**Between the Invisible Hand and the Grabbing Hand:**
**The Ebb and Flow of China's Growth[1]**

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**Abstract**

Contrary to popular belief, the rise of China over the past half century was not driven by industrial or mercantilist policies. The economy grew fastest when the government played a more passive role, allowing market forces and bottom-up initiatives from farmers, local officials, and private entrepreneurs to shape economic development. China's vast size and extensive markets created strong incentives for entrepreneurial innovation. However, the government remained committed to preserving its political system and a dominant state sector, imposing clear limits on private sector and market development. Whenever private entrepreneurs sought to push these boundaries, the government responded forcefully. Over the last five decades, China's economic trajectory has been shaped by the tension between these two forces.

Keywords: China's Economic Growth, Market Forces vs State Intervention, Policy Cycles, Bottom-up Reforms, Top-down Industrial Policies, Private Sector Development, State-Owned Enterprises, Political Economy of Reform

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## 1. Introduction

In January 1979, Yuan Geng–a 61-year-old mid-level official–stood before Vice Premier Li Xiannian with a map and a pencil. When Li asked where Yuan wanted to build an industrial park, Yuan pointed to Shekou, a small fishing village at the tip of a peninsula across the Shenzhen Bay from Hong Kong. Li took the pencil, drew a circle around the entire peninsula, and said, "I will give you the peninsula." Yuan, knowing the risks and the cost, asked only for the village. That village became China's first 'special economic zone'–an area where market-oriented policies and foreign investment were permitted to operate outside the constraints of the planned economy. It was one of countless moments when China's growth was shaped not by grand central plans but by initiative from below–often pushing against, rather than following, official policy. Yuan's leadership and his slogan "Time is money; efficiency is life" inspired a generation of economic reformers across the country.

For most people, it is difficult to think of China as an economy guided by the invisible hand of the market–the mechanism Adam Smith described whereby individuals pursuing their own interests inadvertently promote the public good.[3] The country has a strong central government, and governments at various levels play active roles in the economy. Indeed, many observers attribute the rise of China over the last half century to the government's helping hand or its mercantilist policies.[4] This presents a challenge to Smith's notion that liberty of trade, combined with a state that secures property and provides necessary public goods, is the policy best suited to stimulating economic progress.

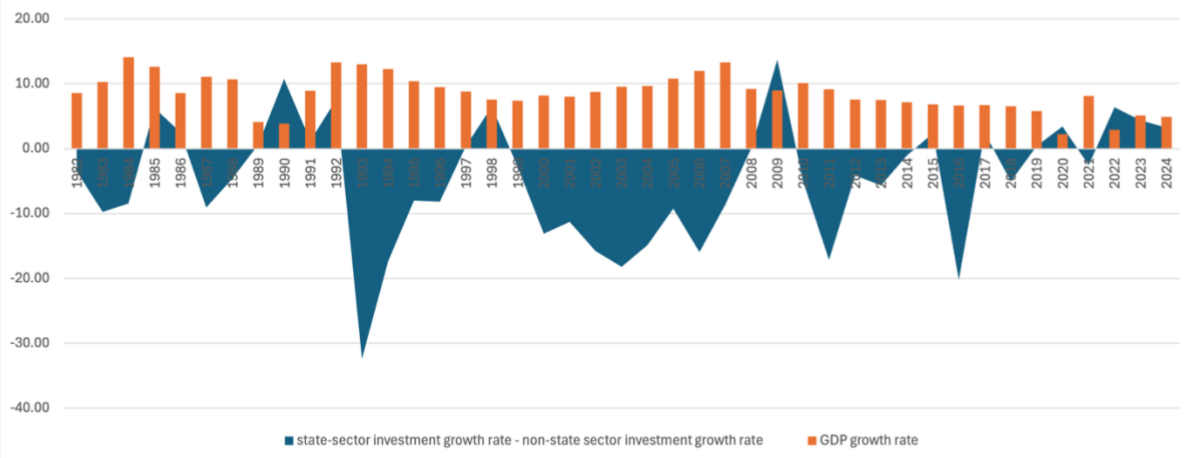
However, a closer examination of China's growth experience reveals a different picture. The modern history of China is not one of unvarying control of the economy by the state; nor is it a history where the role that market forces play in the economy has only increased. Instead, we see periods when the government played a more limited role and other periods when the government exerted itself more forcefully.

China's experience thus offers a distinctive test of Adam Smith's ideas about prosperity. Smith argued that economic growth emerges from individuals freely pursuing their own interests through trade and specialization–but he also emphasized that sustainable prosperity requires secure property rights and the rule of law. China never fully embraced either condition: even during its most liberalizing phases, the state remained deeply involved in the economy, and property rights for private entrepreneurs were never secure. Yet, China achieved remarkable, if fluctuating, growth overall. What lessons does this history hold for understanding the foundations for prosperity?

[3] See Chapter 1 in this volume; Trew, 2026.
[4] For the helping-hand argument, see, e.g., Frye and Shleifer (1997) and Bai, Hsieh, and Song (2020). For the mercantilist perspective, see, e.g., Wen (2016) and Chapter 14 in this volume (Rodrik, 2026).

Comparing the nearly three decades of central planning before 1978 with the period of reforms that followed reveals an immediate and stark contrast: high growth emerged after reforms, apparently supporting the role that market forces play in stimulating growth. A similar pattern can also be observed within the sub-periods of the post-reform era. Since the state sector plays a vital role in implementing government interventions, a straightforward way to gauge their importance is measuring the difference in capital investment (spending on machinery, equipment and infrastructure) growth between the state and non-state sectors. Figure 1 illustrates the relationship between the relative importance of state-sector investment and China's GDP growth between 1982 and 2024.[5] The figure clearly shows that the relative importance of state-sector investment fluctuates, and GDP tended to grow faster during periods when the state sector's investment growth rate was lower than that of the non-state sector.

Figure 1. Pro-State vs Pro-Market Policies and GDP Growth




Source: Huo, Yuan, and Zhu (2025).

