Deng Xiaoping's great transformation.

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I was the last man to receive a Ph.D. in economics from UCLA without having to satisfy a calculus requirement. I earned my credentials by auditing the price theory courses of Armen Alchian and Jack Hirshleifer six times. Since I also wrote my dissertation under their supervision, to borrow a Chinese phase, I was taught by Armen and Jack "inside their chambers.".

In March 1967, Arnold Harberger, then Chairman at Chicago, cabled me at CalState Long Beach that I was awarded their prestigious Postdoctoral Fellowship in Political Economy. The stipend (tax-free) was $8,000 a year. It was an enormous sum at that time. What Al did not know, however, was that I would have gone to Chicago for nothing. A small problem remained: I had only completed one chapter of my dissertation. I called Al, rather timidly explaining that I am not yet a doctor, so could he postpone the offer for a year? The typical Harbergerian reply was that at Chicago everybody was "Miss" or "Mister," and what mattered was not whether I have a Ph.D. Nevertheless I did not want to be a Pre-Doctoral Fellow, and so wound up my dissertation six weeks later.

As postdoctoral fellow one year and assistant professor the next, I regarded myself very much a student at Chicago and seized every opportunity to attend workshops, and audited the classes of Milton Friedman, George Stigler and, of course, Al himself. It was my great fortune to have been befriended, also at Chicago, by other grandmaster economists of the period, notably Ted Schultz, Gale Johnson, Harry Johnson, Hiro Uzawa, Lester Telser, Bob Fogel, Zvi Griliches, Bob Mundell, Harold Demsetz, Aaron Director, and especially closely, Ronald Coase.

Few students have had the opportunity to learn economics at UCLA and Chicago, first at a golden age for one, and then at a golden age for the other. Certainly no other Chinese student came close to having that opportunity. But I was lucky, and so became heir to two endowments: I was brought up during the formative years of the new institutional economics, and I was trained to seek economic explanation in the fundamentals.

Perhaps it was a mistake, but against Al's advice I left Chicago in 1969 and joined the University of Washington at Seattle. This, of course, is not to belittle UW, but Chicago was on a different astral plane. However, I was born on the island of Hong Kong and have a deep attachment to the sea, and so I stayed in Seattle for 13 years.

In summer 1981, Sir John Cowperwaithe, architect of the "Hong Kong System," relayed a message to me: the Chair of Economics at the University of Hong Kong would soon be vacated. At once Ronald Coase urged me to apply. He said that China seemed to be opening up, and that I happened both to know the language and to specialize in a body of knowledge which would fit the situation perfectly. Moreover, in response to an invitation from the Institute of Economic Affairs, I had just completed a monograph entitled Will China Go Capitalist? The book predicted in no uncertain terms that China will go capitalist, gradually adopting a system based on private property rights. Since I let the manuscript go into print against a chorus of disbelieving criticism, it was natural I should be curious whether my prediction would come true, and there was no better position to watch China's developments than in a Chair at the University of Hong Kong.

When Ronald Coase urged that it was my duty in Hong Kong to educate the Chinese people on the functioning of economic systems, he was not aware that I had never published in the language before. I started my Chinese writing adventure in November 1983, twice a week in a Hong Kong newspaper. The aim was to introduce the economics of property rights to laymen. My thirteenth article, published in January 1984, created quite a furore. Entitled "The Deng Dynasty," it was about Teresa Teng, a popular singer in the Taiwan-Hong Kong-Japan circuit, who in Chinese carries the same surname as Deng Xiaoping and the widow of Zhou Enlai.

What happened was that after Deng Xiaoping introduced reforms in 1979, Teresa's popularity soared in the Mainland. Pirated copies of her songs were selling like hot cakes, and to attract even more customers, music shops in Chinese cities took to broadcasting Teresa Teng loud and clear every evening. Then came the "Anti Spiritual-Pollution Movement" at the end of 1983, when Teresa's songs were singled out as a pollutant and banned. My article explained that this happened because she was a living proof that Marx was wrong. Teresa Teng was not a "capitalist" in the Marxian sense, and she certainly was not exploiting the millions of fans who voluntarily paid to buy her songs. She was a mere labourer, who happened to make millions with a few hours of work because capitalist entrepreneurs in Taiwan, Hong Kong and Japan went down on hands and knees begging her to sign contracts. Where, I asked, was the surplus value?

