Modern China
38(6) 665–676
© 2012 SAGE Publications
Reprints and permission:
sagepub.com/journalsPermissions.nav
DOI: 10.1177/0097700412459700
http://mcx.sagepub.com

Making Sense of the Chinese "Socialist Market Economy": A Note

Zhiyuan Cui[1]

Abstract

This short essay explores the theoretical meaning of the Chinese notion of "socialist market economy" in light of the recent financial crisis in the West. It argues that James Meade's theory of "liberal socialism" can help us to understand both "temporary nationalization" as a response to the financial crisis in the West and the Chinese experiment with "socialist market economy."

Keywords

socialist market economy, James Meade, Troubled Assets Relief Program, temporary nationalization

This year is the twentieth anniversary of the official beginning of the "socialist market economy" in China. Building a "socialist market economy" is the key theme of Jiang Zemin's political report to the 14th Congress of the Chinese Communist Party, held on October 12–18, 1992. As documented in Ezra Vogel's new biography of Deng Xiaoping, the concept of a "socialist market economy" was Jiang Zemin's response to Deng's Southern Tour in early 1992 and was approved by both Deng Xiaoping and Chen Yun (Vogel, 2011: 682).

However, most commentators in the West, from the Right as well as from the Left, believe that China is becoming increasingly "capitalist," and that the

[1]Tsinghua University, Beijing, China

Corresponding Author:
Zhiyuan Cui, School of Public Policy & Management, Tsinghua University, Beijing 100084, China
Email: cui-zy@tsinghua.edu.cn

notion of a “socialist market economy” is internally incoherent and at best serves the ideological role of window dressing. At midnight on a day in 1992, Jiang Zemin called Chen Jinhua, the Minister of Economic System Reform at the time, to ask him to prepare an in-depth study on the relationship between socialism and a market economy to counter Mrs. Thatcher’s denial of the feasibility of a “socialist market economy.”[1] Chen’s reply to Jiang was interesting and revealing. Chen discussed with his colleagues and found that Pareto, one of the leading figures of the Western economics which defines the very notion of “market efficiency” as “Pareto-efficient,” wrote a two-volume book titled *Socialist System* in 1902–1903. Chen told Jiang that since Pareto, whose influence in the Western market economics is arguably only second to that of Adam Smith, was himself interested in socialism, that means “socialist market economy” must have some meaning even in Western economics (Chen, 2008: 277–79).

This short article, in a sense, is a continuation of Chen Jinhua’s reply to Jiang Zemin. In my earlier article in this journal on the Chongqing experiment, I started with Nietzsche’s notion “Doing is everything” (Cui, 2011). In this light, I would emphasize that China is already a complicated “mixed economy”—a kind of “socialist market economy.” What is at issue is how to explain and theorize it. I will go roundabout, starting with the financial crisis of 2007–2008 in the United States, and then see how the lessons of “temporary nationalization” in the United States help us make sense of “socialist market economy” in China.

Why Greenspan and Paulson Favor “Nationalization”

In an interview on February 18, 2009, with *Financial Times*, Alan Greenspan, the former chairman of the Federal Reserve, who for decades was regarded as the high priest of laissez-faire capitalism, said nationalization could be the least bad option left for policy makers in dealing with the subprime crisis starting in 2007–2008: “It may be necessary to temporarily nationalize some banks in order to facilitate a swift and orderly restructuring,” he said. “I understand that once in a hundred years this is what you do” (Guha and Luce, 2009).

It may be very surprising to many readers that Greenspan would think at all in terms of nationalization, but he in fact gave the following plausible reason for it: it would “allow the government to transfer toxic assets to a bad bank without the problem of how to price them.”[2] Though Greenspan did not elaborate in the interview on why nationalization could avoid the problem of pricing toxic assets, I think we can understand his implicit reasoning with the help of Henry Paulson’s memoir *On the Brink*. This is how Paulson explains

his decision to inject taxpayers' money through TARP ("Troubled Assets Relief Program") into private banks:

> Banks were stuffed with toxic assets that they could unload only at fire-sale prices, which they were reluctant to do. By buying such assets at auction, we reasoned, we could jump-start the market, allowing banks to sell those bad assets in an orderly fashion, getting better prices and freeing up money to lend.
>
> Initially, when we sought legislative flexibility to inject capital, I thought we might need it to save a systemically important failing institution. I had always opposed nationalization and was concerned about doing something that might take us down that path. But now I realized two crucial things: the market was deteriorating so quickly that the asset-buying program could not get under way fast enough to help. Moreover, Congress was not going to give us any more than the $700 billion we had, so we needed to make every dollar go far. And we knew the money would stretch much further if it were injected as capital that the banks could leverage. To oversimplify: assuming banks had a ten-to-one leverage ratio, injecting $70 billion in equity would give us as much impact as buying $700 billion in assets. This was the fastest way to get the most money into the banks, renew confidence in their strength, and get them lending again. (Paulson, 2010: 200)

It is clear from this long quote that Paulson's logic for "nationalization" (i.e., injecting public capital into private banks) is threefold: (1) banks were reluctant to sell toxic assets to TARP at fire-sale prices; (2) buying these toxic assets would take too long in restoring the economy to health; and (3) given the leverage ratio permitted by the Basel Accord on banks' equity capital, "nationalization" in the sense of injecting public money into private banks as their capital was more effective than just buying up toxic assets at fire-sale prices.[3] Maybe that is also why Greenspan claimed nationalization would avoid the problem of how to price toxic assets.

It is revealing that even though Paulson's TARP program was a form of nationalization, he emphasized that "we wanted to avoid anything that looked like nationalization": "Buying common stock would strengthen capital ratios, but common shares carried voting rights, and we wanted to avoid anything that looked like nationalization. So we were leaning toward preferred stock that did not have voting rights (except in very limited circumstances) and could be repaid in full even if common shares substantially declined in value" (Paulson, 2010: 200). In other words, public capital was injected into private

banks as "preferred stock" without voting rights. Paulson did everything possible to avoid the appearance of nationalization. As David Wessel nicely put it, this particular form of nationalization—public risk-bearing without public control—is "socialism with American characteristics" (Wessel, 2009: chap. 12).

Indeed, Phillip Swagel, the assistant secretary of Treasury under Paulson, has described the political logic of this disguised "nationalization" more clearly:

> Secretary Paulson never would have gotten legislative authority if he had proposed from the start to inject capital into banks. The Secretary truly intended to buy assets—this was absolutely the plan; the TARP focus on asset purchases was not a bait and switch to inject capital.
>
> But Secretary Paulson would have gotten zero votes from Republican members of the House of Representatives for a proposal that would have been portrayed as having the government nationalize the banking system. (Swagel, 2009: 38)

Therefore, Paulson's announcement on November 12, 2008, that he would not use the TARP for its original purpose of purchasing toxic assets as TARP was signed into law on October 3, 2008, was a "pragmatic" adjustment of the goal in the mid-course, in favor of a more effective and leveraged course of action, as Paulson had explained above. A month earlier, on October 13, 2008, Paulson, together with Ben Bernanke, chairman of the Federal Reserve System, had in fact invited the CEOs of the nine biggest US banks to his office, and asked them to accept a government capital injection of $125 billion in the form of preferred stocks. Again, Paulson himself explained this disguised "nationalization" best:

> The key for us was how to get as many institutions as we could to sign up for the capital purchase program (CPP), which is what we called our plan to inject equity into the banks. We settled on equity investments of 3 percent of each institution's risk-weighted assets, up to $25 billion for the biggest banks; this translated into roughly $250 billion in equity for the entire banking system. (Paulson, 2010: 212)

We should not miss the magnitude of "3 percent of each institution's risk-weighted assets," since "Basel I" only requires "Tier 1" capital to constitute 4 percent of risk-weighted assets of banks (Tarullo, 2008: 55).[4] If we measure the degree of "nationalization" of banks as a percentage of "Tier 1" capital being held by the United States government, then the government came to

hold in effect 75 percent of Tier 1 capital, or in other words, it had in effect come to hold three-quarters of the crucial Tier 1 capital of the banks. How could that have happened in a political environment so profoundly allergic to nationalization and socialism?

