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How decentralisation helped China and Vietnam grow

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AHMAD AHSAN

The Chinese Communist Party held its 20th National Congress on October 16-22. Nearly 2,300 delegates met at a crucial time when China is at a crossroads. Which path will China take? To continue on the "reforms and opening up" path taken in 1978 under Deng Xiaoping, underpinned by markets and the private sector? Or return to a more party and state-dominated strategy that pushes back markets?

The achievements of pro-market reforms over the past four decades have been stupendous – albeit accompanied by rising inequality. China's economy grew by more than 10 percent annually for more than three decades, lifting more than 700 million people out of extreme poverty. The economy was transformed from a rural and agricultural one to an urban, manufacturing powerhouse. Almost 883 million people or 62 percent of the population now live in cities, compared to 190 million or 19 percent in 1980. A 500-million-strong middle class has emerged, and incomes in the coastal cities are comparable to advanced economies. With around 250 million college graduates, China uses cutting-edge technology in many fields.

The achievements of similar reforms in Vietnam have also been spectacular. The per capita income has increased more than nine times in the last 30 years – thrice that of Bangladesh. At present, Vietnam is one of the most competitive economies in the world, with exports of over USD 300 billion of diversified products – from agro-processing to textiles to electronics. Vietnam's school students perform exceptionally well in international student assessments.

How did these two countries make such progress? Despite a vast literature on this topic, there is widespread misperception that monolithic, centralised rule enabled such progress.

The different reality is that economic reforms and progress of these countries happened because of institutions that provided three ingredients of effective governance: i) vigorous debates and the competition of ideas in decision-making; ii) significant power-sharing across different tiers of government; and iii) these two factors and term limits enabled political competition.

Decision-making in China and Vietnam in the last 40 years happened based on robust critical debates over ideas, opinions, and even facts. Leaders were not reticent about airing their differences. The much-respected current Chinese premier, Li Keqiang, an economist, was famously known to be sceptical about China's GDP growth numbers. He used railway cargo volume, electricity consumption, and loans disbursed by banks to measure trends in economic activity. *The Economist* magazine later termed it the Li Keqiang index.

Another example of critical thinking I witnessed was when a highly regarded, just-retired minister gave a talk on Vietnam's performance in Washington. Lo and behold, he angrily complained that there was too much praise of Vietnam that overlooked its challenges and problems – which he went on to list.

Both these countries are among the most fiscally decentralised in the world. Subnational governments – in provinces, prefectures, and counties – spend 55-70 percent of all government expenditures, including public investment. Local governments vigorously compete to attract domestic and foreign investment, and help their workers find employment in the more affluent provinces and abroad (in Vietnam's case).

Because they compete, they tend to be experimental and innovative and lead the reforms that have enabled these countries' spectacular success. Let me share some anecdotes. In 2011, at an official dinner in Washington, officials from China's finance ministry explained to me that reforms in China were rarely planned from the beginning as national policies. Instead, reforms started with trial-and-error experiments by some county or provincial governments. Based on the experiment's success, the word spread, and new policies spread spontaneously to other provinces and ultimately adopted by the country.

Let's turn to history. As is now legend, China's reforms were launched when local party officials of Xiaogang village in the then-impoverished Anhui province decided to experiment. They gave 18 farming households the right to cultivate plots of land on their own and sell their produce after they had met their supply quotas. The news of this successful experiment spread and another province, Sichuan, carried out a similar experiment. In 1979, Deng Xiaoping, China's reform leader, directed other provincial leaders to follow the system. Production boomed. In five years, 24 million households participated in it. Farmers' incomes tripled.

Local governments compete hard to raise agricultural productivity, attract manufacturing investment, and provide jobs for their constituents. As economist Stephen Cheung has written, China's "industrial heartlands of the Pearl and Yangtze deltas reveal the cut-throat competition between localities for business. Local governments compete for capital investment and local officials attend conferences all over China and even abroad to solicit this investment."