My telephone rang off the hook the day that article was published, followed by numerous letters from Hong Kong and China. Marxian disciples screamed and attacked me, but judging from the excitement I knew that, insofar as China was concerned, Marx was as good as dead. It is difficult to kill a man, but easy to drive nails into the coffin. I did the easy part.

Over the years I have written some 150 Chinese articles commenting on China's economic reforms, and I am deeply grateful that Beijing has not only tolerated my criticisms, they read all the pieces with care and treated me like a friend. I am not the architect of China's great transformation, as some people have thought: that honor belongs to Deng Xiaoping. I do not believe economists have the ability to change the world. But in a period of great change, economists may become accidental heroes. For during such periods there would often exist an ideological void, and whoever economist happens to possess the knowledge to fill that void will produce the false impression that he has something to do with causing the transformation. My only claim is that it is my good fortune to have been brought up in the property rights paradigm, and that I was able to write about it in Chinese.

I. ON AGRICULTURAL REFORMWhen I predicted in 1981 that China would go capitalist, I was not aware that the responsibility system, introduced into agriculture a few months earlier, would contribute so much to vindicating my arguments. The responsibility system was briefly tried in the early 1960s to alleviate the mass starvation caused by the Great Leap Forward. Then came the Cultural Revolution, and the idea was demolished before it could take hold.

A responsibility system involves a contract between a household or organization and the government, under which the individual assumes responsibility in production, pays dues to the government, and keeps the residual. In principle, the government would not seek to impose further conditions, although numerous restrictions existed in the early 1980s, which were only gradually removed in time. Like other developments in China's great transformation, once given an opportunity the market proved to be more powerful than any authority in shaping the course of events. Allowing individual decision-making was all that was needed for the market to work its magic. As it exists today, the agricultural responsibility contract is really a Chinese version of the deed of trust.

A question which the young Steven Cheung posed to Armen Alchian and later to Ronald Coase turns out to be crucial to understanding the responsibility system and, for the matter, to understanding an important part of China's economic transformation. I asked why ownership rights should be important in defining private property rights. An answer I proposed in 1969 was that the functioning of a private property system requires the exclusive right to use (or to decide on use), the right to freely transfer, and the right to exclusively enjoy income generated from usage. Whether the user of a property has private ownership in title is not important. That is to say, it is economically irrelevant if you claim ownership rights to my house, as long as I have the right to call the police if you enter without my permission. This view is supported if you look at Hong Kong, which is a city founded on private enterprise, but in which all land in private use actually belonged (before 1 July 1997) to the Crown. The responsibility system is thus a method of allowing the State to assign private property rights to resource use without relinquishing ownership rights, in which the assignment is effected through a lease contract. If use limitations are properly delineated and if the duration is perpetual, the lease-hold becomes fee simple; and if this lease is also freely transferable, the property becomes fee simple absolute--or private property in ideal form.

The market forces at work have led to a rapid extension of the duration of land leases under the responsibility system, from the initial one-year term to mostly 50 years today, to the relaxation of use restrictions (thus enhancing exclusive use rights), and to the relaxation of price controls (thus enhancing the exclusive right to enjoy income). Certain dues, of course, have to be paid to the Government. In ancient China, as in medieval Europe, there was no distinction between the meaning of "rent" and "tax." The feudal lord collecting "rent" became a collector of "tax," when he assumed the role of a government in providing services such as law and order. Under the responsibility system in modern China, various dues have similarly been converted into taxes.

There is no question that in China the responsibility system has met with great success in agriculture. By maintaining State ownership rights over land, socialist ideology is preserved, while private land use is implemented de facto. Indeed, this is the central feature of what Deng Xiaoping has called "Socialism with Chinese Characteristics." For several reasons, however, responsibility contracting is easier in agriculture than industry. Agriculture involves a relatively simple production process; land is physically divisible; it is immobile, and given proper crop rotation it will not depreciate; monopoly can hardly be maintained in agriculture, and therefore it is difficult to protect special interests.

A final point calls for elaboration. In the real world, there is no such thing as common property in a valuable resource, or a property subject to unrestrained common exploitation. Broadly speaking, there are only three systems under which rights to use resources are assigned. One is the private property system, which in a watered-down version we enjoy here today. People are born unequal. Because our property rights need not be equal, we can have equal rights before the law: hence our judicial system. A second is what I have called the "India System," in which the rights to incomes are delineated through regulations and protection of monopolies. In this system corruption would not only exist, but the rights to do so would be so well-defined through regulation that corruption becomes institutionalized. Finally, there is the communist system, under which the rights to resource use and income are defined by hierarchical ranking. Human rights are not equal, and comrades are not equal before the law. You may have discipline under communism, like in the army, but not "law" in the judicial sense.