Phillip Swagel again explained this well:

> An important consideration with regard to the terms of the capital injections was that there is no authority in the United States to force a private institution to accept government capital. This is a hard legal constraint. The government can take over a failing institution, but this is done one-by-one, not en masse, and is not the same as injecting capital into an institution that is healthy in order to guard against future asset problems. In order to ensure that the capital injection was widely and rapidly accepted, the terms had to be attractive, not punitive. In a sense, this had to be the opposite of the "Sopranos"—not a threat to intimidate banks but instead a deal so attractive that banks would be unwise to refuse it. (Swagel, 2009: 39)

Paulson himself said basically the same thing, explaining: "We wanted to get ahead of the crisis and strengthen banks before they failed. To do this, we needed to include the healthy as well as the sick. We had no authority to force a private institution to accept government capital, but we hoped that our 5 percent dividend—increasing to 9 percent after five years—would be too enticing to turn down" (Paulson, 2010: 212). Here Paulson is talking about 5 percent dividend on the preferred stocks, to be paid by the banks to the government.

Interestingly, Paulson got the idea of a 5 percent dividend for government's preferred stocks from a phone conversation he had with Warren Buffett two nights earlier (Paulson, 2010: 210), but he did not mention the fact that Buffett got a much better deal than the government: "The 5% dividends are half the 10% yield that Buffett negotiated in Berkshire's investment in Goldman or GE. Moreover, Berkshire got warrants equal to its full preferred investment, not just 15%" (Forsyth, 2008).[5]

Maybe this sweeter deal for the banks was the price Paulson had to pay in order for the nine biggest banks to accept TARP capital injection. Professors Luigi Zingales and Pietro Veronesi of the University of Chicago came to the following conclusion in their evaluation of the redistributive effects of TARP interventions: it provided these banks' shareholders with a subsidy—or, as the authors put it, a gift—which Zingales and Veronesi estimated to be between $21 and $44 billion. According to their study, the subsidy to the banks' bondholders was even larger: $121 billion (Veronesi and Zingales,

2010: 364).[6] They further argue that if Treasury had demanded Mr. Buffet's terms, it would have been a much sweeter deal for the government and the taxpayers:

> Only three weeks before, when Warren Buffett invested in Goldman Sachs, he obtained much better terms: a 10% coupon on the preferred and a warrant with a strike price 8% below the closing price before the announcement (not a 5% coupon and a warrant with a strike price at the market price after the announcement of the injection).[7] . . . Except for JPMorgan and Wells Fargo (where the gain was negative), the government would have captured between 30% and 40% of the gain (i.e., between $39 and $55 bn), instead of losing between $21 bn and $44 billion. The relevant question, though, is whether all the banks would have accepted those terms. (Veronesi and Zingales, 2010: 364)

Here again, we see how the political logic of disguised nationalization required huge subsidies—what Veronesi and Zingales called "Paulson's gift." Thus we can understand why David Wessel termed this "socialism with American characteristics," a very surprising notion indeed.

Figures released by the Congressional Oversight Panel illustrate the exact subsidy each of nine biggest banks got from TARP (see Table 1).

Why Must Nationalization in the United States Be Temporary?

The nine financial institutions that were the recipients of the initial round of TARP investments included the four largest U.S. commercial banks (JPMorgan, Bank of America, Citigroup, and Wells Fargo), the three largest investment banks (Goldman Sachs, Morgan Stanley, and Merrill Lynch), and the two largest custodian banks (State Street and BNY Mellon). At that time, those banks held $10.3 trillion in assets, representing more than 75 percent of all the assets in the American banking system (Congressional Oversight Report, 2011: 23). In addition to the initial capital investments made in the United States' largest banks, the Treasury Department undertook additional steps to ensure the stability of Citigroup and Bank of America in November and December 2008 by purchasing an additional $20 billion of preferred shares from both institutions under the so-called Targeted Investment Program (TIP), which, like what was termed a "capital purchase program,"

