

**Understanding Transition in China: Domestic Tensions,  
Institutional Adjustment and International Forces**

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## **Introduction**

One of the most striking in international political economy in 1980s and 1990s is that China went through three kinds of transitions smoothly, i.e. from a command economy to a market-oriented one; from a rural, agricultural society to an urban, industrial one; and from a non-WTO nation to a WTO one, without leading to catastrophic turmoil or collapse compared to former socialist countries in East Europe and the Soviet Union. China's macroeconomic performance during 1980s and 1990s is even described as either "one of the few bright spots in the region" (Asian Development Bank, 2000) or "a true economic miracle" (Yu, 2001). Around China's successful transition and its robust economic growth, there have appeared two opposite schools: one is convergence school, which views China's economic growth as the natural consequences of its "reform and open door" policy aimed at 'normal' or 'standard' market economy by incremental institutional adaptation and adjustment; another is experimentalist school, which argues that China's robust economic growth is one part of an unique process with deliberate institutional design, or with somewhat institutional innovations such as "two track price system", although without clear and coherent target, sequencing and pace. In this paper, we try to seek linkages between domestic institutional adjustment and international forces to explain the roles of China's government in managing its transition and maintaining its successive economic growth.

Four parts are included, part I focuses on what kind of roles the government has played in the transition from the command economy to a market-oriented economy by scrutinizing the evolution of two developmental paradigms and their smooth transition. In part II, we examine three kinds of domestic tensions China has encountered in past two decades in maintaining its economic growth, and evaluate successes and failures of its institutional adjustment. In part III, we put China's economic growth in the context of globalization and explain how three kinds of international forces promote China's economic growth in past two decades. The final is concluding remarks, in which we point out some possibilities and challenges that China's government is likely to confront in its attempt to foster further a market-oriented economy.

## **I Two Development Paradigms and Transition: A Historical Perspective**

It is well known that China has had a command economy since the Chinese Communist Party(CCP) took over power in 1949. It is commonly asserted that China experienced and is experiencing a tough transition from the command economy to a market-oriented economy since "reform and open door" policy in 1978. In this section, we would like to answer two questions: what kinds of policies China's government took to shape the command economy, and how it has promoted successfully the transition from the command economy to a market-oriented economy?

## I The Command Economy

There are abundant literatures indicating that the Chinese economy had been predominantly agrarian before 1949 when the Civil War ended and the Chinese Communist Party (CCP) came to power (Perkins,1975:117; Riskin,1987,17; Wong, 1993:12). In order to strengthen state capacity to mobilize and organize resources, the CCP embarked on economic and social transformation in both rural areas and urban areas, which consequently laid the foundation for the so-called socialist command economy. The command economy paradigm began with significant advances in the early 1950s, but subsequently faced a series of challenges in late 1950s and 1960s, and finally had to be reformed in 1978. In retrospect, the CCP and China's government mainly took the following economic policies under the command economy paradigm.

1. Setting up national economic command apparatuses. During 1950s, the rehabilitation of economy and development were two main tasks under the goal of "three years of recovery, then ten years of development". After three-year successful economic rehabilitation and centralization of state power (1949-1952), the development planning was given priority. In order to match it, a series of institutional setting measures were taken nationally, including setting up the State Planning Commission(SPC) for long term and perspective planning and the State Statistical Bureau(SSB) in 1952, the State Construction Commission(SCC) for overseeing capital investment in 1954, the State Economic Commission(SEC) for short term planning, the General Bureau for Supply of Raw Materials(GBSR) for materials allocation, and the State Technological Commission(STC) for long term technological development in 1956, etc.. By the end of 1957, China's command system was highly centralized (Riskin,1987:55). In Frederick C. Teiwes' words,

By 1953 the CCP had amassed substantial resources on the basis of which socialist construction and transformation could begin. In economic terms, 70 to 80 percent of heavy industry and 40 percent of light industry were state owned in late 1952. State trading agencies and cooperatives handled more than 50 percent of total business turnover, while government leverage over the remaining sectors had increased due to the development of joint firms and revamped trade unions. ( in MacFarquhar and Fairbank,1987:93-4)

2. Land reform and institutional setting in rural areas. In early 1950s, the land reform in rural areas was carried out from 1950 to 1953 under the slogan of "setting free the rural productive forces, develop agricultural production, and thus pave the way for New China's industrialization"(cited in Riskin,1987: 48), in which four classes were divided based on properties, i.e. poor peasant, middle peasant, rich peasant and landlord, and land and other means of production were redistributed while land, drought animals, farm implement and surplus grain of landlords were confiscated. At the same time, a series of institutional reform were designed to promote agricultural development, including the *mutual aid teams*(1950-1955), *agricultural cooperatives*, the *Soviet-type collectives* in 1956, and finally *people's communes* in 1958. By the end of 1958, the *people's communes* became the only existing production organization in agriculture and private ownership disappeared

completely in rural areas.