The key issue in China's economic reform is to convert the earlier system of hierarchical ranking of rights into a system of property ranking of rights. In this process the distribution of income may change, and those enjoying special privileges under the hierarchical ranking may resist strongly when it does. So stubborn is this opposition in the industrial sector that I have been led to urge repeatedly that, regardless of justice or fairness or ethics, special interests should be paid off by granting them private properties once and for all. There were apparently fewer problems of this nature in agriculture. Previously high-ranking officials in communes or captains of production teams generally received larger allocations of land under responsibility contracting. Indeed, many former high comrades in agriculture have become large landlords today.

II. ON INDUSTRIAL REFORMIt is easier to privatize labor than land. Under the earlier regime in China, labor was not private property: everybody worked for the state, with jobs centrally assigned and incomes determined by hierarchy. But unlike land, which does not make decisions, labor is a volitional entity. The moment the government relaxes control over labor, the individual would automatically assume responsibility for himself. That is to say, labor becomes private property as soon as it is not controlled by the state.

The privatization of industrial labor in China began around 1983, in the Pearl River basin. It was at this time that investors from Hong Kong refused to hire state employees, turning instead to free (and largely unemployed) laborers. The resulting relative wages were significantly higher, and it was not long before state employees began to give up benefit entitlements to join the free-labor pool. By 1987, state enterprises in Southern China, confronted with mounting competition, declined to hire more state employees and opted for contract labor.

Before 1992, there is no question that industrial development in China was far more successful down South. Proximity to Hong Kong is only one reason. The main factor is that in Mao's time Beijing was concerned about attacks from Taiwan, so as a result all large state enterprises were concentrated in the North. Different than what many economists have thought, the key problem of state enterprise is not operational inefficiency--which is true--but that in order to protect this inefficiency, competition must be suppressed and free entry debarred. From about 1985 to 1992, an outside investor who wished to open a factory in Dongguan (near Hong Kong) would be granted permission in a week, and once opened for business, free laborers can be found lining up for jobs. But up North, say in Shanghai, it would be nearly impossible to obtain a permit--a friend who eventually succeeded counted a total of 39 official stamps--and recruitment must be channelled through a government office, with the terms and conditions specified by an official. It was great fun when Milton Friedman and I toured China together in 1988, and challenged every official we met: "If you believe state enterprises are superior, keep them, but at least allow private enterprises to compete. You should have no fear of this if state enterprise is truly superior.".

Nevertheless, market forces were again at work. In addition to outside investors, small and household enterprises grew in number and expanded in size in the villages, mounting an assault that forced state enterprises into the red. Recently Beijing announced the time is ripe to issue and distribute share holdings for state-owned organizations. I presume the word "ripe" means they have lost enough.

As noted earlier, until about 1992 outside industrial investors did not have an easy life in Northern China. Then in February of that year Deng Xiaoping toured the South, and after making blunt remarks walked off the political stage into retirement. There is no official transcript of what Deng said, but the general consensus is that a marked change in openness ensued in cities like Shanghai thereafter. Today, outside investors are heading North. This is solid evidence that the stranglehold of state enterprises in Northern China is falling apart.

The viability of a state enterprise requires monopoly protection to exclude competition; with money which belongs to no one in particular, it is easier to exert control; the right to control generates income to the privileged. It is plain fact that price control is far more prevalent for the state sector. Officials comprise a privileged group, whose rights to ration and to receive from under the table mean they are able to send their children to study in the United States. Unfortunately for them, ultimately all price controls would have to be financed by the state. With every increase in competition from the private sector, this burden would loom larger. If price controls go, the privileged group would lose a major source of income, and the alleged "superiority" of state enterprises would disappear into thin air.

By 1987, the cost of financing price control had become an enormous burden to the Chinese government, with the corruption arising from it apparent to all. Yet dropping the controls would mean stripping corruption rights from a powerful group, and strong resistance must be expected. In April 1988, however, a fateful decision was made by Deng Xiaoping and Zhao Ziyang at Beidaihe, to bulldoze away price control. Although I had urged on several occasions that prices be decontrolled even to the extent of compensating privileged groups, this decision came as such a shock that I could not sleep for nights. Freeing prices without compensating the privileged is an all-or-nothing gamble, and disaster may ensue if it failed. But I thought that since a pay-off could hardly be put into practice, it is a gamble China must take.

