforms, but they're very important changes that we need to keep our eyes on. One of the aspects of it that is especially important is that state firms are increasingly setting up state funds, state-funded venture capital funds called industrial guidance funds. These are large, they're growing rapidly, and they have a very direct impact on the interactions between China and the United States, because these funds are expected to invest in and develop precisely those high-tech sectors where frictions are increasing between the two countries.

James Evans: It's almost like a sovereign wealth fund, but for a province.

Barry Naughton: I guess the one reason I wouldn't like to analogize it to a sovereign wealth fund is that sovereign wealth funds have a pretty clear single objective, which is to maintain high returns in order that you can pay for future wealth, and not always, but often also future pension funds.

These funds, that is not their objective. Their primary objective is to develop a new high-tech industry. We actually don't know enough about the incentives that are given to the people who run the funds, but we know from various hints and partial information that they are not being instructed to maximize return, as a sovereign wealth fund would. They are being instructed to maximize their contribution to the national goal of developing these high-tech sectors.

James Evans: Speaking of contradictions, there are two approaches to contemporary Chinese elite politics. One is that of Alice Miller, who argues that we're seeing a continued institutionalization of processes, and the other is that of Joseph Fewsmith, who broadly argues that elite politics is more about personal power. Indeed, many people will see Xi's end of term limits as an example of that. Is this a genuine dichotomy?

Barry Naughton: Well, I've always been a great admirer of Alice Miller's work. I think in the first Xi term, Alice Miller really pointed out very astutely the ways in which Xi Jinping used the existing institutional arrangements, shaped them and twisted them to

his personal power. I think that helped slow us down a little bit, because in other respects it was so obvious that Xi was becoming the most powerful leader by far over the past decades.

Now, I personally think that since the National People's Congress in the last couple of weeks, we've now passed that stage, because Xi has clearly introduced institutional changes that break with what's happened before. The two that I would point to are the leadership small groups that Alice Miller pointed out have been a traditional component of the administrative system have now been made into commissions and have become fully formal channels for actually making and carrying out decisions. Well, that's a clear break.

The other very striking change was that Politburo members are now supposed to report formally to Xi Jinping, which means there is no pretense of equality between Xi Jinping and other Standing Committee of the Politburo members, so we're definitely in new territory here. I think probably Alice Miller would acknowledge that, while still putting emphasis on the continuing importance of knowing, understanding, and manipulating these institutions for getting things done.

James Evans: Perhaps she might argue that those institutionalizations in some ways might constrain further decision-making.

Barry Naughton: I suppose that's right. I guess it seems to me that for right now, unless there's some kind of change that affects the ability of people who are uncomfortable with Xi's power to coordinate and oppose it, absent that, it's hard to see any obstacles to Xi Jinping's power whatsoever.

James Evans: Here at Harvard, certainly, and I'm sure at a number of other universities, you're probably best known to a number of our students as the author of the textbook *The Chinese Economy: Transitions and Growth*, where you argue that China is still in the process of being both in an incomplete transition from socialism to a market economy and in the midst of a prolonged process of industrialization. To pivot slightly away from Xi Jinping himself and more towards the Chinese economy, to what extent do you think that China is still in some way a socialist and pre-industrialized economy?

Barry Naughton: Well, that's a great question. Of course, it goes back to the beginning of our conversation. The first of these changes, the structural transformation, I think really has basically been completed. Of course, economies always continue to go through structural change, and there's further transition towards a service-oriented economy, but the industrialization has basically been completed. The framework of these two transformations, I think, is still a valid one, but it no longer makes sense, as it did a decade ago, to think of them as two transformations that are both halfway done and still in process.

Actually, I have revised that book, and the new version, the revised edition, is called *The Chinese Economy: Adaptation and Growth*. That especially looks to the systemic transformation, because a decade ago it made sense to think of the systemic transformation as basically being in a direction of a mixed market economy. Of course, there were Chinese special characteristics, but still most of the adaptations were in a direction that was familiar to us.

Well, in the last decade, that's become a lot less true. First of all, the system change has slowed down, and also the nature of the changes have been less clearly in the direction of a mixed market economy. As I say, a lot of the changes can be understood as also allowing the government to steer more effectively. Even though structural change and system reform are still very much with us, neither of them is as simple as they were a decade ago, so I had to produce a new edition, and hopefully that will be of some use to students here and elsewhere.

James Evans: Teachers of the Chinese economy, watch out, there is a new book on the market.

Barry Naughton: And you should all rush out and buy it today.

James Evans: Another theme that runs through a lot of your research is a focus not just on China's macroeconomic setup, but also on the economic differences between a number of provinces within China, and even between rural areas or urban areas, or first-tier cities, second-tier cities, and how a lot of these provinces are very much impacted today by historical investments or historical economic growth. We've just done a podcast, for example, with Ling Zhang of Boston College, who talks about the difference in provincial growth rates in the Tang-Song transition between North China and South China.

Barry Naughton: Fantastic.