Throughout China's policy and growth cycles, its political system has remained stable–a one-party system led by the Chinese Communist Party (CCP). What factors drive policy changes within this system? And how do policy changes influence economic growth?

I argue in this essay that China's economic trajectory over the last five decades has been shaped by the tension between the invisible hand of the market and the grabbing hand of the state–a term coined by economists Timothy Frye and Andrei Shleifer to describe predatory state behaviour. Its cycles of rapid growth and deceleration are closely linked to the changing prominence of market forces relative to government interventions. In deciding how strong its grabbing hand should be, the government trades off between economic growth and the state's control of the economy. Changes that promote market development often emerge not from deliberate government policy, but from the bottom up. The government allows these

[5] This figure is reproduced from Huo, Yuan, and Zhu (2025).

innovations and market forces to shape the economy in order to promote growth, as long as they do not threaten the state's control. Market forces, however, tend to erode that control over time. When this happens, the government reasserts its authority through regulations, industrial policies, and sometimes direct administrative orders, despite their detrimental effects on growth.[6]

I illustrate my argument about policy and growth cycles by discussing the origins of major policy changes and their impact on economic growth during China's reform era. The discussion is divided into four sections, corresponding to four subperiods of the reform era.

- 1978–1988: Decentralization and bottom-up reforms
- 1989–1993: Searching for a new direction
- 1994–2007: State capitalism and global integration
- 2008–Present: Centralization and top-down industrial policies

## 2. 1978–1988: Decentralization and bottom-up reforms

The first decade of the reform era, from 1978 to 1988, was the most liberalizing period in modern Chinese history. Many pivotal economic reforms during this decade were driven by bottom-up initiatives. In this section, I examine how three landmark reforms—the privatization of agricultural production, the establishment of special economic zones, and the emergence of a non-state sector–got off the ground.

Before going into these bottom-up reforms, however, I first discuss a false start in economic reform launched by the central government: an initiative now known as the Foreign Leap Forward (洋跃进). The case not only illustrates the shortcomings of a top-down policy approach but also provides context for the bottom-up reforms that followed.

### 2.1 A False start in economic reform: Foreign Leap Forward

In 1976, a few days after Mao Zedong's death, a group of radical government leaders (the Gang of Four) were put in jail and the ten-year-long Cultural Revolution ended. The Chinese government under the new leader, Hua Guofeng, turned its attention to economic development. At the center of this effort was a Soviet-style Ten-Year Plan (1975-1985) focused on importing foreign technologies for heavy industries.

[6] In related work, Cheremukhin, Golosov, Guriev, and Tsyvinski (2024) study the political development cycles during China's central planning period, while Brandt and Zhu (2000) examine the growth and inflation cycles in the 1980s and early 1990s.

"*The Plan prescribed some 120 brand new industrial projects, including 30 power stations, 8 coal mining fields, 10 oil and gas fields, 10 chemical fertilizer complexes, 10 iron and steel complexes, 10 petrochemical complexes, 10 nonferrous metal complexes, 6 railroad lines, and several ports, all designed to shore up the planned economy by importing modern technology.*"[7]

The Ten-Year Plan was officially launched at the end of 1977 and later dubbed the Foreign Leap Forward for its unrealistic objectives. Although often associated with Hua Guofeng, many top leaders, including Deng Xiaoping and Li Xiannian, fully supported the plan. In fact, the Ten-Year Plan was originally developed by none other than Deng Xiaoping himself in 1975, right before he was purged by Mao Zedong. As late as June 1978, Deng was still very enthusiastic about the plan. In a speech to several central government economic officials, he said:

"*Doing business with foreign countries—we need to scale it up. Why stick to 15 billion? Let's aim for 50 billion. We must seize the opportunity presented by the capitalist crisis, and be bold in our moves. Stop endless discussions; take action once we see the right moment. Launch hundreds of projects, ranging from coal, non-ferrous metals, petroleum, power plants and railways to feed processing factories. Don't waste our precious time.*"[8]

The plan collapsed quickly due to overly ambitious goals and a lack of foreign exchange reserves. This false start of industrial policy highlighted the pitfalls of a top-down approach in economic policy-making. The plan was devised by leaders in Beijing who felt an urgent need to modernize China and catch up with the West. It ignored China's comparative advantage and the financial constraints the country faced at the time. Fortunately, having experienced the disastrous consequences of the Great Leap Forward in the late 1950s and early 1960s, government leaders did not insist on continuing the plan. It was officially called off in April 1979.

## 2.2 Household Responsibility System: An institutional change initiated by farmers

While leaders in Beijing pursued the Foreign Leap Forward, farmers across China quietly launched a revolution: moving away from collective farming by allocating land to households. This practice, now commonly called the Household Responsibility System (HRS), first started in 1956 in Yongjia (永嘉) County of Zhejiang Province (a coastal area in the east of China). The practice was soon labeled as capitalism and forbidden by the central government as Mao launched the Great Leap Forward campaign and the People's Commune

[7] Coase and Wang (2012). Page 30.

[8] *A Complete Record of China's Reform and Opening-up: Chronicles of Major Events*. 中国改革开放全记录：大事记 (http://www.reformdata.org/records/1978.shtml).

movement in 1958. Many cadres and farmers from Yongjia County were severely punished for going in a direction that was contrary to the collectivization movement.

During the subsequent Great Leap Famine of 1959–1961, some farmers secretly adopted versions of the HRS just to survive. During the adjustment period of 1962–1965, government leaders such as Liu Shaoqi, Zhou Enlai, Chen Yun, and Deng Xiaoping openly supported adopting the HRS in agriculture as a solution to the managerial and incentive problems of collective farming. However, the HRS was strictly prohibited by the central government again during the Cultural Revolution period (1966–1976). Even then, some farmers in remote areas still secretly adopted the HRS for survival, but those cases were few and far between.[9]

In 1977 and 1978, rural areas in several provinces suffered extreme bad weather shocks that caused severe damage to the crops. To raise agricultural output for survival, cadres and farmers in villages that had suffered bad weather shocks secretly started adopting the HRS.