In Vietnam, similarly, it was local governments that led reforms through "fence-breaking" experiments, sometimes carried out without Hanoi's approval. In the beginning, commune leaders in the north's Haiphong province secretly gave land to farmers on lease to cultivate on their own, using a "sneak contract" that set procurement prices higher than authorised by the national plan. Production increased by six times. Later, the whole province and the whole country adopted these practices. Ho Chi Minh City (HCMC) ultimately became the "reform leader," carrying out bold market reform experiments. During the 1990s, HCMC and a few other cities, such as the now prosperous Da Nang, were authorised to build infrastructure, negotiate, and approve foreign investment projects.

The historically famous example of political competition in China comes from Deng Xiaoping's famous Southern Tour in 1992. At that time, in the wake of the military crackdown in Tiananmen Square, the Communist Party leadership in Beijing had halted Deng's "Reforms and Opening Up" programme. In response, Deng, then retired, went on a "family vacation" – 17 family members in tow – to the newly emerging economic powerhouses – Shenzhen, Guangzhou, and Shanghai – in the south and convinced their leadership to oppose party leadership in Beijing and reinstate reforms. The rest is history.

One crucial leadership reform introduced in 1982 was the two-term limit for the head of the government; Vietnam also introduced a three-term limit. In 2018, however, the Chinese Communist Party removed term limits. By concurrently holding three of the most important positions in the country, power has also been exceptionally concentrated in party leader Xi Jinping's hands.

Chinese scholars such as Prof Zhang Jun, dean of Fudan University's School of Economics, have recently expressed concern that the new centralisation may dampen innovations by local governments that were responsible for much of China's dynamism.

As it is, for several reasons, the Chinese economy is slowing down and expected to be about three percent or even less this year, lower than the rest of East Asia for the first time in 30 years. Growth is not an abstract number – it employs millions and the stakes are high.

Furthermore, the rules-based international system is now fraying with potentially dangerous implications. Critical discussions, wise counsel and, as necessary, path correction will be needed in all the countries, especially in major powers such as China.

China's and Vietnam's successfully tested collective leadership has provided wise counsel, checks and balances, and what modern parlance calls "executive restraint." That is what enabled their spectacular development in the past four decades. There are vitally important lessons here for all developing countries, including electoral democracies.

(This column draws on a previously published article in PRI's* Policy Insights. *To read the full version of this article, please visit our website.)

Economics Nobel for Central Bankers?

AN OPEN DIALOGUE

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ABDULLAH SHIBLI

The Nobel Prize in Economics this year was awarded to three American economists for their contribution to expounding the role of modern financial institutions, including the central bank, and for providing insights into bank failures and "runs." The three recipients are Ben Bernanke of the Brookings Institution, Douglas Diamond of the University of Chicago, and Philip Dybvig of Washington University in St Louis. Bernanke was chairman of the US Federal Reserve in 2006-2014. The other two are academicians.

The Nobel committee said that their work in the early 1980s "have significantly improved our understanding of the role of banks in the economy, particularly during financial crises. An important finding in their research is why avoiding bank collapses is vital." They added that this was "invaluable" in steering the US (and the global) economic systems during the 2008-09 financial crisis and the coronavirus pandemic downswing in 2020-2021.

A key insight that has shaped policy in the 21st century is that banks are not merely the neutral intermediaries between savers and borrowers, but they offer vital services to the wider economy by gathering information on borrowers and facilitating the transfer of resources from the savers to the investors. Banks are also entrusted to assess to whom to extend credit and to ensure that projects with high (but risky) long-run returns obtain funding by monitoring borrowers on behalf of lenders.

These days, we take for granted how central banks and the regulatory framework help to steer the economy and the financial institutions during times of crisis. But any student of economic history is aware of how a simple stock market failure brought about a major catastrophe during the Great Depression in 1929-1933.