3. Industrial policies and industrialization in urban areas. Compared to agriculture and land reform in rural areas, the industrialization in urban area was much more complicated over the same period. After three years of economic reconstruction and social transformation from 1949 to 1952, the “*general line for the transition to socialism*” was put forward in mid-1953 and announced publicly in October, under which “both industrialization and transformation would take place over a fairly long period of about fifteen years in a step-by-step manner” (MacFarquhar and Fairbank, 1987:92). By copying the Soviet model under Soviet aid, China stipulated the First Five-Year Plan (1953-1957) and priority was given to large-scale, capital-intensive manufacturing, which almost took up 90 percent of total industry investment. The core of the industrialization program in the FFYP consisted of 156 Soviet-aided projects and collectively absorbed about half of total industrial investment (in MacFarquhar and Fairbank, 1987:158). The FFYP attested to be successful in the sense that national income grew at an average annual rate of 8.9 percent (measured in constant prices), with agriculture and industrial output expanding annually by 3.8% and 18.7 percent respectively during the Plan period (Nicholas R. Lardy, in MacFarquhar and Fairbank, 1987:155), even compared to the Soviet economic performance under similar conditions from 1928 to 1940 where industrial production grew at an annual rate of 11 percent and agricultural production at an annual rate of only one percent (Gregory and Stuart 1981:83), let alone to most of these newly independent developing countries with average 2.5 percent per capita growth and agrarian India similar to China’s initial conditions with a per capita growth rate under 2 percent during 1950s (Lardy, in MacFarquhar and Fairbank, 1987:156).

4. Irrational economic policy. From late 1950s to late 1960s, partially because of the inspiring economic performance during the FFYP period, and partially due to the Sino-Soviet split, the CCP first took irrational economic policy known as the Great Leap Forward (1958-1960), and then replaced economic development with “politics in command” during the Cultural Revolution (1966-1976). Starting from GLF, the CCP indulged in class struggle. These indulgences followed by chaos in China resulted in economic stagnation, notwithstanding attempts in making adjustments in 1963-65 (Wu, 1999a: 469-495; MacFarquhar and Fairbank, 1987:391-397; Wong, 1993:18) and rectification in 1975 (Wu, 1999a: 726-732) from pragmatic leaders within CCP.

## **II The Market-Oriented Economy**

In 1970s, it was partially due to power struggles within the CCP after Mao’s death domestically (Shirk, 1994:18), and partially because of the improvement of Sino-US relations and inspiring economic performance of neighboring countries such as Japan, “four little dragons” and other NIEs, that the “reform and open door” policy under Deng Xiaoping leadership was carried out in 1978. From then on, China has entered a new era known as the transition period (The World Bank, 1996), namely the transitions from the command economy to a market-oriented one; from a rural, agricultural society to an urban, industrial one; and from a non-WTO nation to a WTO one. In contrast to a “shock therapy” approach to the transition from the command

economy to a market economy by the former Soviet Union, consequently leading to political collapse and economic stagnation, China has undertaken the transitions smoothly, at least in past two decades, although it also has faced a variety of serious challenges. The question is what kinds of policies China's government took to govern tough transitions smoothly while maintaining its robust economic growth?

1. 1978 to 1993 was the first stage of China's reform and transition, during this period, a series of economic policies were carried out in both rural area and urban area, of which four economic policies were vital to China's early smooth transition. First was the *decentralization of governance*. The new round of decentralization as a policy, starting with the 1980 fiscal reform called "eating in separate kitchens" and followed by the 1984 foreign trade apparatus reform(Shirk,1993:178-181), including administrative decentralization and fiscal decentralization, under which the local governments not only enjoy lower tax rates and higher share of revenues, but also enjoyed special institutional policy and policy environments and gained more authority over local economic development(Lin, Tao and Liu, 1997: 10-12). Second, the *expansion of non-state firms* rather than massive privatization of state-owned enterprises (Qian,1999). As a result, the township and village enterprises(TVEs) became the engines of China's economic growth in 1980s and early 1990s. It is estimated that by 1993, TVEs already accounted for 36% of the national industrial output, up from 9% in 1978, and within the rural sector, the TVEs accounted for three-quarters of rural industrial output, or more than one-quarter of the national total (Che and Qian,1998). Third, the *dual-track approach to market liberalization*. The "dual-track price system" was another key economic policy in 1980s which contributed to economic boom. Different from the single fixed price system under centrally planned economy, the "dual-track price system" as a policy means that the prices for the key commodities like coal, petroleum and steel was fixed while the prices for ordinary consumer goods depended on more or less free market. Last but not the least, *particularistic contracting system* (Shirk,1994). The particular contracting system included "household responsibility systems"(HRS) in agriculture in rural area and "contract responsibility system" in the state owned enterprises(SOEs) in urban area aimed to "expand enterprise autonomy". In contrast to success of agriculture reform under HRS, the "contract responsibility system" (CRS) was introduced to state enterprise in 1986 and 90% of stated-owned enterprises were covered by the CRS by 1988, the CRS, however, could not solve the deep-rooted problems underlying the state enterprises(Wong,1993:32-33).