At the time, the central government's agricultural policy centered on introducing incentives within the existing framework of collective farming. At the *Third Plenum of the Eleventh Central Committee of the CCP*, it was decided that agricultural procurement prices would be raised, prices of intermediate inputs for agricultural production would be lowered, and agricultural output that exceeded procurement quotas would be permitted to be sold in farmers' markets.

However, the government still insisted that collective farming under People's Communes was the only legal production organization in rural areas. On December 22, 1978, the communiqué of the Third Plenum explicitly stated that "*People's Communes must resolutely implement the 'three-level ownership, with production team as the foundation' system, maintaining stability without change.*"[10] In a follow up document issued on September 28, 1979, it was stated that "*individual land cultivation is not allowed. Except for certain special needs in sideline production and for isolated households in remote mountainous areas or areas with inconvenient transportation, the practice of assigning land to individual households should also be avoided.*"[11]

Aware of the political risk, cadres and farmers in villages across China started to adopt the HRS en masse any way. By 1980, when the central government partially approved the HRS, more than 60% of all counties in China had already adopted the practice. When the central

[9]Yang (1996), pp.117-179.
[10] Communique of the Third Plenum of the Eleventh Central Committee of the Communist Party of China. 中国共产党第十一届中央委员会第三全体会议公报. https://cpc.people.com.cn/GB/64162/64168/64563/65371/4441902.html.
[11] The Central Committee of the CPC's Decision on Several Issues about Accelerating Agricultural Development. 中共中央关于加快农业发展若干问题的决定. http://www.reformdata.org/1979/0928/6072.shtml.

government formally endorsed the HRS in January 1982, it was already the *de facto* institution in close to 90% of all counties in China.[12]

The adoption of the HRS, along with the introduction of farmers' markets for agricultural goods, was highly effective in boosting agricultural productivity. According to the estimation by Justin Yifu Lin, most of the agricultural productivity improvement from 1978 to 1984 could be attributed to the adoption of the HRS.[13]

2.3 Political decentralization

The rapid adoption of the HRS between 1977 and 1980, despite its prohibition by the central government, was facilitated by a transformative political environment. In the same communiqué that insisted on collective farming under People's Communes, the central government also called for political decentralization by delegating decision-making power to localities and enterprises:

*"A serious drawback of our country's economic management system at present is the excessive concentration of power. There should be bold delegation of leadership, allowing localities and industrial and agricultural enterprises to have greater autonomy in management under the guidance of a unified national plan. Efforts should be made to streamline economic administrative institutions at all levels and transfer most of their functions to professional or joint companies with enterprise characteristics."* [10]

The communiqué, together with a speech delivered by Deng Xiaoping less than ten days prior, encouraged local initiatives by calling for the need to "emancipate the mind". Deng's speech was drafted by Hu Yaobang and his advisor Yu Guangyuan.[14] Hu, newly appointed as General Secretary of the CCP, went even further in a speech delivered on November 23, 1980:

"*If the central government hasn't considered it, the local government can come up with ideas; if the central government hasn't given instructions, but the local government sees it fit, they can take action; if what the central government says doesn't suit the local situation, the local government can make flexible arrangements; if the central government makes a wrong decision, the local government can debate it.*"[15]

Under this liberating environment, questions such as the advantages of the HRS were openly debated, and some subnational officials began to endorse the system. In Anhui and Sichuan–

[12] Chen, Li, and Zhu (2024).
[13] Lin (1992).
[14] Gewirtz (2022), page 20.
[15] *Be a Thoroughgoing Materialist. 做一个彻底的唯物主义者*. A speech by Hu Yaobang on November 23, 1980. http://www.reformdata.org/1980/1123/3520.shtml.

two provinces severely affected by the Great Leap Famine–the adoption of the HRS were particularly rapid. Their provincial leaders at the time, Wan Li and Zhao Ziyang, recognizing the HRS's effectiveness in boosting agricultural productivity, permitted and even encouraged villages to adopt the system.[16]

### 2.4 Yuan Geng and Shekou–the first Special Economic Zone

The *Third Plenum of the 11th Central Committee of the CCP* was held in Beijing from December 18 to 22, 1978. According to the official narrative of the Chinese government, the meeting marked the beginning of the "Reform and Opening-Up" policy. However, in the communiqué issued after the meeting, the word *"reform"* appeared only once, and the terms *"opening-up"* or *"opening"* were not mentioned.

Six months before the Third Plenum, Yuan Geng, a 61-year-old mid-level official from the Ministry of Transportation, was appointed head of the China Merchant Group (CMG). CMG was an enterprise owned by the ministry but registered and based in Hong Kong. Its primary business was assisting the Chinese government in importing cargo ships from abroad. Yuan grew up in Baoan (宝安) County of Guangdong Province, a rural county adjacent to Hong Kong. He spent most of his career as a Communist official working in Guangdong and Hong Kong and was therefore deeply familiar with the region.

During his first four months on the job in Hong Kong, Yuan consulted extensively with individuals in Hong Kong and Macau on how to develop profitable businesses for CMG. On October 9, 1978, he submitted a written request–through the Ministry of Transportation–to the central government leadership, asking for greater autonomy for CMG in both business operations and scope. In particular, the request sought permission to build an industrial park in Baoan County, to be financed through loans from banks in Hong Kong.

At the time, the central government's ambitious Ten-Year-Plan to import foreign technology was already severely constrained by a shortage of foreign exchange reserves. Yuan's proposal to rely on financing from Hong Kong banks was therefore highly appealing to the central leadership. The request was approved within three days, and Vice Premier Li Xiannian met with Yuan in Beijing on January 31, 1979. When Li asked Yuan where he wished to locate the industrial park, Yuan handed Li a map of Hong Kong and pointed to Shekou (蛇口), a fishing village at the tip of a peninsula in the northwest corner of the map. Li took a pencil that Yuan had prepared, drew a large circle around Shekou–encompassing the

[16] Yang (1996) and Chen, Li, and Zhu (2024).

entire peninsula–and said, "I will give you the peninsula." The peninsula covered an area of 30 square kilometers.[17]

Yuan believed that developing the entire peninsular into an industrial park would require excessive financing and entail substantial risks. He therefore told Li that he needed only the village of Shekou, which covered just 0.2 square kilometers. As a result, in January 1979, Shekou–a small fishing village near Hong Kong–became the first industrial park (and special economic zone) in the People's Republic of China.

