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## Reflections on Chinese Political Economy

By Kalim SIDDIQUI †

**Abstract.** The aim of this paper is to discuss the reasons for the rapid growth in the Chinese economy over the last three decades. China has been growing fastest in human history, which has an impact on the global economy and also various challenges that the country faces. It is seen as heralding a major shift in the international division of labour through changes in its output and employment pattern. China is described as becoming the “workshop” of the world as a result of the expansion of its manufacturing production. Its impact on other Asian economies and also on the world economy has the potential to be enormous. Market reforms and opening up of the Chinese economy to trade and foreign capital since the early 1980s, have unleashed entrepreneurial energies. China’s development policies can be best understood if these are looked at from an institutional economic perspective. This article is based on a review of published papers in the field of economic policies, focusing on the debate concerning the respective roles of the state and the market. A wide range of data sources are presented, including statistics compiled and generated by wide range of organisations such as IMF, World Bank and WTO that are non-governmental agencies. Secondary data of this type provides greater potential for addressing the research questions than statistics produced by the national government. This study finds that corporate debt has risen in recent years in China, a large part of these loans having been financed with investment in trust products issued by the banks. In addition, a huge amount of credit has been channelled into the real estate sector, and seems to be heading towards the housing and estate sectors, meaning that most of this is speculative. Investments are financed by credit; which clearly needs to be repaid. If these levels of debt become unsustainable this could pose a major challenge for the Chinese economy.

**Keywords.** Chinese economic reforms, state intervention, economic performance and trade.  
**JEL.** F11, F40, N10.

### 1. Introduction

This paper examines the growth trajectory of China and the structural change which it has undergone in the last thirty years. The country is gradually transforming its economy from low value-added industries towards high value-added industries. It appears that during this period China did not follow the policies prescribed by the IMF and World Bank but undertook selective government intervention to facilitate domestic businesses (Rasiah et al. 2013; Breslin, 2010).

This article argues that China’s development policies can be fully understood if we take an institutional economic perspective. This means that more attention is needed to look at the economic, political, historical, institutional, and cultural context in which the economic development has taken place. The aim is to explain why and how the Chinese economy has grown so dramatically. China has been growing faster than any previous economy in human history which has had an impact on the scale of the environmental challenges that it faces. Increased water

† University of Huddersfield, Department of Strategy and Economics, West Yorkshire, UK.  
☎. +44-1484-422-288. ✉. k.u.siddiqui@hud.ac.uk

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shortages, depletion of natural resources, ecological crises and widening inequality appear to be the biggest challenges the country is facing.

The intention here is not to focus on issues such as inequality and the environmental challenges China is facing, but to briefly summarise the current position. Inequality in China has grown rapidly since the 1980s and currently it resembles the US, one of the most unequal societies in the world. It is still considerably less unequal than Latin America, but China started this transformation just three decades ago from a very egalitarian society (Nolan, 1991). Within a very short period all this has changed, and due to a 9-10% growth rate, aspirations are high. However, if growth rates start to slow down, then industrial strikes, demonstrations, protests and popular discontent may increase. This could lead to political instability, which in turn would discourage investment, growth and economic development. Rapid income growth and increased levels of consumption has placed further pressure on the country's natural resources such as land, forests, water and air. In relative terms, China has been poorly endowed with natural resources. For instance, it has only 8% of the world's cultivated land, while it has 22% of the world's population to feed. Within the last three decades, a large amount of forests have been cleared to make way for towns and industries. China faces unprecedented challenges with soil erosion and rapid urbanisation. Since 1980, nearly one-half of its forests have been destroyed. Currently, about 40% of China's land is affected by soil erosion, salinization and desertification (Yongding, 2012; Vincelette et al, 2011).