In March 1988 the Friedmans wrote to ask, as they would be attending a conference in Shanghai in September, whether it would be possible to arrange a China tour for them. Soon after I got my Beijing friends to arrange things, the attempt to decontrol prices ran into such flak that I was on the verge of suggesting that Milton should postpone the trip. Then, however, I was informed that Zhao Ziyang would be ready to receive Milton. As the events unfolded later, it is clear that I made a serious blunder in not requesting to meet Deng Xiaoping also.

The meeting between Zhao and Friedman went off remarkably well: the two men became enormously appreciative of each other. Except for Zhao's support of the controlling power of the communist party--a routine political opening--the two men disagreed on only one point: namely, when and how fast to do away with foreign exchange control. Milton wanted to abolish it in five minutes, while Zhao thought this should be done only after the relaxation of domestic price controls. Zhao's explanation, right or wrong, deserves a good grade in any graduate examination, although the translator did such a poor job that Milton could not follow, and I was too absorbed in the argument to remember to correct the rendering.

Zhao's point was this. At the time about half of China's domestic product prices were under control, and the other half were free. Therefore relative product prices inside the country were irrational. Outside China there were no price controls, so relative prices were rational. If exchange control were abolished, irrational domestic relative prices would collide with rational outside relative prices, sending wrong signals which may damage many industries. Therefore, Zhao argued, foreign exchange control should only be dropped after all domestic prices are freed.

The meeting went so well that afterwards the Secretary General walked all the way to the car, and opened the door for us. Because this was the first time Zhao had made such a gesture to outsiders, stories about the meeting spread all over Beijing. This, together with Zhao's subsequent attempt to accelerate price decontrol, are what in my view caused his downfall in 1989--the students in Tiananmen being just ammunition for a last salvo against the beleaguered General Secretary in the political infighting.

While on this subject I should perhaps mention that in December 1991, on the occasion of Ronald Coase's Nobel Prize, I met Milton in Stockholm. I observed that freeing industrial prices without privatization of state enterprises does not appear to be right, and it may have been an error on my part to support the former without warning my Beijing friends of a major obstacle concerned with the latter. Under state operation, industrial output would not be elastic to the price increases resulting from decontrol. As a result, objections against the scheme would come not only from the privileged groups mentioned earlier, but also from industrial workers at large, and there would be a distinct possibility the workers would take to the streets in protest.

My view that privatization of state enterprises should precede the decontrol of prices, or at least be carried out the same time, was shared by Milton. But when I repeated it to Harold Demsetz last year, he disagreed. I have not had a chance to go over with Harold his reasons in detail, and though I have learned over the years whatever Harold Demsetz says must never be dismissed lightly, I submit that the point made here calls for serious consideration by all communist economies currently attempting reform.

Time flies. Eight years have passed since Tiananmen. Market forces at work have rendered most price controls worthless to the privileged. The massive increase of private enterprise, both from inside and outside of China, has forced a retreat of state economic activity. The losses suffered by state-owned enterprises have become too widespread and too large for the public finances to sustain. About four years ago, Beijing adopted an attitude of allowing smaller state enterprises to do more or less whatever they wanted, to relieve some of the burden. Many of these enterprises then put themselves up for sale, but were unable to attract much interest. Few investors would consider buying a losing concern, with an attached condition that the buyer must keep and take care of the state employees. It would be cheaper to build a factory from scratch and hire contract workers. For smaller state enterprises at least, the recent talk of issuing share holdings may be regarded as a result of the failure to find buyers--in some cases at any price!

To complete our story on industrial reforms, let us go back to an earlier date. With responsibility contracting a proven success in agriculture, the idea was extended to industry in 1984. I was granted permission and full co-operation to investigate the implementation, and so found myself sleeping in a Beijing Steel dormitory in 1986, followed by a tour of factories in Hangzhou and Wenzhou. Three assistants from China were assigned to help me, confidential documents were made available, nothing was hidden, and all queries about economic facts, if known, were honestly answered. No other government I know of would give a researcher such a free hand.

I failed to deliver the expected magnum opus. With events unfolding so fast, I simply ran out of steam. The industrial responsibility contracts forwarded to me were breeding new modifications every month, and they differed in different localities. Since I alone was granted the privilege to study the documents, systematic analysis was impossible. All I could do was to step back, and try to comprehend developments in the large.