On March 31, 1979, the central government approved the request of Guangdong Province for changing the name of Baoan County to the City of Shenzhen. In March 1980, the central government decided to set up special economic zones (SEZs) in four cities: Shenzhen (深圳), Xiamen (厦门), Zhuhai (珠海), and Shantou (汕头).

Yuan might have been overly cautious when asking for land parcels, yet he was fearless in spearheading reforms in Shekou. He implemented an incentive wage system, commercialized employee housing, launched open recruitment drives for skill workers, and introduced democratic election of industrial park officials–all pioneering initiatives in China. His iconic slogan "Time is money; efficiency is life" ("时间就是金钱，效率就是生命") inspired an entire generation of reformers across the country. After his many successful reforms in Shekou, he was offered a promotion opportunity to a provincial leadership position in Guangdong Province, but he chose to stay and retire in Shekou. The two join-stock financial institutions he founded in Shekou–China Merchants Bank and Ping An Insurance–have grown into two of China's most successful financial enterprises.

## 2.5 The unexpected rise of the non-state Sector

In 1979, the Chinese government launched reforms of state-owned enterprises (SOEs) in urban areas. Similar to the official agricultural reform policies, the SOE reforms focused on combining plan with market and introducing incentives for SOE managers and workers, while retaining state ownership. A dual-track system was introduced, which permitted SOEs to sell industrial output that exceeded government-set quotas at market prices, creating a hybrid of planned and market allocation. An initiative called the Managerial Responsibility System (MRS)–designed to grant SOEs greater operational autonomy–was first piloted in a selected group of SOEs nationwide before being gradually rolled out on a broader scale.

These SOE reforms have some features that are sharply different from those of the Soviet-style Ten-Year Plan: starting with pilot experiments and then scaling up gradually. However, unlike the HRS reform, which was initiated from the bottom up, these SOE reforms were

[17] Tu (2016). Page 51. The story of the large circle drawn by Li has been widely recounted; however, in most versions–and in some official narratives–Yuan Geng is omitted, and Li Xiannian's role is instead attributed to Deng Xiaoping.

initiated by the central government and were not nearly as successful as the HRS reform. While SOEs did improve their productivity by gaining greater operational autonomy, they remained constrained by government plans on the one hand and faced soft budget constraints from banks on the other hand. Between 1978 and 1988, the share of industrial output accounted for by SOEs did not rise but declined steadily, driven by the unforeseen growth of non-state industrial enterprises.[18]

In July 1979, the central government issued the *Interim Regulations on Several Issues Concerning the Development of Commune and Brigade Enterprises*, encouraging the development of rural collective industrial enterprises in light industries.[19] The central government's original intention behind these policy changes was to allow rural collective enterprises–later known as township and village enterprises (TVEs)–to develop on the periphery as a supplement to SOEs. What the central government did not expect was how rapidly these enterprises would grow. By 1988, they accounted for over 40% of China's total industrial output, and regions such as Zhejiang and Guangdong, previously on the periphery of the planned economy, had become the most dynamic parts of China. In 1987, during a conversation with a foreign visitor in Beijing, Deng Xiaoping stated:

*"In the rural reform our greatest success–and it is one we had by no means anticipated–had been the emergence of a large number of enterprises run by villages and townships…Their annual output value has been increasing by more than 20 percent a year for the last several years. This increase in village and township enterprises, particularly industrial enterprises, has provided jobs for 50 percent of the surplus labour in the countryside…This result was not anything that I or any of the other comrades had foreseen; it just came out of blue."*[20]

There were four key factors behind the rapid development of TVEs. First, the success of the agricultural reform alleviated China's subsistence food constraint and enabled a large number of rural workers to move away from farming, providing TVEs with a substantial pool of low-cost labour. Second, operating on the periphery, TVEs were not constrained by central government plans and were therefore better able to follow market principles. Third, lacking easy access to the formal banking system, TVEs faced much tighter budget constraints and stronger market discipline than SOEs. Finally, they were able to undergo Smithian growth by astutely leveraging the principles of specialization and the division of labour, as articulated by Adam Smith. Smith had argued that 'the division of labour is limited by the extent of the market'–and China's vast internal market, combined with growing access to global trade, offered an enormous canvas for specialization. They focus on light industrial products–such as textiles, garments, simple machinery, and household goods–that required lower level capital investment and aligned with local resource endowments. By concentrating on specific

[18] Naughton (1995) and Brandt and Zhu (2000).
[19] http://www.reformdata.org/1979/0703/8147.shtml
[20] A speech by Deng Xiaoping that was quoted in Coase and Wang (2012).

niches within these sectors, individual enterprises and regional clusters achieved deep specialization, boosting skill development and productivity growth.[21]

Not all TVEs were created equal. There were three main models: the Sunan Model, the Wenzhou Model, and the Zhujiang Model, each shaped by distinct regional conditions. The Sunan Model, predominant in southern Jiangsu Province, featured collectively owned township and village enterprises managed by township and village governments. These enterprises benefitted from strong local government support and coordinated financing. This model thrived in regions with relatively developed infrastructure, a tradition of collective organization, and proximity to the industrial base in Shanghai. However, the active involvement of local governments meant that TVEs in Jiangsu Province often operated more like SOEs than private enterprises. This close government control reduced managerial autonomy and market responsiveness, leading to inefficiencies and soft budget constraints similar to those faced by SOEs. [22]

In contrast, the Wenzhou Model, which originating in Wenzhou and later spread across much of Zhejiang Province, was characterized by privately owned, family-run businesses. Wenzhou's entrepreneurial culture and limited state presence made private ownership the natural choice.[22] Before 1988, however, private businesses were technically illegal unless they employed no more than seven workers. This restriction reflected the government's cautious approach toward private ownership, which was seen as ideologically sensitive and potentially destabilizing. As a result, many private enterprises in Zhejiang operated in a legal gray area, relying on informal networks and local protection to survive. Despite these limitations, southern Zhejiang's entrepreneurial culture, flexible production methods, and informal financing networks allowed these businesses to thrive in light manufacturing sectors such as footwear, garments, and electrical appliances.[23]

Finally, the Zhujiang Model, centered in the Pearl River Delta, relied heavily on investment from and joint ventures with oversea Chinese businesses, particularly in export-oriented industries like electronics and toys. Its success was driven by proximity to Hong Kong and Macau, which provided access to capital, technology, and international markets.