The methodology of this study is derived from the aims of the study and for this purpose secondary data is seen to be useful to find information and to explain our research problem. The research question requires international comparison statistics and provides the main source to answer the research questions and address the objectives of this paper. Analysing secondary data which has already been collated is the only possible way to get meaningful macroeconomic data. The secondary data sets together provide quantifiable information and statistics published regularly by the governments and various international organisations. Secondary sources facilitate research making it is easier to compare data from two or more countries. A number of international surveys conducted, for example, by the World Bank, IMF and OECD, provide comparable cross-country data that can be used for our purposes. Our research questions can be answered by the information from this secondary data and published research papers in this subject area.

Nearly two-third of China's population still lives in the countryside and there are still more than 150 million surplus agricultural labourers. Rural distribution of income is more unequal than in the recent past: the Gini coefficient of rural distribution of income rose from 0.21 in 1980 to 0.40 in 2000. There has been a massive decline in the number of people living below the poverty line during the last three decades. The existence of rural poverty provides an incentive to migrate to urban areas, especially for a largely unskilled or semi-skilled workforce. A large literature exists on Chinese poverty measurement. For example, according to a World Bank estimate, the proportion of people living below the poverty line in China fell from 73.5% (i.e. 730 million people) in 1980 to 8.1% (106 million) in 2005. The calculation was based on US\$1 per capita per day at 2005 PPP. However, since the World Bank has now revised this calculation to US\$ 1.25 per capita per day, such an estimate increases the figure to 16% for those living below the poverty line in China in 2005 (World Bank, 2011a).

Moreover, China has diverse regional economies that range from extreme poverty to relative prosperity. In the early 1990s, Guangdong became a centre for manufacturing industries and its wealth soon began to spread to the other coastal

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towns. In 2003 China became the largest recipient of foreign capital, overtaking the US. This inward investment mainly went to subsidiaries of foreign multinational companies which are largely behind the upsurge in growth of exports, being responsible for up to 60% of all Chinese exports. China's contemporary political economy is a very exciting area of study. The Chinese economy has grown at an average annual rate of 9% for more than three decades. As a result, China is seen as heralding a major shift in the international division of labour through changes in output and employment patterns. It has been described as the "work-shop" of the world through the expansion of manufacturing production (McKay & Song, 2010). These higher growth rates in the Chinese economy have led to changes in all sectors of the economy. As a result, per capita income and domestic demand has risen dramatically in recent decades. This begs the question: Which factors have contributed to this 'miracle' growth for over three decades.

Studying Chinese growth is important because potentially its impact on other Asian economies and also on the world economy may be enormous. China's rapid development within a short period of time represents one of the most striking phenomena in the global economy, which has not been experienced before. To explain this is not an easy task. Several decades of government economic control and regulations stifled entrepreneurship, private enterprise and brought about an economic standstill. Market reforms, opening up markets to trade and foreign capital, have helped to unleash Chinese entrepreneurial energies since the early 1980s. These reforms took place at a time when the global economy was going through huge changes which proved to be beneficial to China.

In the pre-market reform period, China had already invested in critical areas such as education and health care for the majority of its people. The government undertook the policy of egalitarian land distribution and mobilised the female population to participate in education and job markets. It carried out a comprehensive radical land reform, altering rural asset distribution in the country. It eliminated the centuries'-old domination of landlordism and brought greater equality of access to land in the countryside. Along with this, investment in key areas like rural electrification facilitated the growth of rural industries. The government also built an impressive rural health system prior to market reforms. As a result, life expectancy of its people was increased and the infant mortality rate fell to 31 per 1,000 live births. About 85% of its villages had a cooperative medical system. According to Sen, "The sharp expansion of life expectancy took place in China well before its recent agricultural reforms, which have led, for the first time, to very substantial increase in food availability per head. In fact, much of the expansion of Chinese life expectancy has taken place with very moderate increases in per capita food output and availability, and much of the enhancement seems to have been brought about by skilful public intervention in the delivery of health care, medical attention and food" (Sen, 1987:26).