Table 1. Estimated Value and Subsidy Rates of Certain TARP Investments as of COP's February 2009 Report

			Total Estimated Value		
				Subsidy	
Purchase Program Participant	Valuation Date	Face Value	Value	%	$
Capital Purchase Program					
Bank of America Corporation	10/14/08	15.0	12.5	17	2.6
Citigroup, Inc.	10/14/08	25.0	15.5	38	9.5
JPMorgan Chase & Co.	10/14/08	25.0	20.6	18	4.4
Morgan Stanley	10/14/08	10.0	5.8	42	4.2
Goldman Sachs Group	10/14/08	10.0	7.5	25	2.5
PNC Financial Services	10/24/08	7.6	5.5	27	2.1
U.S. Bancorp	11/3/08	6.6	6.3	5	0.3
Wells Fargo & Company	10/14/08	25.0	23.2	7	1.8
Subtotal		124.2	96.9	22	27.3
311 Other transactions		70.0	54.6	22	15.4
SSFI & TIP					
American International Group, Inc.	11/10/08	40.0	14.8	63	25.2
Citigroup, Inc.	11/24/08	20.0	10.0	50	10.0
Subtotal		60.0	24.8	59	35.2
Total		$254.2	$176.2	31	$78.0

Note. TARP = Troubled Assets Relief Program; COP = Congressional Oversight Panel; SSFI & TIP = Systemically Significant Failing Institutions and Targeted Investment Program.
Source. Congressional Oversight Panel (2011: 40).

was intended to obfuscate the reality of an injection of government capital into private banks, i.e., nationalization. TIP was utilized only for those two banks. Furthermore, in November, Treasury, in conjunction with the Federal Reserve and the Federal Deposit Insurance Corporation, put together a hastily crafted $301 billion guarantee of Citigroup assets.

The scale of injection of government capital into the banks—or, in other words, of nationalization—under TARP was indeed staggering; but equally staggering was that fact that as of March 8, 2011, not only had the nine biggest banks bought back the government stocks, but 145 of the 707 banks that participated in the TARP had redeemed in full their preferred shares either

through capital repayment or exchanges for investments under other government programs, including the Community Development Capital Initiative (Congressional Oversight Report, 2011: 55). This makes nationalization truly temporary, as Greenspan (and Paulson) urged.

My question is why does it have to be temporary? After all, it was Buffett who suggested to Paulson to inject capital in the form of preferred stocks, and Buffett himself to this day still holds his stocks in Goldman Sachs, awaiting a higher return. I submit that if we imagine what would have happened if the US government had continued to hold some significant proportion of stocks of the nine biggest banks (remember, in terms of "Tier 1" capital under Basel I, they were already 75 percent nationalized by TARP), we will get a sense of what a "socialist market economy" might mean.

Jiang Zemin's political report to the 14th Congress of the Chinese Communist Party defined "socialist market economy" as the system under which public ownership of the means of production occupies the commanding heights while various other forms of ownership would co-develop in a market environment. In my earlier article on the Chongqing experiment in the special issue on "Chongqing: China's New Experiment—Dialogues among Western and Chinese Scholars, IV" in this journal, I argued that

> The Chongqing experiment demonstrates that public ownership of assets and private business are not substitutes for one another. Rather, they can be complementary and mutually reinforcing. . . . When the government can get market revenues from public assets, it can reduce the tax burden on private business and individuals, therefore realizing the co-development and mutual reinforcement of public and private ownership of business. The fact that Chongqing has been levying a 15 percent income tax on enterprises when the national rate is 33 percent says it all. (Cui, 2011: 654–57)

Now, I want to ask, if the U.S. government had not sold its 79 percent stake of AIG completely (say, selling only 39 percent), wouldn't we see what is tantamount to a "socialist market economy" emerging in the United States?

James Meade's Topsy Turvy Nationalization

As I said in the earlier article, the Chongqing experiment is consistent with the key insight of James Meade, winner of the Nobel Prize in economics in

1977 and an advocate of "liberal socialism" since 1936. Now I would like to argue that his notion of "topsy turvy nationalization" can help us to make sense of a "socialist market economy."