These regional variations of TVE models illustrate that it was not central government policies but local economic conditions, institutional environments, and resource endowments that shaped the development of China's non-state sector.

<u>2.6 Summary of reforms between 1978 and 1988</u>

[21] Long and Zhang (2011).
[22] Whiting (2001).
[23] Nee and Opper (2012).

Due to space constraints, I have focused on the origins of three major economic reforms during the period of 1978–1988. Other economic reforms were also significant, including financial decentralization and the emergence of non-bank financial institutions, as well as fiscal decentralization and particularistic contracting.[24] A common feature of these reforms is that their initiation or critical progress were driven largely from the bottom up by farmers, low-level government officials, and private entrepreneurs.

Importantly, none of these reforms advanced in a smooth or linear fashion. Almost all experienced setbacks before making further progress. These reversals typically occurred when reforms moved so quickly that they prompted the central government to feel that it was losing control or that the changes were undermining the role of the state sector and threatening the existing political regime. The experience of private business development in Wenzhou is a good example.

In 1981 the central government launched a crackdown on private businesses, claiming that they have disrupted market order through "profiteering and speculation" (投机倒把). An investigation team was sent to Wenzhou in 1982, and eight small private business owners were accused of committing commercial crimes. These entrepreneurs were either imprisoned or forced to fled the city to avoid arrest. The crackdown had a chilling effect on private business development in Wenzhou. In 1983, local officials from Wenzhou traveled to Beijing multiple times to appeal for reversing the investigation team's decision. With the support of the liberal-minded General Secretary Hu Yaobang, Yuan Fanglie, the party secretary of Wenzhou City, reopened the case in 1984, declared the eight private entrepreneurs wrongly indicted, and returned their confiscated properties.[25]

The events of 1987 and 1988 provide another example of the winding road of reform. In 1987, believing that the political liberalization spearheaded by Hu Yaobang had gone too far, Deng Xiaoping and other senior CCP leaders decided to remove Hu from his position as General Secretary of the CCP. He was succeeded by Zhao Ziyang, a key architect of economic reforms, whose appointment signaled continued commitment to market-oriented policies despite growing political caution. In March 1988, China's constitution was amended to legalize private businesses.[26]

By the summer of 1988, however, the tension between reform and control had become acute. The rapid decentralization and bottom-up reforms of the previous decade had delivered impressive economic gains, but it also eroded the central government's authority and

[24] For financial decentralization, see Brandt and Zhu (2000). For fiscal decentralization, see Shirk (1993) and Montinola, Qian, and Weingast (1995).

[25] *"Wenzhou was hit by the "Eight Kings" Incident in 1982 (温州1982年遭遇八大王事件).*" http://www.reformdata.org/2011/0624/15658.shtml.

[26] Having legal status, however, does not mean private businesses were exempt from administrative abuses and discrimination by the state banking system.

challenged the dominance of the state sector. The central government's commitment to support the state sector despite its declining contribution to aggregate output required large transfers to SOEs. Due to fiscal decentralization, the central government had limited fiscal resources to finance the transfers and resorted to money creation, which led to inflation exceeding 20% in the summer of 1988.[27] On August 30, 1988, premier Li Peng held an emergency meeting of the State Council, which made the decision to abort the broad price reform that was announced just eleven days prior, and implemented rectification and consolidation measures to curb investment growth, credit expansion, and inflation.

## 3. 1989-1993: Searching for a new direction

### 3.1 Political crisis

Despite the emergency measures, inflation persisted well into the spring of 1989, and rampant corruption associated with the dual-track price system–which the aborted broad price reform was intended to dismantle–led to widespread social discontent. Feeling that the existing political system had blocked deeper reforms, liberal intellectuals and college students began demanding political change. In April 1989, following the death of Hu Yaobang, thousands of students, intellectuals, and even government officials gathered in Tiananmen Square to commemorate the man who had symbolised the political liberalization of the previous decade. What began as a commemoration soon escalated into mass protests calling on the central government to implement meaningful political reforms, with some participants even demanding radical changes to the political system.

Faced with direct challenges from the populace, Deng Xiaoping and most central government leaders were determined to defend the existing political system. While Deng was a pragmatic leader who viewed economic development as essential for strengthening the ruling party's grip on power, he was also resolute in safeguarding the political system whenever it faced serious threats. Back in 1979, Deng had laid down the Four Cardinal Principles–*upholding the socialist road, the people's democratic dictatorship, the leadership of the CCP, and Maxism-Leninism and Mao Zedong Thought*–as a red line that could not be crossed. On May 20, 1989, Premier Li Peng announced the imposition of martial law; on June 4, the People's Liberation Army (PLA) cleared all protesters from Tiananmen Square; and on June 24, Zhao Ziyang was officially removed as General Secretary, with Jiang Zemin appointed as his successor.

[27] Brandt and Zhu (2000). Many observers attributed the rising inflation at the time to the failed attempt of price liberalization in August 1988. While the central government's announcement through the central TV and radio stations on August 19, 1988, about the broad price reform (价格闯关) did triggered panic buying by consumers and a spike in consumer good prices, inflation was already high before the announcement, reaching more than 19% in July 1988.