There is a substantial body of literature concerning this transition from state control to pro-market reforms. Economic reform in China began back in 1978 with the replacement of the commune system of agriculture by the household responsibility system. Under the new system, a household was granted land cultivation rights i.e. each household got a more or less equal size plot of land, subject to differences in family size. This led to a rapid increase in agricultural output, raising rural income and helped poor households to break out of poverty. In fact, this is a form of contract system with households subject to taxes and procurement prices on their land use. Besides raising procurement prices, the farmers were also allowed to retain and sell much of the surplus of their produce, after having fulfilled the required quota. As a result, agricultural output rose at an

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annual rate of 7% between 1979 and 1984, compared to 2.7% in the previous decade (Bardhan, 2010).

In 1978, the township and village enterprises (TVEs) were given responsibility for resource allocation, which created very successful and dynamic sectors of the economy in the 1980s and 1990s. It became a stimulating force to attract private investment into the rural sector. TVEs started producing wide varieties of goods, ranging from consumer goods to capital goods. Regional governments provided freedom and incentives to help these businesses. Entrepreneurship was encouraged. Economic reforms in agriculture, special economic zones, TVEs, management contracts in state owned enterprises (SOEs) and privatisation were initially tried in a few regions and then spread further. Farmers' savings increased, which led in turn to greater investment in agriculture and along with the spread of primary education and dissemination of knowledge, this helped farmers to invest in more profitable commercial crops (Bardhan, 2010).

After two decades of economic reforms, TVEs, largely under local government control played a leading role in the rapid expansion of labour-intensive rural industries. The contribution of rural industries to GDP rose sharply from just 6% in 1978 to 26% in 1996. China benefitted from the plentiful availability of rural labour force, cheap credit from rural cooperatives, and the high savings of the farmers. Instead of the previous "grain first" policy, farmers were encouraged to diversify production to more high-value commodities. At the same time, crop prices rose by 30% over the five year period. In addition, supplies of agricultural inputs were increased and also provided at subsidised rates.

This paper is organised as follows. The remainder of this introductory section briefly outlines the importance of the Chinese economy. This is followed by an overview of Chinese economic history. The focus then shifts to government developmental policy, particularly after the adoption of pro-market reforms. Economic growth, investments and savings issues are then examined. Analysis then centres on issues of exchange rate, followed by comparative advantage and trade issues. The Chinese economy is then considered from a global perspective before the closing remarks summarise the key findings of this research.

Higher economic growth in the 1980s led to a sharp decline in absolute poverty levels as a result of largely internal factors. These included institutional changes in the agricultural sector, which employed the largest proportion of the poorest workers, with global factors initially playing a negligible role. With respect to poverty alleviation in China, Bardhan (2008) argues that the rapid decrease in the number of people living below the poverty line was linked to domestic rather than external factors and is often mistakenly attributed by the mainstream economists to global competition. According to Bardhan these factors include earlier land reforms, and an increase in agricultural commodity prices and productivity (Bardhan, 2008).

There has been intense debate about China's high growth rates and poverty reduction since it adopted economic reforms in 1978. Growth was achieved due to high rates of capital accumulation. In terms of economic diversification and structural change, China has followed the classical industrialization pattern from agriculture to manufacturing activities in the last three decades. China's manufacturing sector has doubled its share of the workforce and tripled its share of output (Jacques, 2009). China is trying to industrialise in 21st century and might be expected to experience difficulties as a late industrialising nation. Some academics argue that China's industrialisation is characterised by an authoritarian political and economic order (Hutton, 2006; Myres, 1991). They see this face as 'primitive capitalist accumulation' as described by Marx's Capital Volume 1. It may involve the huge task of maintaining political stability in the country (Nolan, 2005). While

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others argue that China should follow US model of development rather than social democratic European model or state-led industrialisation of the Japanese model (Jefferson, 2008; Naughton, 2007). According to them, under current globalised conditions and high mobility of capital and products, the only option for China is that to organise its economy on the basis of 'free-market' policies (Tisdell, 2009; Sun 2007; Naughton, 2007).