The crux of the matter is that workable responsibility contracts are far more difficult to construct in industry than in agriculture. Industrial production is a complex undertaking which varies greatly across products. While this partly explains variations in the observed contracts, managers in the state factories I interviewed routinely complained that the government tried to impose stipulations about which it knew nothing. Moreover, unlike land, most of the resources used in an industrial organization are not physically divisible. It is thus difficult to hold an individual or household responsible for any specific outcome. Joint responsibility would amount to a communal system, unless transferable equity shares are issued and distributed. Finally, and this is the most troublesome point, many industrial assets are not only subject to depreciation, they may disappear or get stolen. With the state unwilling to relinquish ownership rights, stipulations in industrial responsibility contracts concerning maintenance and replacement tend not only to be arbitrary, but represents a constant source of contention between the state and the enterprises.

The depreciation and possible disappearance of assets, when an industrial responsibility contract is created without the state relinquishing ownership rights, occupied my thinking for several years. A breakthrough came in early 1988, when I remembered that when I bought my first car at UCLA in 1959, a depreciable and stealable small Fiat, I was the registered owner and the bank was the legal owner. Legal ownership of the Fiat belonged to the bank, so that if it got stolen and if I had been delinquent on insurance payments, it had the right to hold me responsible.

With this insight as a starting point, a viable industrial responsibility contract can be envisaged. First, estimate the net asset value of the organization. Second, state ownership is retained, and it is entitled to a tax equalling a low interest charge on asset value. Third, the state surrenders all other rights. Fourth, issue share holdings against assets and distribute them to members of the organization, preferably through a voting procedure similar to that by which baseball players divide earnings in the world series. Finally, allow shares to be freely transferable. If all the government cares about is to retain state ownership in title, this proposal would work.

My Beijing friends were convinced when I broached the above ideas in late 1988. But price decontrol was raising the dust, and then came Tiananmen. Beijing's recent decision to introduce share holdings in state enterprises bears some resemblance to my scheme, but we must not be too optimistic. It is not clear to what extent the shares will be transferable, so the whole thing may prove to be no more than the assignment of points under the agricultural team-production system in the 1970s. Furthermore, for a major state enterprise, the government would hold 52% of the shares. On this latter I explained to a Beijing friend that it would not be too bad if the government does not get voting rights, that betting on correct government decisions on resource use has a lower chance of success than betting on horses, and that given voting rights, a government representative on the board could easily get fat through corruption.

Still, it is too early to be pessimistic about China's industrial reforms. With share holdings put into place, the market may work its magic yet again. In all likelihood, there will come a time when the authorities learn that for any organization in which they have a say, it will lose out in competition.

III. ON FINANCIAL REFORMIn June 1986, Beijing announced that the Foreign Exchange Certificate (FEC), one of two domestic currencies then circulating in the country, would be abolished. Two months later it was proclaimed that no more FECs would be issued beginning October, and it would pass out of circulation in November. In response I published (in September) a lengthy article analyzing the situation, and reached the conclusions that, if the FEC is abolished, China would either have to return to comprehensive price controls--thus pushing back reform--or it would have to abandon exchange controls. I should not have published the article, for because of it Beijing withdrew its decision. The FEC was not abolished until seven years later, when apparently another game plan had been devised.

When China began to open up in 1979, tourists poured in. They were granted a special privilege to buy the best of domestic production in "Friendship Stores," from which locals were excluded. Hungry for quality goods and services, local Chinese turned to tourist friends to buy on their behalf. It was to plug this loophole that the FEC was introduced in April 1980. As sole legal tender in higher class shops and hotels, the FEC was not only a currency, but was also a permit to buy restricted goods and services.

Foreign tourists could exchange their currencies for FECs and vice versa, freely, at the official parities for Renminbi (RMB). Officially, therefore, Yuan for Yuan FECs and RMBs had the same value. But because the FEC had wider usage, it began to command a premium that often ran as high as one-third. Local Chinese, however, had no trouble obtaining FECs in the market. If they were willing to pay a premium, it was possible to have access to things only sold in Friendship Stores. In less than two years it became obvious to the authorities that it was very costly to police local purchase, so the prohibition was dropped.

The FEC, however, remained in circulation alongside the RMB. Though its earlier function had disappeared, FECs continued to command a premium because one could convert them into foreign currency without restriction, at official rates. Calculated according to its black market rate, the RMB was worth less. With two currencies in circulation having officially the same value though one is actually at a premium, the following situation ensued. Individuals who knew how to bargain could elicit substantial discounts for goods and services by paying in FECs. Therefore, with two domestic currencies and two nominal prices, the same product price was implied. But for the innocent tourist who paid in FEC at the same nominal price as locals paying in RMB, it became price discrimination.