### 3.2 Retrenchment and economic crisis

After the political crisis, the CCP leadership concluded that the political liberalization and economic decentralization of the previous decade had gone too far. They moved swiftly to reassert party and state authority. On the political front, they emphasized ideological unity and party discipline, reaffirmed adherence to the Four Cardinal Principles, and insisted on strict separation of economic development from political liberalization. They also launched a rectification campaign to "unify the thinking" of party members and government officials.[28]

On the economic front, the State Council announced a three-year retrenchment plan, issued several administrative directives to crack down tax evasion and "profiteering and speculation" by private enterprises, and required all financial institutions to drastically reduce new loans to non-state enterprises. As a result, millions of TVEs went bankrupt, tens of millions of jobs were lost, and China's GDP growth rate plummeted from 10.6% in 1988 to 4.1% in 1989 and 3.8% in 1990–the lowest rates of the reform era prior to COVID. Furthermore, despite the government's effort to redirect resources to the state sector, SOEs' profitability continued to decline in 1989 and 1990.[29] In summary, the retrenchment measures failed to revitalize the state sector and instead triggered an economic crisis.

### 3.3 Finding a way to survive

Chinese government leaders were concerned not only about their economic problems but also alarmed by the collapse of the Soviet Union and the concurrent disintegration of Easter European communist regimes. To some elder leaders such as Chen Yun, Li Xiannian, and Yao Yilin, these developments confirmed their long-held suspicions that Western influence and economic decentralization would undermine the CCP's socialist regime. They called for making the economy more centralized and unified and for readjusting the balance between the state and non-state sectors, even if that meant slower economic growth. Deng Xiaoping, on the other hand, believed that slower growth rates posed an even bigger threat to the CCP's authority and urged Premier Li Peng and General Secretary Jiang Zemin to halt the retrenchment measures.[30]

Jiang took a more cautious approach. In October and December 1991, he convened a group of prominent Chinese economists for a series of eleven discussion sessions to understand the reasons behind the collapse of the Soviet Union and Eastern Europe communist regimes and search for a new path forward for the China's socialist economy. To better understand the role of the market, he even studied Western economic texts, including Adam Smith's *The Wealth of Nation*. After these sessions, he reached a conclusion similar to Deng's: a market economy

[28] Gewirtz (2022), Chapter 14.
[29] Naughton (1995), Chapter 8.
[30] Gewirtz (2022), Chapter 15.

can function not only under capitalist regimes but also under socialist regimes, provided that the CCP and the state maintain firm political control.[31]

In January 1992, feeling impatient with the leadership's hesitance to promote faster economic growth, Deng set out on a tour to several southern cities, most notably Shenzhen–a pioneer of economic reforms–and delivered highly publicized speeches calling for market-oriented reforms. One simple sentence he uttered had a profound and immediate impact: "Whoever is opposed to reform must leave office."

Deng's Southern Tour reignited momentum for reform, but translating his vision into policy required endorsement from the party leadership. In March, Jiang stated at a Politburo meeting that he would make promoting faster growth a central theme of his upcoming speech at the 14th Congress of the CCP. Just days later, the People's Daily published an article declaring that the retrenchment was "basically completed." In June, in a speech at the Central Party School, Jiang announced that China would build a "socialist market economy." After three years of retrenchment, the central government embraced economic reforms once again. Unlike the reforms in the first decade, however, political liberalization was no longer on the agenda.[30]

Growth accelerated quickly, with GDP growth reaching 13% in both 1992 and 1993. The private sector also responded rapidly. According to China's business registration data, 1992 recorded the highest entry rate of private businesses that has not been matched since. However, this surge in growth was accompanied by rapidly rising inflation once again.

## 4. 1994-2007: State capitalism and global Integration

### 4.1 The Problem of growth and inflation cycles

Since the start of the reform period, China's rapid growth had always been associated with rising inflation. This phenomenon reflects a fundamental contradiction of the Chinese government's policy. On the one hand, the government encouraged financial and fiscal decentralization in order to promote growth. On the other hand, it was resolute in ensuring that the state sector did not shrink. Financial decentralization allowed financial institutions to channel more resources to the more productive non-state sector, resulting in higher aggregate productivity and faster GDP growth. To maintain its commitment to the state sector in the face of faster growth in the non-state sector, the central government needed to provide subsidies to the SOEs for capital investments and wage payments. However, with fiscal decentralization, the central government lacked sufficient resources to finance these transfers. As a result, it resorted to money creation, which led to rising inflation. Prior to 1993, there had been three rounds of accelerating growth accompanied by rising inflation–in 1980, 85,

[31] Chen and Hong (2012). Gewirtz (2022), Chapter 15.

and 88. Each time, inflation was only brought under control when the central government used administrative measures to rein in credits to non-state enterprises, at the cost of slower GDP growth.[32]

This time it was no different. In May 1993, the annualized inflation rate reached 17% in large cities and continued to rise.

4.2 Recentralization of the fiscal and financial System

Alarmed by the accelerating inflation, Zhu Rongji–then vice premier in charge of economic policy–took action in June 1993: he dismissed the governor of the People's Bank of China (PBOC), China's central bank, and appointed himself as governor. The central government issued the well-known No.6 Document on macroeconomic regulation, and launched a crackdown on financial decentralization to curb inflation.[33]

Zhu knew very well the inherent contradiction between the government's commitment to the state sector and financial and fiscal decentralization. In a speech on June 9, he stated that "What needs to be done now is not rectification and consolidation, but further deepening of reform."[34] The reforms he had in mind, was recentralization of the financial and fiscal system.

Soon after, a fiscal reform was implemented nationwide in 1994. Before the reform, the system was what Yingyi Qian and others called as "fiscal federalism." Local governments collected taxes from enterprises and they had discretion in setting tax rates. They negotiated a fixed amount of revenue to remit to the central government and retained the remainder. As a result, the central government's share of fiscal revenues was very low. After the reform, tax rates were set centrally, and the main source of tax revenue, the value-added tax (VAT), was collected directly by the central government, which kept 75% of the revenue and shared only 25% with local governments. With more fiscal revenue under its control, the central government launched ambitious infrastructure investment projects and regional redistribution initiatives, such as the Western Development strategy.

