The Economist

China's economy

Bamboo capitalism

China's success owes more to its entrepreneurs than its bureaucrats. Time to bring them out of the shadows

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FEW would deny that China has been the economic superstar of recent years. Thanks to its relentless double-digit annual growth, it has become the world's second-largest economy and in many ways the most dynamic. Less obvious is quite what the secret of this success has been. It is often vaguely attributed to "capitalism with Chinese characteristics"–typically taken to mean that bureaucrats with heavy, visible hands have worked much of the magic. That, naturally, is a view that China's government is happy to encourage.

But is it true? Of course, the state's activity has been vast and important. It has been effective in eradicating physical and technological obstacles: physical, through the construction of roads, power plants and bridges; technical, by facilitating (through means fair and foul) the transfer of foreign intellectual property. Yet China's vigour owes much to what has been happening from the bottom up as well as from the top down. Just as Germany has its mighty *Mittelstand*, the backbone of its economy, so China has a multitude of vigorous, (very) private entrepreneurs: a fast-growing thicket of bamboo capitalism.

These entrepreneurs often operate outside not only the powerful state-controlled companies, but outside the country's laws. As a result, their significance cannot be well tracked by the state-generated statistics that serve as a flawed window into China's economy. But as our briefing shows, they are an astonishing force.

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First, there is the scale of their activities. Three decades ago, pretty much all business in China was controlled by one level of the state or another. Now one estimate—and it can only be a stab—puts the share of GDP produced by enterprises that are not majority-owned by the state at 70%. Zheng Yumin, the Communist Party secretary for the commerce department of Zhejiang province, told a conference last year that more than 90% of China's 43m companies were private. The heartland for entrepreneurial clusters is in regions, like Zhejiang, that have been relatively ignored by Beijing's bureaucrats, but such businesses have now spread far and wide across the country.

Second, there is their dynamism. Qiao Liu and Alan Siu of the University of Hong Kong calculate that the average return on equity of unlisted private firms is fully ten percentage points higher than the modest 4% achieved by wholly or partly state-owned enterprises. The number of registered private businesses grew at an average of 30% a year in 2000-09. Factories that spring up alongside new roads and railways operate round-the-clock to make whatever nuts and bolts are needed anywhere in the world. The people behind these businesses endlessly adjust what and how they produce in response to extraordinary (often local) competition and fluctuations in demand. Provincial politicians, whose career prospects are tied to growth, often let these outfits operate free not only of direct state management but also from many of the laws tied to land ownership, labour relations, taxation and licensing. Bamboo capitalism lives in a laissez-faire bubble.

But this points to a third, more worrying, characteristic of such businesses: their vulnerability. Chinese regulation of its private sector is often referred to as "one eye open, one eye shut". It is a wonderfully flexible system, but without a consistent rule of law, companies are prey to the predilections of bureaucrats. A crackdown could come at any time. It is also hard for them to mature into more permanent structures.

Cultivate it, don't cut it

All this has big implications for China itself and for the wider world. The legal limbo creates ample scope for abuse: limited regard for labour laws, for example, encourages exploitation of workers. Rampant free enterprise also lives uncomfortably alongside the country's official ideology. So far, China has managed this rather well. But over time, the contradictions between anarchic opportunism and state direction, both vital to China's rise, will surely result in greater friction. Party conservatives will be tempted to hack away at bamboo capitalism.

It would be much better if they tried instead to provide the entrepreneurs with a proper legal framework. Many entrepreneurs understandably fear such scrutiny: they hate standing out, lest their operations become the focus of an investigation. But without a solid legal basis (including intellectual-property laws), it is very hard to create great enterprises and brands.

The legal uncertainty pushes capital-raising into the shadows, too. The result is a fantastically supple system of financing, but a very costly one. Collateral is suspect and the state-controlled financial system does not reward loan officers for assuming the risks that come with non-state-controlled companies. Instead, money often comes from unofficial sources, at great cost. The so-called Wenzhou rate (after the most famous city for this sort of finance) is said to begin at 18% and can even exceed 200%. A loan rarely extends beyond two years. Outsiders often marvel at the long-term planning tied to China's economy, but many of its most dynamic manufacturers are limited to sowing and reaping within an agricultural season.

So bamboo capitalism will have to change. But it is changing China. Competition from private companies has driven up wages and benefits more than any new law—helping to create the

consumers China (and its firms) need. And behind numerous new businesses created on a shoestring are former factory employees who have seen the rewards that come from running an assembly line rather than merely working on one. In all these respects the private sector plays a vital role in raising living standards—and moving the Chinese economy towards consumption at home rather than just exports abroad.

The West should be grateful for that. And it should also celebrate bamboo capitalism more broadly. Too many people—not just third-world dictators but Western business tycoons—have fallen for the Beijing consensus, the idea that state-directed capitalism and tight political control are the elixir of growth. In fact China has surged forward mainly where the state has stood back. “Capitalism with Chinese characteristics” works because of the capitalism, not the characteristics.

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