China did not begin its transformation by following the standard theory such as dismantling quantity restrictions on imports, reduction in import tariffs and currency convertibility, as prescribed by the international financial institutions (Bardhan, 2008; Dornbusch & Helmers, 1988). China rather began by reforming its economy gradually using appropriate techniques for this approach such as state trading monopolies being replaced by non-tariff barriers and license restrictions. At the same time Special Economic Zones (SEZs) were set up to specialise in exports and attract foreign investors. As a result, a dramatic increase in output and investment took place in the 1980s and 1990s. By the 1990s China started exporting whole range of products and its portfolio resembled that of those countries with an income level at least three times higher than China. It could be described as phenomenal development in the last nearly three decades. The FDI has risen sharply since 1980s. The availability of a pool of cheap skilled labour did help it to export at competitive prices. FDI played a key role in building its manufacturing sector and which became integrated backwards and the supply chain moved from developed countries to China. Chinese state provision of basic goods in terms of housing, food, and cheap transport facilities for urban registered inhabitants has played an important role in keeping wages low (Davies, 2012; Naughton, 2007).

Exports and FDI did contribute to an increase in employment opportunities, technical upgrading and management efficiency. Contrary to what is widely believed, FDI, imported technology and skills were the principal source of economic growth, however, their net impact on GDP growth has been modest compared to that of domestic investment or consumption. Even when trade was booming between 2002 and 2008, the increase in net exports contributed only 15% of total GDP growth (Branstetter and Lardey, 2008; Naughton, 2007). However, with increased openness in East Asian countries imports rose faster than exports, along with the surge in capital inflows, which eventually led to East Asian crisis in 1997 (Siddiqui, 2011). China was the only exception, where exports rose faster than imports. The success lies besides other things, in its ability to shield its economy from the global economy; this proved critical to its efforts to build rapid industrialization (Davies, 2012).

## 2. Economic History

For a comprehensive understanding of development in present-day China, it would be useful to look at its history. China has more than 4000 years of recorded history and is regarded as one of the cradles of human civilization. Its economy is known for prosperity in the remote past. However, its most recent history (of the last two centuries) it has been hampered by feudal crisis, civil wars and colonisation resulting in economic downturn, mass poverty, frequent occurrence of famines and misery. From the beginning of the 19<sup>th</sup> century to mid-20<sup>th</sup> century, the economy rapidly deteriorated and the country became one of the poorest countries in the world. Angus Maddison (2006) has calculated Chinese per capita income in constant 1990 US dollars, in PPP (Purchasing Power Parity) terms for different periods. According to his estimation in 1700 in PPP terms China's share alone of the world's income was 23.1%. It rose further to 32.4% in 1820. Thereafter, in 1890 it rapidly declined to 13.2%, and further declined to only 5.2% in



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1950. China's per capita income declined from US\$600 in 1820 to US\$552 in 1913, declined further to US\$439 in 1950. China began the 20th century at very low income levels. The country's share of world income was much smaller than its share of the world's population. For example, in 1913 China's share of world GDP was 8.9%, while the share of population was 26.4% (Maddison, 2006).

During the 18<sup>th</sup> century, the Chinese economy was far more advanced than that of Europe in both an economic and cultural sense, but a question arises as why China did not become birthplace of capitalism? Tawney argues that "China ploughed with iron when Europe used wood, and continued to plough with it when Europe used steel" (Tawney, 1966:11). China's agrarian structure in the past was not dominated by a land aristocracy on the scale known in Medieval Europe. The landlords in imperial China were always subordinated to bureaucracy. The aim was that they must not become too powerful and were prevented from owning beyond a certain size of landholdings and thus to limit their economic and social power in the country side. Unlike in Europe, Chinese bureaucrats did not depend on landownership to acquire wealth, but rather relied upon their control of state apparatus (Tawney, 1966).