The financial sector reform was also launched in 1994. The main objective of the reform is to impose a tighter control of lending by the banking system and eliminate the need for money creation in funding investment projects in the state sector. This was done by strengthening the central bank and insulate it from local government pressures, setting up three policy banks for policy lending, shutting down all bank-affiliated trust and investment companies, severing the

[32] Brandt and Zhu (2000).

[33] Opinions on Current Economic Situation and Macroeconomic Regulation 中共中央、国务院关于当前经济情况和加强宏观调控的意见. http://www.reformdata.org/1993/0624/4247.shtml
[34] Zhu Rongji on the record 朱镕基讲话实录, volume 1, page 291.

links between the state-owned banks and urban and rural credit cooperatives, gradually consolidating these credit cooperatives into urban and rural commercial banks controlled by local governments, and centralizing loan decisions of the state-owned banks.  The result of the reform is a much more centralized banking system that favours large firms at the expense of small and medium-sized firms in the non-state sector.[35]

The fiscal and financial recentralization was effective in reasserting the central government's control over fiscal and financial resources and eliminating its reliance on money creation. As a result, inflation was brought under control for much of the period that followed. However, the recentralization also tightened financial constraints on small and medium-sized enterprises in the non-state sector and led to greater misallocation of capital between the state and the non-state sectors.[36]

### 4.3 SOE reform: Grasp the large and let go of the small

The fiscal and financial recentralization did not resolve the financial problems faced by small and medium-sized state-owned enterprises (SOEs). Despite years of reform efforts, including implementing the Managerial Responsibility System (MRS), these SOEs in downstream industries could not compete with more market-oriented non-state enterprises and suffered mounting financial losses. These loss-making SOEs were supported primarily by loans from state-owned banks, which led to a growing volume of non-performing loans on the banks' balance sheets. Maintaining the commitment to these failing SOEs became an unsustainable burden for both the central government and the banking system. Consequently, the central government launched a new round of SOE reforms, closing or privatizing small and medium-sized SOEs in the downstream industries while concentrating support on large SOEs in upstream sectors, which were shielded from competition through entry barriers.

In addition, the government sought to enhance the efficiency of large SOEs by transforming them into corporations and separating their social welfare functions from core business operations. Notably, employee housing services were privatized and commericalized, spurring rapid growth in the urban real estate sector. The government also introduced more diverse ownership structures while still maintaining a controlling share.[37] These large SOEs were also given priority in raising capital from the stock markets, both domestically and international. In 1997, China Mobile completed a dual listing on the New York and Hong Kong stock exchanges, raising $4.2 billion. Since then, with the help of investment bankers from Wall Street, many corporatized large SOEs have successfully launched international

[35] Brandt and Zhu (2007) and Zhu (2021).
[36] Brandt, Tombe, and Zhu (2013).
[37] Hsieh and Song (2015).

IPOs. Wall Street was enthusiastic about these corporatized SOEs not because they were highly efficient enterprises, but because of the hefty monopoly rents they enjoyed in China.[38]

### 4.4 Liberalization of downstream manufacturing industries

With the closure or privatization of small and medium-sized SOEs, the government had effectively withdrawn the state sector from the downstream manufacturing industries and allowed free entry of foreign and domestic private enterprises into these sectors. In 1997, the government also officially announced that private enterprises were an integral part of the socialist market economy, and eliminated "profiteering and speculation" from punishable commercial crime list. No longer shadowed by the legal uncertainty, private enterprises in Zhejiang and Guangdong provinces grew rapidly during this period.[39]

### 4.5 Trade and labour market liberalization

With the recentralization of the fiscal and financial system and the associated worsening of capital allocation, growth began to slow in 1995. The restructuring of SOEs and Sunan TVEs also resulted in a large number of layoffs, putting further downward pressure on growth. Despite the central government's efforts to stimulate domestic demand through infrastructure investment, the GDP growth rate declined gradually from 12.3% in 1994 to 7.4% in 1999.

Facing weak domestic demand and high employment pressure, the central government sought to reignite growth through trade and labour market liberalization. It actively pursued WTO accession and finally succeeded at the end of 2001. To fully capitalize on integration into the global market, the government also began reducing barriers to internal trade and migration and invested heavily in transportation infrastructure. As a result, both internal trade and internal migration increased significantly between 2000 and 2007. The government also permitted private enterprises of all sizes in downstream industries to export directly. These internal market liberalizations, more than export expansion, reignited China's growth, which surged from 8% in 2001 to 13.3% in 2007.[40]

### 4.6 Summary of policy changes between 1994 and 2007

There are two opposing trends in economic policy changes during this period. On one hand, the centralization of fiscal and financial systems, along with the central government's regional redistribution policies, led to greater capital misallocation, negatively affecting aggregate productivity growth. On the other hand, product market liberalization in the

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[38] Walter and Howie (2011).

[39] However, TVEs following the Sunan Model in southern Jiangsu Province, which had enjoyed impressive growth in the 1980s, began to experience financial difficulties due to their mixed-ownership structure and local governments' interference in business operations. Like SOEs, these Sunan TVEs underwent restructuring–some closed down, some were privatized, and others consolidated and corporatized as share-holding firms.

[40] Tombe and Zhu (2019).

downstream manufacturing industries, investments in transportation infrastructure, internal and external trade liberalization, and reductions in internal migration costs all contributed positively to productivity growth. Between 2000 and 2007, the later force outweighed the former, resulting in accelerated economic growth.

