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### 17.7 China, a case study

The main difficulty of calculating the dynamic costs of trade restrictions as explained in section 17.6 is the fact that even if you think that the dynamic costs are much more important than the static costs, it is almost impossible to estimate their size. Again, how do you estimate the size of the welfare loss as a result of goods and services that are not introduced using a generally accepted methodology? It is virtually impossible, at least for the moment. Nonetheless, we can provide circumstantial evidence that the dynamic costs are more important than the static costs. My favorite example is the difference in economic development between North Korea and South Korea after the Korean cease fire in 1953. North Korea isolated itself economically from virtually all outside influences, thus not benefiting from the knowledge increases and inventions of new goods and services in the rest of the world. The result was a stagnant, or slowly deteriorating, North Korean economy for more than 5 decades, eventually resulting in large famines. The developments in North Korea contrast sharply with those in South Korea, which aggressively focused on expansion on the world market, using knowledge and capital goods from all over the world, leading to an enormous rise in living standards, see Figure 16.9c. Unfortunately, lack of reliable data on the North Korean economy prevents me from going into further detail here.\(^1\) Instead, we will briefly focus attention on the developments in mainland China.

China is a very large country, with an impressive cultural, economic, and military history, dating back thousands of years. According to recent estimates, there are some 1.2 billion Chinese. While I am typing this, some 6 million Chinese are crossing their huge country to perform a population census and check the accuracy of the 1.2 billion estimate. Since we want to get a feel for the importance of international trade and capital flows and

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\(^1\) Similar examples of neighbors with different openness of economic systems, and corresponding differences in economic development are: East- versus West-Germany, and Thailand versus Myanmar.
openness to the outside world, even for such a large country as China, we will measure economic progress in China relative to the outside world. To this end, Figure 17.9 depicts China's GNP per capita as a percentage of world average GNP per capita.

In 1949 Mao Zedong proclaimed the founding of the People's Republic of China and installed a new political and economic order modeled on the Soviet example. In 1958, Mao broke with the Soviet model and started a new economic program called the *Great Leap Forward*. Its aim was to raise industrial and agricultural production by forming large cooperatives and building "backyard factories". The results of the market disruption and poor planning, leading to the production of unsalable goods, were disastrous. Within a year, starvation appeared even in fertile agricultural areas, resulting in famine from 1960 to 1961. The relationship with the Soviet Union deteriorated sharply, leading to the restriction of the flow of scientific and technological information to China, and the withdrawal of all Soviet personnel in 1960. When compared to the world average, the impact of the Great Leap Forward shows up in Figure 17.9 as a deterioration of China's living standards from an already low 3.44% in 1960 to an even lower 2.14% in 1962 (a relative decline of 38%).

*Figure 17.9 Economic development in China; GNP per capita: China/world average (%)*

Data source: World Bank, World Development Indicators CD-ROM (1999); GLF = Great Leap Forward, CR = Cultural Revolution, Mao = Mao's death, ER = Economic Reform, SP&TS = Student Protest & Tiananmen Square.
In the early 1960s Liu Shaoqi and his protege Deng Xiaoping took over direction of the party and adopted pragmatic economic policies at odds with Mao's revolutionary vision. In 1966, when the Chinese economy almost had recuperated from the consequences of the Great Leap Forward and Chinese per capita GNP had bounced back to 3.00% of the world average, Mao started the Cultural Revolution, a political attack on the pragmatists who were dragging China back toward capitalism. The Red Guards, radical youth organizations, attacked party and state organizations at all levels. Again, Mao's insightful ideas were disastrous to the Chinese standard of living, which dropped to 2.32% of the world average in 1968, see Figure 17.9 (this time 'only' a relative decline in position of 23%). The Chinese political situation stabilized after some years along complex factional lines, stabilizing the Chinese living standards to slightly above 3% of the world average and leading to the reinstatement of Deng Xiaoping in 1975, who was stripped of all official positions only a year later by the Gang of Four (Mao's wife and three associates).

Mao's death in September 1976 set off a scramble for succession, leading to the arrest of the Gang of Four and the reinstatement of Deng Xiaoping in August of 1977. In a pivotal meeting in December 1978 the new leadership adopted Economic Reform policies to expand rural incentives, encourage enterprise autonomy, reduce central planning, open up to international trade flows with the outside world, establish foreign direct investment in China, and pass new legal codes in June of 1979.
The positive consequences of the Economic Reforms for the Chinese standard of living were enormous, dramatically illustrating the dynamic costs of trade restrictions. The policy of openness is illustrated in Figure 17.10 for the net foreign direct investment flows into China as a percentage of GNP. There are no data available prior to 1971, but as illustrated by Figure 17.10 there were no foreign direct investments into China from 1971 to 1979 (we can be sure that this also held for a long period preceding 1971). After the Economic Reforms, foreign direct investments into China rise rapidly to a stagnating level of about 1% of GNP in the period 1988 - 1991, followed by a continued rise to a peak of more than 6% of GNP in 1993 and 1994, and stabilizing at around 5% of GNP thereafter (remember that these are percentages of a rapidly increasing GNP level, see Figures 16.9b and 17.9).

The period of temporary stagnation in 1988-1990 is indicated by the term \textit{Student Protests & Tiananmen Square} in Figures 17.8 and 17.9. At the end of the 1980s party elders feared, in reaction to student demonstrators, that the reform program was leading to social instability and called for greater centralization of economic controls. The political debate culminated in university students in Beijing camping out at Tiananmen Square to protest against those who would slow reform. Martial law was declared and
military force was used against the protesters, leading to hundreds of casualties. Eventually, this only temporarily stopped the reform process as younger, reform-minded leaders began their rise to top positions and Deng Xiaoping renewed his push for a market-oriented economy, as sanctioned by the Party Congress in 1992.

The impact of the economic reform program, interrupted temporarily by the events surrounding Tiananmen Square, is clearly visible in Figure 17.9. As a percentage of the world average, the Chinese standard of living rose from 3.6% in 1979 to 6.9% in 1988, where the increase interrupted for a year, to continue rising to 12.8% in 1997 (a relative increase of 250% in 18 years!). As far as economic prosperity is concerned Deng Xiaoping, who died in 1997, has been extremely important for the Chinese people.