During the Ming and Qing dynasties the pace of technological development was slower i.e. innovation in labour saving technologies, compared to what happened in Western Europe. In the 13<sup>th</sup> century unlike Europe, China had no labour shortage but had a land shortage. Due to the land shortage, Chinese were driven to find a remarkable solutions such as raising land productivity through more intensive farming not by more capital input but by increasing the amount of labour input and by the introduction of improved seeds and promoting the use of multiple cropping and organic fertilizers (Huang, 1990; Perkins, 1969). For instance, Bray (1984) argues that, "Chinese crop characteristics, together with the Chinese farmer's attention to economical sowing and careful tending of each plant, generally produced far higher rates of return than were normal in Europe before agricultural revolution" (Bray, 1984: 287). He further emphasises that the ratio of harvested to seed grain in China was average twenty or thirty to one, while in medieval Europe three or four to one (Bray, 1984:7). Therefore, this period was one of technological and economic slowdown but agricultural productivity kept on rising and also kept pace with rapid increases in the population.

However, the state did not encourage the expansion of trade and commerce, as happened in Europe. Commercialisation did not lead to development of new thinking and policies. Any surplus from commerce and industry was invested in land rather than further expansion of industry. Unlike in Europe, the new emerging traders and industry owners did not challenge the existing political culture, in China, "the artisans and merchants of towns had no power and knew nothing of self-government; their social status was low and they had to rely on officials for protection" (Xu & Wu, 2000: 389). Another way capitalism could have been developed such as from within, neither witnessed revolution from above as happened with *Meiji Restoration* in Japan. China's location and geographical isolation acted as protection from its western border by high Himalaya range of mountains, which reduced indirect contact with other civilisations. On the other hand, the eastern Chinese neighbours were much small nations, did not pose any threat or challenges. These conditions dampened external forces which may have driven China towards capitalism (Jacques, 2009).

European visitors to China were impressed by the level of development in trade and commerce. In 1738 Du Halde argues, "The facilities of conveying merchandise by means of rivers and canals, have rendered the domestic trade of empire always very flourishing... The inland trade of China is so great that the commerce of all Europe is not to be compared therewith; the provinces being like so many

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kingdoms, which communicate to each other their respective products” (cited in Nolan, 1991: 119). Trade and commerce were quite developed in China by the 17th and 18th centuries, especially in areas like the *Yangtze Delta* and the *Pearl River Delta* which witnessed huge expansion of textile production and exports, in turn leading to further commercialisation and urbanisation of the region. Due to this, in the 17<sup>th</sup> century, the region was already known as one of the largest centres of economic development and innovation (Nolan, 1991). Economic historians have pointed out that the Chinese economy made sustained development in the centuries prior to industrial revolution in Europe. In the past the Chinese state encouraged market forces to achieve certain goals. A remarkable increase in productivity and output in the agricultural sector prior to 17<sup>th</sup> and 18<sup>th</sup> century was an unparalleled experience. To meet the challenges of growing population, rice production was increased by raising productivity (particularly by additional labour rather than capital per acre) and by employing more of the labour force in agricultural sector. China’s technological achievements were stimulated by long term growth of both domestic consumption and trade. By the end of the Ming dynasty (1368-1644) China had high levels of urbanisation for a pre-industrial society. Cloth spinning and weaving became the largest handicraft industry of which in 1750 China’s share of global manufacturing output was 33% compared with 25% India and only 18% of Europe (Girdner, & Siddiqui, 2008; Bairoch, 1982).

Unlike Europe, historically in imperial China the state did not share power with other interest groups such as merchants and religious institutions. China never had organised religion as witnessed in Europe. Merchants in China were not organised as a class with a collective voice to promote their interests but sought to obtain favour through individual contact. Confucian philosophy and ideas shaped China for a long time and the state was not required to share power with other socio-economic classes (Nolan, 2005; Siddiqui, 1989).