2. From 1994 to 1998, China's reform and transition entered into a new stage known as a market-oriented economy following the "Decision on Issues Concerning the Establishment of a Socialist Market Economic System" adopted at the Third Plenum of 14<sup>th</sup> Party Congress in November 1993, and subsequent "Outlines of State Industrial Policy" by the State Council in March 1994. A series of radical reforms was launched:

(1). Unification of foreign exchange rates and convertibility of the current account. On January 1 1994, the plan allocation of foreign exchange under dual-track system was completely abolished, and in December 1996 a farther step was taken to

promote account convertibility of its currency without liberalizing capital account. Because of this policy, not only did export and foreign direct investment increase dramatically during this period, but it also helped China ride the Asian Financial Crisis in 1997(Qian,1999).

(2). Overhaul of the tax and fiscal systems. On January 1,1994, the National Tax Bureau and local tax bureaus were established, each responsible for its own tax collection which made it difficult for local governments to reduce taxes as they had in the past. The taxes were divided into three parts: “central taxes” are taxes needed to maintain the ability to exercise macro control on a national scale for the national benefit; “regional taxes” refers to taxes to meet regional needs; and “shared taxes” are taxes to directly support economic development at the central level and local level(Qian,1999).

(3). Monetary centralization and financial reform. While cleaning up the banks’ bad debts, the banking system was divided into three types in 1994: commercial banks, policy banks and cooperative banks. Policy banks including three newly-established Banks(China Development Bank, the Agricultural Development Bank and the Export-Import Bank of China) mainly look after government-mandated lending, and the commercial banks including four state banks (the Industrial and Commercial Bank, the Bank of China, the Agricultural Bank of China, and China Construction Bank) and cooperative banks were given greater capacity to make loans on a commercial basis. In 1995, the central bank was endowed the mandate to control monetary policy so that it reduced local government influence over monetary policy and credit allocation decisions (Xie,1996; Qian,1999). After Asian Economic Crisis, the central bank of China was freed from political interference of local authorities in 1998 and strengthened its regulatory functions while replacing its 30 provincial branches with 9 cross-province regional branches (Qian,1999; Saich, 2001: 238).

(4). Privatization of state-owned enterprises. From 1992 on, a series of new economic policies were issued to promote SOEs reform, first the “14 stipulations” issued by the State Council in July 1992, in which SOEs autonomy including hiring and firing and allocating investment capital was legally endowed, then policy of “grasp the large and release the small” in 1995 was issued, under which the central government promote privatization of state-owned enterprises. While 50-55 large state-owned enterprises are kept under state control, the small and medium-size enterprises supervised by county and city government would be turned into a variety of non-state firms through the expansion of shareholding system(Saich, 2001: 234; Wu,1999b:1061; Qian,1999).

(5). Reconstruction of a new social contract. In order to cope with rising unemployment from inefficient SOEs and growing social discontent derived from traditional inequalities between urban and rural area, coastal provinces and inland areas, and newly emerged inequality between those in the official core of the economy and those surviving in petty and informal economic activities, the Ministry of Labor and Social Security was established and a National Social Security Fund was set up in 1998. “Two guarantees” policy has been adopted since then. The first is a guarantee of the basic livelihood of the laid-off personnel from SOEs in which the

laid-off personnel receive allowance for basic living expenses and are paid social insurance premiums; the second guarantee is to ensure basic livelihood for all retirees and that they receive basic pensions in full and on time( Wang, 2004 ). Although it is on initial stage, the institutionalization of a new social contract is available for both laid-off workers and residents in most urban areas. For example, in today's China, the enterprises, either state-owned or private, have to pay social insurance premiums for both old employees and new-recruited employees.

From the evolution of China's macro-economic policies from the command economy to a market-oriented one, we have seen that the central government has played an active role, by and large, in both promoting earlier industrialization and creating Chinese pattern of primitive accumulation in 1950s(Selden, 1993), and in managing the transition from centrally planned economy to a market-oriented one while maintaining its robust economic growth in 1980s and 1990s. In the 1950s, it emphasized on development of capital-intensive heavy industry by institutional setting, invest, technology fostering and getting aid from the Soviet Union at the expense of agricultural development. In 1980s and early 1990s, it carried out a series of institutional reforms, for example, administrative decentralization and particularistic contracting such as "household responsibility system" in rural area and "contracting responsibility system" in enterprises in urban area, to promote and maintain its robust economic growth(Shirk,1993; 1994).

## **II Domestic Constraints: the Central-Local Tensions, Government-Industry Relations and Winner-Loser Constraints**

Around China's government policy and its robust economic growth, there have appeared two opposite schools: one is convergence school, which views China's economic growth as the consequences of its "reform and open door" policy aimed at 'normal' or 'standard' market economy by incremental institutional adaptation and adjustment(Moore,2000); the other is experimentalist school, which argues that China's robust economic growth is one part of an unique process with deliberate institutional design, or with somewhat institutional innovations such as "two track price system", although without clear and coherent target, sequencing and pace(Shirk, 1993, 1994; Qian,1999 ). The former highlights the international forces, and the later emphasizes on domestic forces. I would like to seek the correlation between domestic forces and international forces and its effect on target, sequence and pace of government-dominated policy in the transition.