## 5. 2008-present: Centralization and top-down industrial policies

### 5.1 Industrial policy

As the Chinese economy expanded and the central government's fiscal revenue as a share of GDP increased, the government grew more confident and assertive. Since the failure of the Foreign Leap Forward, it had generally avoided industrial policy. This changed in February 2006, when the central government introduced the Medium- and Long-Term Science and Technology Plan (MLP) for 2006-2020. The plan identified 68 key areas and priority themes in 11 industries where China should pursue "indigenous innovation" and listed 16 mega projects to be supported and financed by the government. [41]

When the Global Financial Crisis hit the Chinese economy in 2008-2009, the government launched a massive stimulus package, prominently featuring industrial policies aimed at promoting strategic industries outlined in the MLP. The temporary rebound in China's GDP growth following the stimulus further emboldened the Chinese government to pursue industrial policies more actively. The State Council announced the *Decision on Accelerating the Cultivation and Development of Strategic Emerging Industries* in October 2010[43] and issued the *Made in China 2025* plan in May 2015.[44]

A careful comparison between *Made in China 2025* and *China 2030*—a policy blueprint jointly issued by the World Bank and the Development Research Center of the State Council in 2013[45]—reveals a pronounced divergence in policy orientation. *China 2030* advocates a comprehensive agenda of market-oriented reforms, including reduced state intervention, strengthened rule-of-law institutions, and enhanced competition. It calls for establishing a level playing field between state-owned enterprises (SOEs) and private firms and underscores the central role of competitive markets in fostering innovation and efficiency.

By contrast, *Made in China 2025* embraces a state-led industrial policy paradigm. It places substantial emphasis on top-down strategic guidance in the identification of priority sectors, the allocation of resources, and the direction of technological upgrading. The plan prioritizes the cultivation of national champions, the use of industrial planning instruments, and the

[41] Naughton (2021) and Ministry of Science and Technology of China (2006). https://www.most.gov.cn/xxgk/xinxifenlei/gjkjgh/200811/t20081129_65774.html.
[43] https://www.mee.gov.cn/zcwj/gwywj/201811/t20181129_676498.shtml.
[44] https://www.ndrc.gov.cn/xxgk/zcfb/qt/201505/t20150520_967388.html.
[45] The World Bank and the Development Research Center of the State Council, P.R. China (2013).

deployment of targeted subsidies as means of advancing government-determined technological and industrial objectives.

5.2 Centralization of policymaking process

After 2012, the new CCP leadership has placed great emphasize on loyalty to the party center, and officials who deviate from central government policies were often severely punished. As a result, economic policymaking has become highly centralized and top-down. Unlike the first three decades of the reform era, few policies are now initiated from below.[46]

This shift was further reinforced by a series of large-scale policy campaigns. From the Supply-Side Structural Reform launched in November 2015—which sought to reduce excess capacity, cut excessive inventories, and deleverage—to the imposition of the "three red lines" policy on real estate developers in August 2020, top-down interventions have increasingly shaped the economic landscape. These campaigns, though aimed at achieving macroeconomic stability and risk reduction, have often imposed substantial constraints on private enterprises and inhibited broader market development.

In addition, the current leadership has emphasized building larger and stronger SOEs. The anti-corruption campaign launched in 2012 has also made local government officials and banks reluctant to engage with private enterprises, further tilting the playing field towards the state sector.[47]

5.3 Cracking down on private entrepreneurs

Even in this environment, private entrepreneurs continued to innovate, with particularly rapid progress in the platform economy and EdTech industry. For example, by exploiting the inefficiencies in highly regulated services such as transportation, education, and finance, companies like Didi, Alipay, and New Oriental introduced ride-hailing, digital payment, and online/ offline education services to fill market gaps and grew rapidly. However, when their expansions pushed the regulatory boundaries, the government responded forcefully. In 2021, both Didi and Ant Financial–the parent company of Alipay–were investigated by the government, and their planned international IPOs were canceled. The government also launched a campaign of rectification and consolidation of the EdTech industry, resulting in the closure of many education service providers, including the shutdown of New Oriental's online education services.

5.4 Growth deceleration

The centralization of policymaking, top-down industrial policies, the promotion of larger and stronger SOEs, and cracking down on "disorderly expansion of capital" by private enterprises

[46] Fang, Li and Lu (2025), and Luo, Wang and Yang (2025).
[47] Fang and Zhang (2025).

have had a significant negative effect on China's growth. Aggregate productivity growth declined from 4% between 1990 to 2007 to only 1% between 2008 and 2023, and China's GDP growth has been on a decelerating trajectory since 2010.[48]

## 6. Conclusion

China's remarkable economic rise over the past five decades was not the product of carefully designed industrial or mercantilist policies, as is often assumed. Instead, its most dynamic periods of growth occurred when the government adopted a more passive stance, allowing bottom-up initiatives, private sector development, and market forces to shape the economy. Farmers, local officials, and entrepreneurs played a pivotal role in driving reforms that unleashed productivity gains, while the government tolerated these changes as long as they did not threaten political control.

However, this growth model was inherently constrained by the state's commitment to preserving its political system and a dominant state sector. Whenever market forces eroded state control or private enterprises pushed beyond regulatory boundaries, the government reasserted its authority through recentralization, industrial policies, and administrative interventions. These cycles of liberalization and retrenchment created a pendulum-like dynamic in China's economic trajectory, with periods of rapid growth followed by slowdowns as state intervention intensified.

China's experience thus offers support for Adam Smith's framework for understanding prosperity, but that framework also raises questions about China's future. Smith recognized that markets and the division of labour could generate remarkable productivity gains, and China's most dynamic growth periods point to this mechanism at work: when the state stepped back and allowed market forces to operate, growth accelerated; when the grabbing hand strengthened, growth suffered. China's recent slowdown, coinciding with increased state intervention and weakened protections for private enterprises, fits this pattern. But Smith also emphasized that sustainable prosperity requires secure property rights and the rule of law. He wrote that "Commerce and manufactures can seldom flourish long in any state which does not enjoy a regular administration of justice, in which the people do not fell themselves secure in the possession of their property" (*WN*, p.910). China never fully embraced these institutional foundations even during its most liberalising phases. Whether China can sustain long-term prosperity without them remains an open question.

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[48] Zhu (2025).

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