The seminal work by this year's Nobel laureates took shape at the beginning of the 1980s. Bernanke showed that the financial disruptions of 1929-33 reduced the efficiency of the credit allocation process, and that the resulting higher cost and reduced availability of credit acted to depress aggregate demand, thus leading to the unusual length and depth of the Great Depression. The takeaway was that bank failures can propagate a financial crisis rather than simply be a result of the crisis. These findings informed the decisions of the Federal Reserve, led by the then Fed chair Bernanke to steer the US financial system, and markets everywhere else, and avoid a meltdown in the aftermath of the bankruptcy of Lehman Brothers that occurred on September 15, 2008.

Dybvig and Diamond developed theoretical models that explain why banks exist, how their role in society makes them vulnerable to rumours about their impending collapse, and how society can lessen this vulnerability. These insights form the foundation of modern bank regulation and the ecosystem in which a country's central bank plays a pivotal role in shepherding financial institutions, and particularly so with the advent of digital space.

Another area of concern for the Nobel trio has been bank failures that create problems for the rest of the economy, which is often compounded by "run" on any bank. A bank run is a situation when a large number of its clients withdraw their money all at once. In a modern banking system, known as a fractional cash reserve system, a bank run may occur over concerns regarding the bank's solvency.

Fractional reserve banking entails a bank keeping only a portion of the money deposited on the premises. If depositors expect the bank to fail, the ensuing panic can become self-fulfilling. When numerous consumers withdraw their funds simultaneously, it leads to a significant cash shortage and stops financial institutions from providing loans to borrowers. In the worst case, a bank is pushed into insolvency and becomes bankrupt. An example could be the crisis faced by the Padma Bank, formerly known as The Farmers Bank, in Bangladesh.

Bank runs are a common feature of the extreme crises that have played a prominent role in monetary history. The research that followed in the 1980s helped to show how better regulations can reduce the risks, and how state intervention can restore stability – albeit at a considerable cost to taxpayers. In this context, the example of People's Leasing and Financial Services, managed by PK Halder, illustrates the risk embedded in unregulated financial service companies that embezzle money after exploiting the trust of the average depositor.

Well, the prize announcement did not go down well with everyone. David R Henderson of the Hoover Institution of Stanford University mocked the award committee in a *Wall Street Journal* op-ed, "The winners hold views on dealing with financial crises that many monetary economists find strange." Prestigious weekly journal *Nature* said, "Economists win the Nobel prize for showing why banks fail... [their] work explained how finance greases the wheels of capitalism – and why the system is inherently unstable."

The role of the central bank has evolved over time. A central bank has one universally accepted role: to maintain a steady supply of money. However, it also acts as a regulator of commercial banks. In Bangladesh, as well as in other countries, the central bank is also entrusted with maintaining the foreign exchange rate. In the US, the Federal Reserve performs five key functions, but the most visible one is to regulate the money supply and conduct the nation's monetary policy to promote maximum employment and stable prices.

Two of the much-dreaded lessons from the Great Depression was that a central bank can play an active role in creating liquidity or curtailing it. It can also prevent runs on the banks. Since the last global financial crisis in 2008-09, we've seen significant structural changes in the banking sector. As a report published by the Bank for International Settlements said, "The crisis revealed substantial weaknesses in the banking system. Technological change, increased non-bank competition and shifts in globalisation are still broader environmental challenges facing the banking system."

VISUAL: STAR

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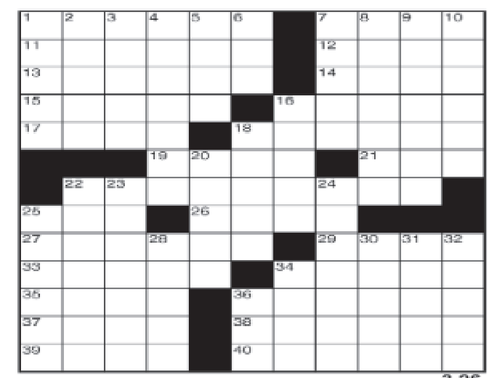

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