### **(1) The central-local tensions**

The central-local tension was first key issue in China's economic reform. Just as what we mentioned before, the decentralization of authority in China started with 1980 fiscal reform, followed by 1984 foreign trade apparatus reform and 1993 separate tax system reform. It aimed to delegate central economic power to local governments and alleviate long-term tensions existed between the authoritarian

central government and local governments under the command economy system. As a result, the local governments have authority to approve foreign investment projects, special trade and investment zones, tax rates for foreign investment firms, establishment of trading companies, export subsidies, allocations of foreign exchange at official rates, and access to the foreign exchange swap markets, along with extensive domestic economy such as establishment of industrial project and creation of local market in favor of local economy(Shirk,1994:31). With economic growth of provinces, especially coastal areas, the central government has to gradually withdraw from direct command in economic domains to “macro economic adjustment and control” including administrative engagement, fiscal and tax engagement, financial engagement, and law and social reconstruction (Singh,1992; Shirk,1993; Lu and Tang,1997; Hannan,1998; Zhao,2000; Moore,2002). Therefore this lays the institutional foundations for China’s market transition(Qian,1999).

While the decentralization of authority as a policy alleviated the tension between central and local, it also weakened state’s capacity to govern macro-economy. As a result of decentralization, the negative significance with the increase of local government’s power came to scene in late 1980s and early 1990s, according to Susan Shirk, the most serious of which were (i) economic overheating accompanied by inflation, shortages, and budget and trade deficits; (ii) segmentation of the national market by local protectionism; (iii) competition among local governments for foreign trade and investment; and (iv) local administrative interference and rent-seeking in enterprise management (Shirk,1993:182). Moreover, the central finance got improved gradually from 1994 on with implementation of the tax system reform, however, the central government fiscal deficit has been kept in 1990s (National Bureau of Statistics of China, 2002:265), because the central government has to give fiscal subsidies to many inland provinces, which finally diminished and limited the state capacity to govern macro-economy and deal with potential crisis. For example, in the aftermath of the Asian crisis, the government followed an expansionary fiscal policy. Two fiscal stimulus packages (\$12 billion in 1998 and \$7.2 billion in 1999) were used to increase investment in infrastructure and pump prime growth, as a result, the fiscal deficit increased from less than 2 percent of GDP to 4.2 percent in 1999 (Asia Times, 2000).

With the onset of the Asian financial crisis in 1997 and the realization that the local governments became challengers to central government as well as became each other’s competitors in 1990s as a result of decentralization, from 1998 on, both CCP and China’s government began to take a series of tough measures to strengthen central government’s capacity to govern macro-economy. Of which two policy measures are special worth to note as far as central-local relations are concerned: one was overhaul of banking system. It include reorganization of local branches of People’s Bank along regional lines to reduce political interference by powerful provincial party chiefs (Saich, 2001:74). Another was to rationalize the tax collection system after 1994 tax system reform to prevent the levying of excessive fees and levies by local authorities(Saich,2001:75; Wang, 2004: 537).

## **(2) Government-industry relations**

The government-industry relation was second key and sensitive issue in domestic

economic reform when the China's leadership turned its attentions to reform of the urban industrial sector in 1984. It was complicated because it dealt with not only relation between central government and large SOEs but also with relations between local government and SOEs and TVEs. It was sensitive because it was seen as watershed between socialist economy and capitalist economy.

Different from mass privatization in other transition economies like the Czech Republic and Russia, China took the partial reform to deal with government-local relations through the optimal choice of sequencing(Roland,1999).

In 1980s, three important measures were introduced to reform government-industry relations in order to improve industrial performance. The first was to reform management of SOEs while maintaining state's ownership over enterprises. It included "expanding autonomy of enterprises" (1978-1982), "tax for profit"(1983-1986), and "contract responsibility systems"(1986-1988). The second was to leave the administrative management of TVEs to local governments (1984-1995) because of the decentralization of authority, consequently TVEs became the engine of economic growth in mid-1980s and early 1990s. And third was to encourage the development of individual enterprises and foreign-invested enterprises commonly called "three capital enterprises"(Chinese-foreign joint venture, Chinese-foreign contractual joint venture, and 100 percent foreign capital enterprises).

Of these three measures, the most unsuccessful is the reform of SOEs although it received the most attention. It is estimated officially that in the late 1970s state-owned enterprises contributed nearly 80 percent of production. However, their contribution had declined to around 50 percent by 1990(Yabuki,1995:47). Moreover, of the 100000 plus industrial SOEs in 1995, according to World Bank figures, less than 10 per cent were fundamentally viable although they absorbed 60 percent of national investment and received total subsidies amounting to one-third of national budget(Saich,2002:233).In contrast to SOEs, TVEs became the driving force of China's economic growth while the contribution of individual and "three-capital" enterprises increased from zero to 10 percent at the same period(Yabuki,1995: 47). The expansion of the non-state enterprises in national economic structure paved the way for legitimization of private ownership and further liberalization of market in mid-1990s.

From mid-1990s, the reform concerning ownership of all industrial sectors and liberalization of market came into policy domain known as "grasp the large and release the small". This meant that small and medium-size enterprises (SMEs) would be turned into a variety of non-state firms through the expansion of shareholding systems, formation of joint venture or sale to interested private parties. By the end of 1997, one-third of the 500000 TVEs had been sold off or turned into shareholding cooperatives and subsequently the private sector was given full political legitimacy (Saich, 2001: 234; 237).