What Meade calls "topsy turvy nationalization" is essentially to reverse the U.K. nationalization process in 1945. The U.K. government nationalized the steel, electricity, railways, and coal industries after World War II, but the state in the United Kingdom

> . . . did not receive for its own free use the profits . . ., since this was offset by the payment of interest on the national debt issued to raise the compensation cost of the nationalization schemes. Thus, the state became the owner-manager but without the benefit of an increased income. (Meade, 1993: 95)

In other words, the U.K. government issued more public debt to raise money for nationalization. We can observe a similar process going on in the financial crisis in the United States and the European Union (EU). The ongoing crisis in the EU shows a clear pattern of a linkage between a crisis in sovereign bonds and a banking crisis. The logic is that the banking crisis in the EU requires a TARP-type injection of government money, but the government can only raise money by issuing more public debt. This is what Viral Acharya and his colleagues at New York University mean by "A tale of two overhangs: the nexus of financial sector and sovereign credit risks" (Acharya, Drechsler, and Schnabl, 2012).

Meade's program of "topsy turvy nationalization" consists of the following:

> State does not possess a National Debt; it possesses instead a National Asset equal in value to some 50 percent of the productive wealth of the country. The government does not manage the productive concerns which lie behind this wealth. It simply invests its wealth on the competitive Stock Exchange in the form of holdings in private competitive trusts and similar financial institutions. (Meade, 1993: 94)

The point of "topsy turvy nationalization" is to gain two major benefits: (1) the government can use the proceeds of its shareholding to finance a "social dividend," which will provide added flexibility to the labor markets by granting minimum income to everyone (Cui, 2005) and (2) the government can be separated from micro-managing business decisions for the companies it partly owns. Meade recognizes that

> this process of Topsy Turvy Nationalization would present a formidable fiscal problem for the Capitalist countries of Western Europe starting off with a large National Debt, whereas in the case of a Socialist country of Eastern Europe the result might well be achieved merely by refraining from selling the whole of the beneficial ownership of all the state-owned assets to the private sector. (Meade, 1993: 201)

Now, it seems that my hypothetical conjecture of "what if" the U.S. government were to continue to hold some TARP shares in the major financial institutions is not so far-fetched after all.

Huang Qifan, the mayor of Chongqing, once said that the Chongqing experiment can be explained as "Marx Plus Reagan": Marx, for public ownership; Reagan, for low tax on private businesses. May I add that "Marx + Reagan = Meade"!

I hope by this short note that more people will be interested in this formula, which may eventually make sense of the concept of a "socialist market economy."

Declaration of Conflicting Interests

The author(s) declared no potential conflicts of interest with respect to the research, authorship, and/or publication of this article.

Funding

The author(s) received no financial support for the research, authorship, and/or publication of this article.

Notes

1. The British Prime Minister Margaret Thatcher visited China in 1991. In her discussion with Jiang Zemin and Zhu Rongji, Mrs. Thatcher expressed her view that socialism and a market economy are incompatible since a market economy is based on a capitalist system and private ownership (Chen, 2008: 316).
2. "Bad bank" here means the financial institution set up by the government to remove non-performing loans and other "toxic assets" from "troubled banks."
3. The Basel Accords are designed by the Basel Committee at the Bank of International Settlements in Basel, Switzerland. Although the committee was set up in 1974 by the Group of Ten industrial countries, its rules on capital requirements have been voluntarily adopted by many other countries, including China (Tarullo, 2008: 3).