James Evans: Are these vast provincial differences still the case, or are we starting to see more convergence of growth patterns across provinces?

Barry Naughton: Well, certainly in the last decade, we've seen more convergence. One of the uncertain questions is, to what extent is that really market driven and to what extent is that the cumulative result of many different smaller policies that tend to disadvantage the coastal areas and privilege the inland areas? One, for instance, that people often don't think about is it's much easier to convert agricultural land city or industrial land in the interior than it is in the coastal area. There are a whole set of changes like that that are hidden policy driven.

Now we're seeing a new wave of urban transformation that's going on that's most obvious, of course, in Beijing, where we're going to see a whole new city being built. We already see in Beijing these telltale signs of a less friendly attitude toward commercial activity. Of course, there was the expulsion of some

of the migrant workers that took place in the last couple of months of 2017. There are also things like this.

This worries me quite a bit. It worries me both because, as an economist, I think these are valuable activities, and also because, as a part-time student of urbanization, it seems to me that urban fabrics that are more diverse and lively and complex are often associated with more successful cities. I'm very worried that the policies toward Beijing and towards Xiong'an district will end up restricting the growth of the vibrant Beijing that I think many of us have come to know and, in a way, love over the past few years.

James Evans: A question I have actually from a conference that I attended a couple of months ago was from a Turkish academic who is studying how China can be a model for Turkey's growth. Do you think there are models or there are lessons that China can give to other developing countries so that they can have a similar mode of growth, or is China very much a sui generis case?

Barry Naughton: There must be models, but I'm very skeptical of the idea that there is a China model that can be copied. The political system in China is so distinctive. It's a communist party autocracy that still builds in certain kinds of flexibility and consultation. To try and create something like that from the ground up would be, I'd say, impossible. But certainly there will be some aspects of China's developmental experience that could be useful for Turkey or Iran, or India for that matter, and maybe even for the United States and Germany.

James Evans: We have a new segment that we're introducing to our podcast that we're calling the Field Trip, and a Field Trip is a literal trip through your field to give you a chance to tell us what are some of the biggest changes that you've seen in the development of whichever field you happen to be in, as well as if there is a future direction of your field or a future area of research that you think is particularly exciting or undertapped.

Barry Naughton: Well, that's a great question, a very tough question. I think, if I consider my field very broadly to be the Chinese economy and the relations, in particular, between industry and government, I think it's an immensely exciting time. There's a whole group of new Chinese scholars. There's lots of data about individual enterprises. There's a huge range of ideas that can be tested from industrial organization and old ideas about industrial policy and what kind of industrial policies work or don't. In that sense, I think it's very flourishing.

Then at the same time, some of the new institutions that are being introduced right now, we really haven't had a chance to study at all. We know almost nothing about, for instance, these industrial-sector guidance funds that I was describing earlier, where government money is going in, but people are being incentivized to invest and grow their investments. We don't know yet what the incentive contracts look like and how these programs are going to develop. I think there's a huge amount to do.

- James Evans: Budding PhD students, listen up.
- Barry Naughton: Absolutely.
- James Evans: To finish off, we have a quick fire round that we do with all of our speakers here. The premise is mainly just to get our listeners to know a bit more about you as a person. A lot of people know these professors for their research and books, and it's to give them a bit more of an understanding about your background in China. It's called the Fairbank Five, and our first question is your favorite Chinese food.
- Barry Naughton: I've really been enjoying lately there's these little stews, maybe because I came to them late in life. For 15 kuai in Beijing, you can get a little bowl of beef ribs and green beans in this rich stew. It's not what I think of as Chinese food, but I love it. It's delicious.
- James Evans: Our second question is your favorite place in China.
- Barry Naughton: That's a tough one. I can't really answer because I've been in Beijing so much more than other places the last decade or so. I do love Beijing, it's a fantastic city, but I can't say it's better than other places.
- James Evans: Agree. Your favorite Chengyu or your favorite saying in Chinese?
- Barry Naughton: Wu ji bi fan: Maybe we have reached one extreme now; maybe we'll swing back to the other direction.
- James Evans: That's a good one. A book that you've read recently on China that you would recommend to our listeners?
- Barry Naughton: I just read a fantastic book by my colleague in the history department at UC San Diego about the melons that were presented to the founder of the Ming dynasty, Zhu Yuanzhang, where she takes this and looks at it from the different historical records and how it meant different things to people who were observing at the time. I thought it was exemplary of the historian's craft.
- James Evans: Oh, great. And very appropriate, as this month at the Fairbank Center we're currently celebrating Ming Madness.
- Barry Naughton: Very good. I had no idea it was Ming Madness month.
- James Evans: Then our final question is a class that you either took or have taught on China that changed your thinking about the country in some way.
- Barry Naughton: That's easy. When I was an undergraduate, I took Steve Harrell's class at the University of Washington on Chinese society. It was such an interesting class



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that it just made me feel that the study of China was rich and worth undertaking.

James Evans: Well, Professor Barry Naughton, thank you so much for being with us here today.

Barry Naughton: My pleasure.

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