For several years, my Beijing friends thought this kind of discrimination would earn China more foreign exchange. I kept telling them not necessarily, for it entailed a number of price elasticities on which Al Harberger is the world authority, but which my Beijing friends could not understand. Ultimately, they were convinced by the discovery that more and more tourists were learning the trick of bargaining. Both in logic and in fact, the Gresham's Law has no merit at all.

The important point, however, is that with two currencies and two nominal prices for the same good, a black market exchange rate was implied in the transaction. This was perfectly legal under the circumstances, because the black market rate was not revealed. Essentially, therefore, the FEC supplied camouflage for an illegal activity. On the other hand, if a buyer exchanged for RMB at the black market rate before purchase--which was really doing the same thing as bargaining and paying in FEC--this would be clearly illegal.

It therefore is a critical issue whether, after the abolition of the FEC, foreign currencies were allowed to circulate in China. (I estimated that in Hong Kong dollars alone some 3.9 billion were circulating in China in 1986.) If foreign money were disallowed, black market exchange would soar, and to suppress them would call for controls detrimental to reform. If foreign money were allowed, transactions involving them would go by the market exchange rate, thus rendering the official exchange rate good only on paper. Protection of the latter would then necessitate the prohibition of bargaining and the re-introduction of comprehensive price controls. In either case, there would arise great pressure to abandon exchange control.

Beijing chose to keep the FEC. When the authorities finally decided to do away with it in 1993, China had become mired in a disastrous financial situation. Inflation was at 17% a year (even according to official statistics) and rising, and in the black market the RMB, which traded at about 45 cents to one Hong Kong dollar in the early 1980s, fell to 1.50 to one Hong Kong dollar in June 1993. Corruption, which by any measure was widespread as early as 1985, was invading the banking sector on a massive scale beginning 1990. It was standard practice for state banks to lend at official interest rates, while the rates actually charged under the table were double that, plus a 10 to 20% share of the project profit (if any) going to the loan officer. The price controls still remaining in monopolistic state enterprises continued to be a major source of corruption, and the People's Bank could hardly print money fast enough to subsidize them.

Commentators inside and outside China all called for the authorities to restrain the money supply, and by the early 1993 such statements were appearing every day. I disagreed, and produced an article on 21 May 1993, entitled "Power Induced Inflation." My thesis was so simple and convincing, that the control-of-the-money-supply argument was seen no more.

I explained that the People's Bank and its subsidiaries in China were payroll offices and not commercial banks, and by the late 1980s this paymaster function was extended to investments. When powerful state enterprises or high ranking comrades or their sons and daughters asked for "loans" the banks had to comply, and corruption merely added fuel to the fire. It is naive to tell the Chinese to restrain money supply and curb inflation--on this subject they have had no peers since the days of the Kuomintang. My point was that the enormous demand for money did not come from ordinary bank customers but from people in power, some of whom could shut down a bank. So why bother to say "restrain money supply"? The banks could not do so even if they wanted to. To curb inflation in China, the authorities would have to cut off the demand from people in power. That is, the power demand for money must go.

In conclusion, I suggested that the banking system in China should be reconstructed from scratch. The People's Bank should only play the role of a central bank, controlling the money supply and increasing it by no more than 20% a year a la Friedman (not a high figure considering the real growth rate), but not having the right to lend. All its branches and subsidiaries should be converted into commerical banks, preferably by selling them to qualified buyers. Improve collateral and bankruptcy laws, to allow bank lending to be based on sound economic and accounting principles. Privatize state enterprises through stock holdings to remove the burden on the public finances. Demolish all exchange and price controls.

Zhu Rongji took charge of the People's Bank in June 1993. The banking reforms he proposed two months later were similar to those I had suggested, but what eventually transpired was quite different. Zhu is not a free-market believer as often thought. The man loves to control. But he is strong, rather smart, and there is no evidence he has ever been corrupt. Under Zhu the People's Bank turned to a central bank, but instead of restraining money supply Zhu squeezed credit by imposing lending limits, starving state enterprises and creating rising unemployment. The power demand for money fell, and inflation rapidly subsided. Today, inflation in China is exactly zero.