On the question of Chinese economy and per capita output growth in the mid-19<sup>th</sup> century a question remains about whether China improved or declined. Some earlier studies claim that per capita output has declined (Brandt, 1989). However, most recent studies have contradicted this view. According to Myers (1991) “foreign and interregional trade in North China speeded up commercialisation and enabled family farms to maintain their same per capita income overtime, even as population steadily rose” (Myers, 1991:604). It was also found that property holdings were unequal and the rich rural people extracted a large amount of surplus, but did not invest in technology to improve labour productivity. Brandt (1989) argues that increased market integration started by the third-quarter of the 19th century. As a result commodity prices were changed and domestic producers and farmers began to specialise in order to take advantage of financial incentives arising from markets. He estimated that in central and eastern China, the agricultural output rose nearly 1.5% annually. Commercialisation in agriculture increased in this region during the last quarters of the 19th century (Brandt, 1989).

In market system, which is characterised by trade in subsistence goods, the rural households sold their goods and services in the market, while the rural factor markets for land and credits were greatly constrained by customs and feudal institutions meaning the market was far from competitive. As Huang (1990) notes, “The fact that the product as well as factor markets of the delta in the late imperial and Republican periods indicate not transformative development but involution: peasant marketing consisted chiefly of the exchange of subsistence necessities with little two-way trade between town and country; peasant households marketed more for rent payments and survival needs than for enterprise; and peasants borrowed more for emergencies and survival than for productive investment” (Huang, 1990: 112).



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Rawski (1972) studied manufacturing output growth for various sectors such as handicraft, construction, transportation, finance, and agriculture. He finds increasing per capita consumption of cotton cloth and increasing wages in both agriculture and manufacturing sectors. He emphasises that the Chinese economy in the beginning of the 20th century grew about 20-25% (GDP in inflation adjusted output per head) (Rawski, 1972). He estimated capital stock over the two decades and found higher figures than previously estimated implying that the composition of capital and labour significantly changed. However, innovation in the economy was slow, which might be positively related to its highly competitive product and factor market system. Not much technical change was observed in industries like tea, sugar and silk because of highly competitive market structures. Thus, the Chinese economy began to take off by 1910, by breaking the economic structure based on mainly agriculture.

In our discussion we should not ignore the unique culture and values of Chinese people, where Confucius has played an important role not only in China but for the East Asian region. Historically, China's culture and values have been influenced by Confucian ideas and philosophy. In the past for long periods, Confucian thinking has had a profound impact on Chinese bureaucrats and ruling elites. The impact of Confucian philosophy has been the most powerful social and cultural factor throughout the East Asian regions. "Confucius believed that human nature [was] in need of development and continuous transformation, and he believed that human development and transformation could only take place through continuous learning and education" (Dahlggaard-Park, 2006:228). Culture does have influence in shaping the norms and work ethics, which has consequences for institutions. For example, China's culture does seem to have been influenced by Confucian philosophy, especially respect for authority and family and social stability maintained by the rulers is seen as important. Confucian philosophy is claimed to have been the main factor behind the economic success in China and earlier achievements of the other East Asian countries.

### 3. Market Intervention Policies since 1980s

Under the developmental state the government takes an active role in guiding the development in close cooperation with businesses. The pattern of economic development that some countries have followed is termed by academics as the "developmental state" (Nee et al, 2007). In Chinese case Bolesta (2007) notes, "China has adopted similar developmental approach to that followed by Japan during Meiji era and by Germany's Bismarck in relation to their country's economic development. These countries followed as state designed a developmental path and until now have been favouring state interventionism over a liberal open market.... The developmental state is often conceptually positioned between a liberal open economy and a central planned model" (Bolesta, 2007:105).

After the Communist Party unified the country in 1949, it launched land reforms and collectivisation measures, which eliminated private property rights for households. Finally, such policies did undermine the role of traditional rural elites. During the period from 1950 to 1978 the rural workforce were largely confined in the production of grain and expansion of irrigation and water control. China's farmers were locked into a system where procurement targets had been kept high and procurement prices low, leaving them little enthusiasm to invest in agriculture. However, non-agricultural activities which improved the income of rural labourers of the past were neglected. The rural households were unable to make choices as they did in the past.