This kind of partial reform through the *optimal choice of sequencing*, in retrospect, has its advantage for smooth transition. It is less costly to reverse than full form, and thus political acceptability can be easier. According to Roland, if the signals given by early reform are promising enough(e.g. robust economic growth), then the

reform can continue with greater support; if the signals given by early reform are unattractive to majority, it is much easier to come back to the status quo and thus reduce political risk of economic reform(Roland,2001).

### **(3) The winner-loser constraints**

The winner-loser constraint was the third domestic challenge in China's economic reform. The social constraint stems mainly from rising unemployment and widening social inequalities. The real unemployment rate in China since 1993 has risen sharply, much higher than China's officially registered unemployment rate. For example, the official unemployment rate was 3.0% in 1996, 3.1% was kept successively in 1997, 1998, 1999 and 2000, but the real one calculated by researchers was 5.1-6.0% in 1996, 6.8-7.8% in 1997, 7.9-8.3% in 1998 and 8.2% in 1999 respectively(Lai, 2003). The rising real unemployment rate in China is directly related to the bankrupt state of state-owned enterprises (SOEs), especially in the traditional manufacturing sectors. The state-owned enterprises (SOEs) have been regarded as the pillar of Chinese economy, on which socialism market-economy with Chinese characteristics is based and legitimized. However, it is noted that deficits of SOEs had been pervasive and the amount of subsidies to deficit enterprises had been increasing year by year from 1985 to 1990, while the "triangle debt" was kept (Yabuki,1995:51-52). Even entering into 1990s, it is estimated that approximately 40 per cent of SOEs has chronic deficits, and over 20 per cent of banks' portfolios in China consists of non-performing loans to money-losing SOEs (Economy,1998: 12). Moreover, the unemployment in China took a unique form called "Xiagang" (lay off). In 1980s and early 1990s, the "Xiagang" staff and workers refer to those in urban state-owned and collective enterprises who became redundant while keeping welfare connections with their original units and receiving a minimum wage. After 1997, "Xiagang" workers are no longer registered as employed ones within the relevant units but become main part of unemployment in China(Wang,2004). These "lay off" workers as losers of economic reform express their discontent by different ways here and there once they can not find alternative.

As far as the widening social inequalities is concerned, in addition to well-known the inequality between per capita income of rural households and that of urban household, and the growing inequalities between coastal provinces and inland areas, there emerge a growing inequality between those in the official core of the economy and those surviving in petty and informal economic activities. An Asian Development Bank study shows that 'about 230 million people (18.5 per cent of the population) still lives below the US\$1-a-day poverty line and 670 million (53.7 per cent of the population) live below US\$2-a-day' (Asia Times, 2000). Even in urban areas, about 12-15 million people (4-5 per cent of the urban population), were living under the poverty line, assuming an urban poverty line of \$200 (Y 1700) per capita income per year, according to the Development Research Center of the State Council of China in 1997 (Asia Times, 2000). There is, however, no official urban poverty line in China(Wang,2004).

In order to maintain social stability and build constituencies for further reform, two important policies were taken by the central government to manage social

**discontent.** The first was the use of “divide and rule tactics” rather than force to ensure transition although China is still authoritarian(Roland,2001). The second was the establishment of a social welfare system independent of the individual enterprises and regulated through the central government(Saich,2002: 230,241-271; Wang, 2004).

### **III International Sources: FDI, Overseas Chinese Business Network and the Industrial Product Cycle**

Many scholars attribute economic success of East Asia, so-called “East Asian miracle” to international forces, for example, to either “flying geese paradigm” or international economic system. It may be true for other East Asian countries(economies), but it is not applicable to China given its initial conditions: (1) unlike other countries(economies) in East Asia which have directly pursued their strategies within a capitalist-market context since the end of the Second World War, China has to take the transition from the command economy to a market-oriented economy when China embarked its “reform and open door” policy in 1978; (2) different from most of East Asian countries (economies) such as Japan, Thailand, Philippines, South Korea, Singapore and even Taiwan economy, which have allied with US politically and therefore had easy access to US market or international market centered on US, China has to learn how to deal with US politically after its open up. China not only missed the process manifested in the “flying geese paradigm” like ASEAN-4 countries, but also cautiously dealt with international forces in order to maintain the legitimacy of the Chinese Communist Party. It comes out that China’s government has had to pursue its own strategies in the context of domestic transition and international forces.

However, it does not mean that international forces are of insignificance in China’s economic growth and transition, especially in the context of globalization and China’s open door policy. In fact, the international forces such as FDI(Shirk,1994), foreign trade(Lardy,1992; Shirk,1994), and international institutions did contribute more, in some sense, than domestic forces to the development of some industries, for example, textiles and shipbuilding as showed by Thomas Moore(Moore,2002) and even to that of both the automobile industries and electronic industries especially in 1990s we have showed in our case studies.