Sure enough, after the FEC ceased to circulate on 1 January 1994, the black market for RMB went out of business when the authorities replaced the official rate with the market rate. The RMB has miraculously floated within a narrow range of 1.05 to 1.09 to one Hong Kong dollar for three long years. Since the latter is linked to the US dollar, the RMB's exchange rate against the US dollar has also been stable. Apparently it is easy to maintain a dirty float, in a period when inflation is rapidly declining and foreign exchange reserves are rapidly rising.

What Zhu Rongji and his colleagues have created is a monetary system sui generis. Exchange controls are still officially in force, but one can always get around them through loopholes and paying a small premium--my estimate is 0.2%-1%. Foreigners may hold foreign currencies in a domestic bank and they may transact in foreign currencies with the Chinese, but not the Chinese themselves. Most interestingly, domestic organizations receiving FDI are required to convert into RMB. This is now the main avenue by which the domestic money supply increases in China. The foreign currency would all go to the government, resulting in a phenomenal accumulation of reserves--from about USD20 billion in 1993 to USD130 billion today.

We cannot deny that this monetary system, though rather strange, is ingenious and serves certain purposes well. However, with fuzzy exchange controls and with foreign banks unable to do real business inside China, not even a city like Shanghai could develop into a major financial center. To bring this about exchange controls must go, and banking must be privatized and thrown open to world-wide competition.

I believe that market forces will again be at work, to open up China's financial sector within five years. During the past five years the high rise offices erected or under construction in Shanghai equalled what Hong Kong could manage in 50 years. Most of these buildings are standing empty, with rents slashed by half the past year and still falling. Mostly investments of privileged groups with political muscle, these office blocks will never be filled up until the financial sector is opened for all.

IV. ON CORRUPTIONWhen in 1985 corruption became widespread in China, I was relieved rather than concerned. Corruptive activities were replacing the earlier backdoor transactions, sending a clear signal that the hierarchical ranking system was losing hold. For another thing, when decentralizing state controls over resource use, rising regulation must be expected, and regulations facilitate corruption. In passing from a hierarchical ranking system to a property ranking system, China would have to touch base with rising regulation and corruption, and it is not a bad thing that this development should come so soon.

These comforting thoughts lasted only a few months. By mid-1986 Beijing and other local authorities were drawing up product classifications and state enterprise classifications, for the imposition of regulations and controls. If officials are assigned delineated rights to monitor categorized regulations and controls, then their rights to corrupt might become so well defined and protected that the whole thing would end up being institutionalized. I immediately wrote that China was on a passage to India, and that if reform remained gradual it would likely get stuck with the India system, and the great transformation would be all over.

Economists writing about China at this time have mostly argued for gradualism, and they have had no trouble finding officials in the country to share their views. I literally spent the whole of 1987 repeating my arguments to Chinese friends, several of whom were seconded from Beijing to spend time with me at the University of Hong Kong. In early 1988, editorials in Beijing admitted that China was indeed displaying the India syndrome.

What kept China from going the India route was neither my efforts nor that of my Beijing friends. Three counter-corruption forces were at work. First, Deng and Zhao's decision to do away with price controls in April 1988, though abortive, led to a collision which weakened the privileged group. Second, managers of state enterprises holding responsibility contracts were dead set against regulation and controls. Among some 30 factories I visited in 1986 and 1987 (all holding responsibility contracts) they found favor only in two, which enjoyed strong monopoly protection. Third, we must give credit to Jiang Zemin, Li Peng and Zhu Rongji, the top three men in power today. None of them, nor their sons and daughters and even relatives, have been rumored to have been corrupted. It takes at least two, and typically more than three, to corrupt, and therefore it is not easy to keep the tale from spreading. Insofar as corruption is concerned, I believe most of the rumors are true.

I am inclined to think that Jiang, Li and Zhu are clean. If so, we must ask: why? This is a difficult question because so many opportunities are open to them. I believe everyone is corruptible, including myself, if the cost is low enough. The answer, I think, is that to top leaders the cost of corruption is lower with democracy but higher in a dictatorial state. Power itself is an economic good. Corruption may bring an end to power. In a democratic state power is transient, and therefore its leaders have less to lose by corruption. In a dictatorial state power may last a lifetime--thus a higher corruption cost to its leaders. This view is consistent with the Asian experience. In voting societies in Asia corruption is from the top down, whereas in dictatorships corruption is from the bottom up. Corruption in China, though still widespread, has not reached the top level.