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In 1978 China made the decision to initiate market reforms under the leadership of Deng Xiaoping. The Communist Party decided to make changes in institutions to promote market friendly environment as it was considered necessary to achieve higher growth rates (Tisdell, 2009). For an adequate understanding of the economic changes, analysis of institutions would be helpful to the economist and provides comprehensive evidence about the outcome and the process as well as explaining under what conditions it happened. As North argues, “The economic institutions we have that shape directly our world drive from political institutions. Economists do not like to think that they are dependent on political science but they are. As well recognising the formal rules like constitutions, laws, rules and regulations, we are interested in who makes the rules and for whom” (North, 2003:3). The decision to dissolve rural communes was initiated by Deng Xiaoping in 1980 and aimed at strengthening the rural family. The rights of village communes increased. The holders of land had the right to “rent” to other farmers but not to sell. This encouraged young to migrate to cities and also meant larger operational area for farmers who chose to stay in rural areas. At the same time it encouraged specialised production to cultivate high value crops. With the launching of pro-market reform policies, agricultural output began to surge, which was facilitated by higher prices and increased availability of modern inputs such as chemical fertilizers.

The Communist Party of China took a decision to initiate economic reforms first with agriculture as it was then seen as the foundation of the national economy. To assist this process laws were changed along with decentralisation and resource ownership in the agricultural sector. Later on these reforms were extended to the rest of the economy. In the 1980s shifts in policy meant with the expansion of village industries and also the arrival of more capital investment and the growth of overseas markets. Increased investment in capital stocks in rural industries also created more job opportunities for rural households. Huang terms this new development as “rural industrialisation without residential urbanisation” and “new market opportunity” (Huang, 1990:288). Since 1980 China’s rural areas have served as the key supplier of a cheap labour force to expanding industries, undermining the bargaining power of the urban working class.

The Chinese government played a very active role in steering the general direction of all economic reforms. In 1992, Den Xiaoping visited south coastal regions and assured both foreign investors and Chinese entrepreneurs that pro-market reform and open door policies will continue. A number of institutional reforms were carried out in order to attract foreign investment, which rose from merely US\$2.2 billion in 1980 to US\$10 billion in 1992 and thereafter rose rapidly to US\$30 billion in 1993. And in 1997 China became the largest recipient of foreign capital among the developing countries i.e. more than US\$40 billion was invested in China annually. Further in 2005, China became the 3rd largest recipient of foreign capital in the world after US and the UK. As a proportion of GDP, foreign capital only contributed to 3-4% of total investment but still played a crucial role in the country’s drive towards modernisation and industrialisation, particularly in upgrading technology and in general spreading of technology. Foreign capital also contributed towards integration of Chinese businesses with the global economy. Gary Jefferson (2008) argues, “China’s government has played a central and on-going role in the economy’s transition ...China’s ruling party and central government have remained intact with the legitimacy and administrative capacity to steer China’s economic transition and development. China’s government has played a central role in reassessing property rights from the state to individuals and thereby incentivising China’s economic growth” (Jefferson, 2008:5-6).

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The Chinese government considers some sectors as “strategic sectors”, industries that are seen as important to national security and to its infrastructure, security and technological advancement. In fact, China attracts more FDI than any other country, but it does not mean that it has the most liberalised economy. Academics argue that the ‘developmental state’ of China has adopted new domestic and global realities. Some argue that China had become a ‘developmental state’ as its other East Asian neighbours had done it few decades earlier: land reforms, strong state, emphasis on exports, and state and bureaucracy working in close cooperation (Nee et al, 2007; White, 1993), while other academics are sceptical about it. China’s patterns of state regulation are different as sectors are tied to the strategic value framework, rather than statist impulse to limit foreign capital and pursue industrial policies to suit its national and strategic interests (Breslin. 2010).