As in most countries, especially in developing countries, the government always hopes to make plans to improve its economic performance depending on its own unique situation such as economic structure, developmental standard and comparative advantages, etc, while it has to adjust itself continually responding to the challenges from international environment. China’s economic policies tell us the same stories. In 1950s, with both the Cold War and backward agricultural society, China had to promote industrialization characterized with heavy industry priority at the expense of agriculture. During 1960s when the split between the Soviet Union expanded and “politics in command” dominated, China fell into ten-year economic and social chaos. When taking “reform and open door” in 1980s, in contrast to “big bang” liberalization

of market in former Soviet Union, the decentralization (administrative and fiscal), particularistic contracting systems (first agriculture and then enterprises) and dual-track system were carried out to promote domestic reform and liberalize the market step by step. Entering into 1990s, radical liberalization of price and foreign exchange rate were carried out to attract foreign direct investment while centralizing bank and finance to stabilize macro-economy.

Given powerful forces of inertia that prevailed in traditional China, the incentives from the outside world have been critical, of which the foreign direct investment, overseas Chinese business network and diversified production networks are three crucial international forces.

### **(1) Foreign Direct Investment**

The foreign direct investment has played key role in driving China's economic growth and makes China's economy depend more and more on foreign direct investment. It is estimated that by 2001, Chinese mainland has swallowed up \$321 billion, or 45 percent, of the \$719 billion in direct foreign investment flowing into East Asia since 1990(Hawkins,2002). The foreign direct investment contributed to China's economic growth in two ways.

Firstly, it has significant policy implications for China to integrate into world economy. As late as 1977, the Chinese press was insisting that China 'would never receive foreign loans' and 'never allow foreigners to meddle in the management of our enterprises', however, the lack of advanced technology and capital became a bottleneck to economic development. In order to go beyond this dilemma, special economic zone as a policy was put forward in 1979. The creation of SEZs was a way to reduce resistance to the new open policies from the powerful, finance, and industrial bureaucracies(Shirk,1995,36), and on the other hand it could meet the desire for capital and advanced technology. After initial difficult time, SEZs finally became an important model for further open policy due to their success to attract FDI, and numbers were extended from four SEZs (Shenzhen, Zhuhai, Xiamen and Santou)in 1979 to 14 coastal cities and Hainan island in 1984, finally over whole country in 1990s. Moreover, after adoption of Joint Venture Law in 1979, the Law on Wholly Foreign-Owned Enterprises was passed in 1986, and finally Joint Venture Law was amended in 1990 that led eventually to not only equity joint ventures but paved the way for the establishment of contractual joint venture and wholly foreign-owned enterprises(Saich, 2001:287).

Secondly, it directly provided capital needed to Chinese economic growth. When economic reform shifted from agriculture in rural area to industry in urban area in 1984, attracting foreign direct investment became priority because of high inefficiency and deficits of SOEs. Foreign-invested enterprises (called three capital enterprises including Chinese-foreign joint venture, Chinese-foreign contractual joint venture, and 100 percent foreign capital enterprises) were encouraged to established first in SEZs and later in developmental zones in inland areas. These enterprises enjoyed different kinds of "preferential policies" issued by both central government and local governments(Lu and Tang, 1997). It is estimated that by the end of 1992, the contractual value of cumulative investments was \$191.1 billion and the cumulative

amount actually disbursed was \$98.83 billion (National Bureau of Statistics of China , 1993, 647), it rose to 997 billion and 623.418 billion respectively by the end of 2002(National Bureau of Statistics of China, 2003, 671). It is worth to note that in late 1980s and early 1990s, of these enterprises, 95 percent are engaged in simple manufacturing processes, and industries are mainly in infrastructure such as energy, transportation, communication and export(Yabuki,1995: 56), however, FDI gradually flow to more capital-intensive areas such as automobile after mid-1990s.

While meeting the demand for capital, FDI, however, raises a series of challenges to China's FDI policy. One is well-known "round-trip" capital. Because FDI can help to avoid taxes and help enterprises to gain reduced tariffs on certain imported goods, it led many Chinese SOEs to shift funds to Hong Kong and then reinvest in China as FDI. It is estimated that the number of this kind of SOEs was 400 in 1991, and rose sharply to 2000 by 1994 (Saich, 2001: 289). Another is technology transfer. Most of FDI flows to China with the main purpose of exploiting cheap labor advantage. Such capital-intensive enterprises as automobile and electronics are keen to exploit the huge Chinese domestic market through the transfer of out-of-date technology. One manifestation is that few automobiles made in China are exported to international market although the automobile industry registered much faster growth in past decade.

## **(2) Overseas Chinese Business Networks**

The second international force to promote Chinese economic growth is overseas Chinese business network. What kinds of roles does overseas Chinese business network play in China's economic growth?

First, FDI is said to play key role in promoting China's economic takeoff, however, most of FDI in past two decades came directly from, or through this kind of overseas Chinese business network. Worldwide, overseas Chinese hold an estimated \$2 trillion of liquid assets, excluding securities, compared to an estimated \$3 trillion that are deposited in Japanese bank account, and since 1980s three-quarters of the 28000 Chinese firms with significant foreign equity are financed by ethnic Chinese not living in the People's Republic of China and that financing accounts for up to four-fifths of foreign direct investment in the PRC(in Katzenstein,1997:12-13). More precisely, from 1979 to 1997, 68.34 percent of the foreign capital in China came from ethnic Chinese outside of mainland China(Li, 2000:7, in Peng,2002:432), even by the end of 1998, foreign direct investment peaked at \$45.5 billion, over 60 per cent came from Taiwan and Hong Kong(Saich,2001:286).