4. The first Basel Accord, Basel I, was adopted in 1988 and it was still in effect in the US when the 2007–2008 financial crisis started. Though Basel II was adopted in 2004, only in April 2008 did the United States issue implementation guidelines. Ironically, the crisis made it clear that Basel II, which relied on the risk models and rating agencies which led to the crisis, needed a major overhaul. This gave rise to Basel III at the G-20 Seoul Summit in November 2010 (Barth, Caprio, and Levine, 2012: 187). "Tier 1" capital consists of equity capital (common and preferred stocks) and disclosed reserves (retained earnings and other surplus). See Dewatripont and Tirole, 1993: 50.
5. Treasury's purchase had warrants attached worth 15 percent of the preferred stock's par value. Warren Buffet bought preferred stock with warrants on 100 percent. A warrant entitles the holder to buy the underlying stock of the issuing company at a fixed exercise price until the expiry date.
6. The existing equity owners of the financial institution are typically reluctant to issue new equity because a large amount of the total-firm value added by new equity capital would go toward improving the position of creditors. This problem, called debt overhang, was first explained by Myers (1977). Obviously, by issuing new equity to the government the position of debt holders has been improved significantly.
7. The strike price can be defined as the fixed price at which the owner of a warrant can purchase the underlying security.

References

ACHARYA, VIRAL, ITAMAR DRECHSLER, and PHILIPP SCHNABL (2012) "A tale of two overhangs: the nexus of financial sector and sovereign credit risks." Financial Stability Rev., no. 16. www.banque-france.fr/fileadmin/user_upload/banque_de_france/publications/Revue_de_la_stabilite_financiere/2012/rsf-avril-2012/FSR16-article-05.pdf.

BARTH, JAMES, GERARD CAPRIO, and ROSS LEVINE (2012) Guardians of Finance: Making Regulators Work for Us. Cambridge, MA: MIT Press.

CHEN JINHUA (2008) Eventful Years: Memoirs of Chen Jinhua. Beijing: Foreign Languages Press.

Congressional Oversight Panel (2011) "March Oversight Report." Mar. 16.

CUI ZHIYUAN (2005) "Liberal socialism and the future of China: a petty bourgeois manifesto." Pp. 157–74 in Tian Yu Cao (ed.), The Chinese Model of Modern Development. London: Routledge.

——— (2011) "Partial intimations of the coming whole: the Chongqing experiment in light of the theories of Henry George, James Meade, and Antonio Gramsci." Modern China 37, 6 (Nov.): 646–60.

DEWATRIPONT, MATHIA and JEAN TIROLE (1993) The Prudential Regulation of Banks. Cambridge, MA: MIT Press.

FORSYTH, RANDALL (2008) "Buffett drives a harder bargain than Paulson: banks get cheaper financing from Treasury than from Berkshire Hathaway." Barron's, Oct. 14.

GUHA, KRISHNA and EDWARD LUCE (2009) "Greenspan backs bank nationalization." Financial Times, Feb. 18. www.ft.com/cms/s/0/e310cbf6-fd4e-11dd-a103-000077b07658.html#ixzz201qkrvm8.

MEADE, JAMES (1993) Liberty, Equality, and Efficiency. New York: New York Univ. Press.

MYERS, STEWART (1977) "The capital structure puzzle." J. of Finance 39, 4: 575–92.

PAULSON, HENRY (2010) On the Brink. New York: Business Plus.

SWAGEL, PHILLIP (2009) "The financial crisis: an inside view." Brookings Papers on Economic Activities, Spring.

TARULLO, DANIEL (2008) "Banking on Basel." Peterson Institute for International Economics.

VERONESI, PIETRO and LUIGI ZINGALES (2010) "Paulson's gift." J. of Financial Economics 97: 339–68.

VOGEL, EZRA (2011) Deng Xiaoping and the Transformation of China. Cambridge, MA: Belknap Press of Harvard Univ. Press.

WESSEL, DAVID (2009) In Fed We Trust: Ben Bernanke's War on the Great Panic. New York: Crown.

Biography

Zhiyuan Cui (PhD, University of Chicago, 1995) is a professor in the School of Public Policy and Management, Tsinghua University. Among his publications are *The Dilemma of the Invisible Hand Paradigm* (in Chinese, 1999), *The Second Thought Liberalization Movement and Institutional Innovation* (Oxford University Press, Hong Kong, 1997), *Whither China?* (in Korean, 2003). He is also a coauthor of *Sustainable Democracy* (Cambridge University Press, 1995), and the editor of Robert Unger's *Politics* (Verso, 1997). With Huang Ping, he coedited *China and Globalization: Washington Consensus, Beijing Consensus or What?* (in Chinese, 2005).