In China, corruption peaked in 1992, and has declined since. Most of the decline has occurred in the next to top level. This experience has also convinced me that many regulations and controls are designed to facilitate corruption. Last year I published a paper here in the U.S., arguing that contrary to conventional wisdom, corruption breeds regulations and controls and not the other way around. Regulations and controls only facilitate corruption. If people were born with a special non-corruptive gene, we would have far less regulations and controls in the world today.

V. CONCLUDING REMARKSHistorians have long debated whether history makes heroes or heroes make history. It is beyond doubt that history made a hero in Deng Xiaoping. Deng could not have triumphed had history not been kind. The timing was perfect: when Deng re-emerged with full power in 1978, Rose and Milton were about to publish Free to Choose, which topped the best seller list in the United States for months. Then Thatcher, Reagan and later Gorbachov contributed in one way or another. In 1983 Deng declared that, for the first time in his life, he felt world peace was possible. This must be a great relief for a person leading a nation on one of the most difficult endeavors mankind has ever known.

It is also clear that as a hero, Deng Xiaoping made history. A man more qualified to transform China can hardly be imagined. Deng became a member of the Communist Party at nineteen, spent six years laboring in France, and then returned to a roller-coaster ride of three downs and three ups on the political stage in China. He therefore had no peers in his understanding of how the communist system worked. Deng spoke little, but judging from what he said I must rate him as by far the clearest thinker among the Chinese leaders of this century. It is a miracle that Deng took the lead in reform when already seventy-five years old, and still almost made the distance. He must have felt his time was running out, however, for the became impatient at the end. In my obituary of Deng, my only criticism of the man is that he was too sensitive about students and democrats trying to tell him what to do.

Deng Xioaping determined the directions for China's great transformation. Over and again, his writings reiterated one fundamental principle. Deng believed that a society consists of individuals, and that society will not do well unless every individual is encouraged to deliver his best. This view is as ancient with Lao Tzu in China as it has been in western economics since Adam Smith. What is so special about Deng is that he managed to put this belief into practice, with great consistency and against the opposition of countless political foes. If we ignore the political slogans, we find that every move he made since 1979 was in the direction of economic freedom. Deng may have erred in priority and timing, but never once in direction.

Perhaps we can understand the man better if we recall Deng loved to play bridge. He demonstrated an absolute mastery in political strategy. He upheld the "four principles" of Mao, but because of their vagueness he interpreted them in the ways he saw fit. He maintained state ownership to define his brand of socialism, but unshackled the market forces at work. He designed special economic zones, argued that they worked, and allowed everywhere to go special. "Hong Kong is particularly special," he said, "so we should have 100 Hong Kongs inside China." In the 1980s he staged three anti-capitalist movements, but only spiritually. Only God knows what "spiritual" was, and a few months after each movement, capitalist "spirits" would soar to new heights. One year after the banning, Teresa Teng's songs sold better than ever. It would have been easy to ban Teresa's songs: all Deng would have to do was to put a few sellers behind bars--and to do so would have been hailed as benevolent in Mao's time.

In praising Deng, I may have painted too rosy a picture of the great transformation he engineered. But if a grade must be assigned by a professor Deng certainly deserves an "A+," even for an incomplete project. No one who follows the history of Deng's era would fail to be awed by what was accomplished in the thirteen years from 1979 to 1992. However, the grand project is only about 70% complete. The remaining 30% contains some ticklish problems. Taxes are too high and too numerous; law and order leave a great deal to be desired; the recently proposed share-holdings for state enterprises fall far short of privatization; protection of state monopolies, thought weakening, still persists; the presence or absence of exchange controls breeds confusion; the tightly restricted financial sector has yet to open up for competition. Though somewhat subsided, corruption is still widespread--the passage to India still looms open for China. I should say that by American standards three-quarters of the population still live in poverty.

Whatever the future holds, Deng Xiaoping's Great Transformation must be regarded as one of the most remarkable chapters in economic history. Hearing that the Czech Republic and Hungary might have done better I went there last summer, and found their performance not even close. Prague and Budapest are great tourist attractions. In comparison Shanghai is a great metropolis, with a vitality in commerce and industry that boggles the mind.

Ladies and gentlemen, have you ever been to the Bund in Shanghai? I would love to take you there tonight!

Added material.

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This is the address delivered by the President at the general session at the Western Economic Association International 3rd Biennial Conference in Bangkok, Thailand, January 16, 1998, and The First Annual Arnold C. Harberger Distinguished Lecture, University of California, Los Angeles, November 17, 1997. Thanks are due to M. T. Cheung for comments, and to Geng Xiao for updating developments in China.