Demystifying the Chinese Miracle
The rise and future of relational capitalism

Yongqin Wang
Demystifying the Chinese Miracle

The last three decades has witnessed miraculous economic growth of China. What has accounted for its miracle? What is the nature and future of the Chinese model? Is it unique?

This book presents an analytical framework to demystify China’s economic growth miracle. The book suggests that interlinked and relational contracts between the agents (in particular, between the state and the business) can compensate for flawed markets to achieve high growth. This kind of relational capitalism is significant in the investment-based stage of development, when mobilization of resources to exploit the existing technologies is the key for growth.

The book presents a general theory of the interlinked relational contract, the workhorse model of the book. The theory highlights that effective governance is a function of market extent and market completeness. The process of economic development and modernization can be looked at fruitfully from two perspectives: the markets and the institutions; and their interactions. The book stresses the critical fit between the development stage and the governance for a country’s economic transition and development and thus the idea of “appropriate institutions”.

Yongqin Wang is currently Associate Professor at the China Center for Economic Studies (CCES), Fudan University, China, and has held a visiting position at Yale University (2008–2010). He received his PhD in Economics from Fudan University in 2004 and has also attended Queen’s University (Kingston, Canada) and IDEI, University of Toulouse 1 (Toulouse, France) as a visiting scholar. His main research interests include microeconomic theory, financial economics, development economics, and Chinese economy.
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1 Introduction

Motivations and questions

The last three decades have witnessed China’s history-making economic growth, with an average annual growth rate of over 9 percent, despite a general lacking of sound legal system, financial system and other formal institutions. From an international perspective, China’s transition so far is undoubtedly a huge success when compared either with other transition economies like Russia, or with any other developing economy. It is an intriguing challenge for social scientists to offer some theory to account for the economic miracle and to predict its future.

China’s current growth record is reminiscent of those of the East Asia developmental states after World War II, which had comparable growth records. Japan, and later, four industrialized economies – Korea, Taiwan, Singapore and Hong Kong – had comparable annual growth rate for almost three decades. Now these economies are all high-income developed economies. During their catch-up period, most of these economies share the following features. (1) Authoritarian governments played a substantial role in economic development through various policy instruments, like industrial policy. (2) The role of the legal system was not that pervasive, as in the Western world, while relational contracting played an important role in socioeconomic life. (3) The economic structure was centralized and there were a few big firms and banks as major players in economic arena. There is long-term relationship between banks and firms, and banks are dominant financing sources for large corporations. (4) Economic success at preliminary stages, once dubbed as Asia’s miracle, was followed by economic crisis in many economies at the end of 1990s. Japan, for instance, began to fall into long-term stagnation even in the early 1990s. (5) From the perspective of political transformation, the free market system was accompanied by a political democratization process in these economies. What’s behind the East Asian miracle? Are there similarities between the East Asian miracle and the Chinese miracle?

Conventional wisdom suggests the protection of private property, a sound legal system, government transparency and an efficient financial system contribute
Table 1.1 The rule of law index

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Note: From 0 to 100, the higher the score, the better the rule of law.
Source: Kaufmann et al. (2005).

to economic development. Interestingly, there were weak formal institutions in place during China’s transition. Table 1.1 shows that the rule of law index is rather low for China. In historical retrospect, authoritarian governments played a pivotal role in economic development at the early stages of economic takeoff in East Asia. In the past 30 years international organizations like the World Bank and the IMF have made futile attempts to introduce a set of standard formal institutions (the so-called “Washington Consensus”) in the developing world. A general question thus arises: what is the relationship between institutions and economic development?

This book presents a theoretical framework to account for the dynamic relationship between economic development and institutions. The basic idea is as follows. The efficient institution is a function of the extent of market and the division of labor. In the stage with limited market extent and low level of specialization (incomplete market), the contracting between agents often takes the form of an interlinked relational contract, which internalizes externalities. From the perspective of the relationship between state and economic development, a government with a high level of autonomy and state capacity is more likely to foster economic development through interlinked relational policies, to address the missing markets problem. In this sense, the form and extent of economic organization and government intervention is a function of economic development stages. At stages with a large extent of market and relatively complete markets, formal institutions enforced by a third party will play more important roles.
Contributions and conclusions

The extent of the market and division of labor endogenously determines the efficient forms of contract. The key to understanding the relationship between formal institutions and informal institutions is to know how economic development endogenously changes the form of contract. A theory of interlinked relational contracts is introduced for understanding the relation between economic development and endogenous institutions. The theory shows that in a developing economy with limited extent of market and division of labor (missing markets), transactions between agents tend to be multiplex and interlinked. A typical case is share tenancy in agriculture. In a developing economy, landlord and tenant make transactions not only on the product market (tenants may buy agricultural produce from landlords), but also interact on the labor market (landlords employ tenants), the credit market (landlords provide loan to tenants), and the insurance market (through sharecropping). Thus an unprofitable contract on a separate market may be viable in an interlinked transaction. That is, the interlinking markets expand the feasible set of viable relational contracts. In an economy with more complete markets, economic transactions occur on different specialized markets among anonymous traders. Further, the interlinked and relational contract may endogenously determine the structures of economic organization and forms of property rights.

Economic development and institutional change. Economic development often unravels the interlinked relational contract through specialization and market thickness effects. With a larger extent of market and division of labor, transactions through interlinked relational contracts can now be undertaken on specialized markets. Moreover, frequency and volume of transactions made on specialized markets will be higher – that is, markets are getting “thicker” – reducing the search cost for trading partners and unraveling relational transactions. Through the two effects personal transactions are gradually giving way to impersonal transactions.

Both relation-based governance and rule-based governance can be self-sustaining. Economic development does not necessarily lead to transformation from relation-based governance into rule-based governance. The reason is that both relation-based society and rule-based society are self-sustaining. If interlinked relational transactions between agents are sufficient to suppress impersonal specialized markets and formal institutions, we may expect a relation-based society. Only when specialization effect and market thickness effect are powerful enough to unravel the viability of interlinked relational transactions, will transformation from relation-based governance into rule-based governance occur. In particular, economic history has suggested that a successful transformation usually involves both economic and political liberalization.

The role of government is a function of the stages of economic development. Government can play an important role at the early stages of economic development. At the stage of limited market extent and missing markets, interlinked institutional arrangements (e.g. industrial policies) between government