Second, in addition to bring capital into China, the overseas Chinese business network provides business expertise and marketing connection, given the fact China is late developer in world economy and not very familiar with marketing connection and international regulations. The overseas Chinese business network facilitates expansion of domestic market relations. At initial stage of reform, overseas Chinese business can easily transcend political and nontariff barriers and enter into mainland China to invest in TVEs because of their amazing characters with small scale, kinship and ethnic linkages, high efficiency, and accurate information through global ethnic Chinese business network(Peng,2002:430). Later, with thousands of oversea Chinese students

coming back to mainland China either to invest or establish technology-intensive SMEs, overseas Chinese business network gets strengthened further to parallel with foreign large multinational corporations. Moreover, overseas Chinese business network also promotes China's economy to integrate into world economy. For example, the foreign trade is seen as a key indicator for China's openness and economic success. The ratio of foreign trade to GDP rose from 12.6 percent in 1980 to 39.5 percent in 1995 to 49.6 percent in 2002(National Bureau of Statistics of China,2003: 55, 654). However, when valuating regional distribution of China's foreign trade, we could find that it quadrupled from \$115 billion in 1990 to \$475 in 2000, of which over 60 percent is concentrated in Asia, with US accounting for 21 percent of exports and 12 percent of imports(Saich,2001: 286). It means that the marketing connection of overseas Chinese business network in Asia, mainly concentrated Southeast Asia, Hong Kong and Taiwan, contributed to China's trade. Some scholar even label it as "Greater China"(Chen and Kwan,1997).

### **(3) The diversified production networks**

The third international force that contributed to China's economic growth is diversified production networks. The diversified production networks mean globalized production networks, regionalized production networks and bilateral production networks. Many scholars attributed East Asian economic growth to product cycle, of which the most well-known is "flying geese paradigm": countries in this region are said to follow one another in a developmental trajectory in which latecomers replicate the developmental experience of the countries ahead of them in flying geese formation, and the economic rise of states is seen as a process that is tightly linked to the emergence, maturation, and decline of particular industrial sectors(Kaname,1962; Cumings,1984). Later, East Asia industrialization was elaborated, by both Japanese economists and Western economists and political scientists, as a "rational" pattern of industrial diffusion from Japan to the East Asian newly industrializing countries(NICs), to ASEAN, and most recently to China(cited in Bernard and Ravenhill,1995: 174). However, China's industrial policy in past two decades tells us a very different story especially in terms of diversified production networks and related technology transfer.

The technology upgrading has been a core concern in China's industrial policy. Generally speaking, China's government took two measures to upgrade its technology in past two decades: one was to invest directly in R&D and transfer military technology to civil one; another was "domestic market for international technology".

At initial stage of reform from mid-1980s to early 1990s, as a result of decentralization of authority and policy of SEZs, overseas Chinese business network played a key role in promoting growth of TVEs and SMEs in terms of capital inflow, expertise and marketing connection. It is estimated that from 1979 to 1996, overseas Chinese capital accounted for 69 percent of the foreign direct investment in China(Peng, ,2000:239). However, there was little or no transfer of technology. It is partially because China was at initial stage of reform and industrial sectors open to outside were limited out of consideration of national security, although it issued the Joint Venture Law in 1979 and the Enterprise Law in 1986 respectively, and partially

because early generation overseas Chinese were characterized with less professionalized and thus heavily relied on the competitiveness of labor-intensive industries such as real state, financial, commercial, and food industries (Peng,2000:240-41). As for foreign direct capital from advanced countries like US and Japan, even if it flowed into tech-intensive industries such as automobile, electronics and telecommunications industries, technology transfer was less. There were two reasons. First was that China's government itself had either no clear ideas about how to transfer technology or were puzzled with a classic "make or buy" dilemma during whole 1980s. Consequently, there were no specific stipulations on technology transfer although requirement for the foreign companies was to get the technology into production. Second was that many advanced countries were wary of generating a potential competitor, thus they transferred obsolete technology into China when they established joint venture corporations in China. The Japanese participation in Chinese passenger car development is very good example(Harwit,1995:15-43). When China's government decided to develop automobile industry through technology licensing and the formation of joint ventures, initially China asked the Japanese for new products and technologies of vehicles, but the Japanese interest and initial performance in China was to sell finished vehicles. Japanese passenger car exports to China peaked in mid-1980s, however, and gradually declined for the rest of the decades as the Chinese relied more on joint venture products as a result that two major manufacturing joint ventures were established between the state-owned Beijing Automobile Industry Corporation (BAIC) and American Motors Corporation (AMC) in January 1984 and between the Shanghai Automotive Industry Corporation (SAIC) and German VW in October 1984 respectively. Moreover, as a key measure the government mulled over technology transfer of passenger cars in the early 1990s, two new joint ventures were formed to produce passenger cars: one between VW and First Auto Works to produce Jettas in 1990 and the other between French Citroen and Second Auto Works (now Dongfeng Auto Company) to produce the *Fukang* compact in 1992. In a word, during this period, there was, more or less, technology transfer in some industrial sectors, especially labor-intensive industries such as consumer electronics processing industries through establishing joint venture companies or introducing production lines, however, there was no or little transfer of advanced technology in general. The technology upgrading in industry mainly relied on the government's direct invest and transformation of military to civil.

Entering into mid-1990s, the story has been different. With a series of radical reforms launched domestically under establishing a socialist market economy and increasing inflow of foreign direct investment, the "market for technology" becomes a priority for China's industrial policy in attracting FDI into capital-intensive and tech-intensive industries from the globalized product networks and overseas Chinese business network. It is worth to note that there are some essential changes in both global product networks and overseas Chinese business network. In the global product networks, the biggest change is the rapid pace of technological change(for example, the telecommunications industry). It not only transform production and exchange

based on interstate system into fragmented market of globalized networks((Bernard and Ravenhill,1995:171-72), but decentralize the dependence of one country on one leading industrial sector alone such as textile, steel, and automobile industries each did in its time(Kurth,1979:33). The interplay of these two changes in global product networks provides China with more opportunity to transfer technology rather than depending only on one country or one corporation. At for the overseas Chinese Business network, because the new generation of ethnic Chinese received better training in science and engineering in Europe, North American and Japan and are getting better organized, the ethnic Chinese merchants are moving aggressively into high-tech, information, communication and other industries in 1990s so that some scholars argue that perhaps Chinese-style capitalism will provide an alternative to the Japanese model(Peng, 2000: 241-42). Against this background, the China's government has readjusted industrial policies, for example *Automobile Policy* in 1994, *New Auto Industry Policy* in 2004, *Policies Supporting the Development of Software Industry and IC Industry* in 2000 and *Regulations on Protection of IC Design* in 2001, to shape foreign investment to meet its domestic goals. It is in this sense that we say Susan Shirk is right to point out that "international factors did not determine the specific content and style of reform policies; the domestic institutional setting did"(Shirk, 1996: 206).

#### **IV Conclusion: Socialist Market Economy as a Functional Institution-Design**

From the evolution of general economic policies from the command economy to a market-oriented economy, the survey of government-dominated policies on the automobile and electronics industries, and scrutiny of correlations between domestic forces and international forces in shaping China's economic policy in the context of transition, we could find that China's smooth transition and robust economic growth in past two decades is neither one part of an unique process with deliberate institutional design as the experimentalist emphasized on, nor the natural consequences of its "reform and open door" policy aimed at "normal" or "standard" market economy by incremental institutional adaptation and adjustment as the convergence school highlighted. More precisely, it is, more or less, close to "doing by learning" in which China's government unceasingly readjust the target, sequencing and pace of domestic reform and related industrial policy to alleviate its domestic constraints to reduce reform cost and shape international forces to meet its goal of economic growth. To sum up, at least three factors cannot be neglected in order to understand China's industrial policy and its roles in promoting and maintaining China's successive economic growth.

Firstly, the transition economy is precondition for us to understand development paradigm China took in past decades. While other Asian economies have pursued directly their industry development strategies within a capitalist-market context, China has to pursue its strategies in a context of transition, which includes transitions

from centrally planned economy to a market-oriented one; from a rural and agricultural society to an urban and industrial one; and from a non-WTO nation to a WTO one. Given the fact that China has been characterized with tradition of long-term agrarian society, authoritarian state and lack of commercial value, it was gradualism approach, rather than “big bang” or “shock therapy” taken by other former centrally planned economy, which contributed to smooth transition while maintaining its robust economic growth without leading to catastrophe. However, it has a long way to go to finish these three kinds of transition.

Secondly, the socialist market economy is a kind of functional institution-design. Of three kinds of transition, the key is the transition from the command economy to a market economy. China had to take the historical legacy of one-quarter century socialist command economy seriously, with reference to the fact former the Soviet Union did take “big bang” strategy and finally led to the collapse. Consequently China put forward to establish a socialist market economy as a expedient. It is commonly complained that the socialist market economy make it difficult to identify the usual distinction between market forces and government policy, however, in practice the socialist market economy performed a dual function in past two decades: on the one hand it did help to reach a consensus on domestic reform between conservatives and liberals within the CCP and maintain the legitimacy of the CCP, and consequently reduced the cost of reform and avoided the risk of the large-scale institutional changes; on the other, it also met the needs of international society through making partial institutional adjustment and adaptation, no matter reluctantly or voluntarily, and thus improved relatively international environment of reform and shaped international forces, in most cases, to serve for domestic reform. But it still remains open about how long the socialist market economy will last and which direction it will go towards in the future. The challenges China faces today reveal that only functional changes are obviously not enough, a structural and institutional change seems irreversible and imminent.

Thirdly, economic globalization is an important international sources for China’s reform and economic growth. It, as a crucial driving force, not only provided China much more opportunity than 1960s and 1970s East Asian economies to integrate into world economy, but also made China needlessly dependent on one country to obtain capital and technology. However, it also makes China feel more difficult to govern its economy. In other words, globalization or international forces has to be received more and more attention when China makes its economic policy in the future.

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