The predominant explanation has been put forward by the developmental state theory. Gerschenkron (1962) argues that countries, which have launched industrialisation later on such as Germany and United States, had a different pattern of development which was not due to cultural reasons. Kim (2009) argues that, “the developmental state fundamentally requires relative income equality as the initial socio-economic condition. Some of the Northeast Asian countries (e.g. Japan Taiwan and Korea) undertook radical land reforms that dramatically equalised income in society. While most Southeast Asian countries inherited “extractive colonial institutions” that perpetuated income inequality, Korea and Taiwan were able to break away from the colonial legacy, which allowed the emergence of the developmental state... the success of East Asian tigers – with Japan as pioneer, South Korea, Taiwan, Singapore as models, and China as the a tiger still waking up – was largely a result of the crucial role played by the state” (Kim, 2009: 383).

However, the state must also have an ability to insulate itself from particular interests in society such as seen Japan’s Ministry of International and Trade Industry (MITI) or Korea’s Economic Planning Board (EPB) (Amsden, 1989). The state-directed industrial policy is not just limited to East Asian countries but also followed in the 19<sup>th</sup> century by European countries when they were initiating their modern industrial expansion. As Chang (2002) emphasises, state intervention is not restricted to East Asia, but also followed by all successful economies in their early periods of industrialisation e.g. the UK, Germany and the USA. Rodrik (1995) points out that growth in East Asia can be largely attributed to rapid accumulation and investment rather than industrial policy (Krugman, 2010). In some East Asian countries land reforms did manage to remove or undermine colonial legacy and helped to build greater rural income equality, which later on proved to be favourable for economic development and industrialisation. As in earlier decades South Korea, Singapore and Taiwan and most recently China pursued a mercantilist path to modernise their economies. As stated: “In foreign trade our principle is to encourage exports and organise imports according to needs” (Beijing Review, 1990). The government promoted exports through varieties of subsidies policy, at the same time imports were strictly controlled. “The pattern of exports and imports appears to be determined more by administrative decisions at the industrial bureau or foreign trade corporation level than by incentives at the level of the individual enterprise” (World Bank, 1985: 106).

The most important changes in policy matters were seen when in the early 1980s the government attempted to create a professional bureaucracy in China, which were supposed to have positive attitudes towards market reforms. Similar policies were adopted in the 19th century by Bismarck in Germany, Meiji Japan and in the third quarter of the 20th century by South Korea and Taiwan both by active state support to build industrialisation and to a create a professional bureaucracy

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which could play a positive role towards implementing government stated policies (Siddiqui, 2013a). Such attempt was made by the Chinese government in 1980s, which seems to be extraordinary, “The speed of organisational turnover, and the relative ease with which it has occurred, has been impressive...Chinese bureaucracy now has a greater ability and willingness to bring technical competence to bear on competing policy alternatives” (Harding, 1987: 208-9).

Economic reforms in China have reduced bureaucratic control over state enterprises. It means turning away from using direct budgetary allocations and household deposit as the primary source of funds for propping up SOEs. The SOEs have to rely on bank credit with the hope that this increases incentives and efficiency. Reforms also provided managers more autonomy and allowed companies to keep a large share of its profits for bonuses and further investments. Direct state subsidies were replaced by bank loans and self-financing (Jacques, 2009).

### 4. Economic Growth, Investments and Savings

China’s dramatic growth today is the result of various factors such as government policies, global environment, savings and investments. Since the 1980s China’s economic progress has been phenomenal. As a result its GDP was over 13 times higher in 2007 than in 1980. According to a World Bank estimate China’s GDP was US\$ 157.7 billion in 1978 and it rose to US\$ 2100 billion in 2007. China’s gross exports were about 14% of its GDP, which increased to 40% of the GDP by 2007. Figure 1 shows real and per capita GDP growth between 2006 and 2015. Furthermore due to hardly any population growth, per capita income has risen sharply since reforms were undertaken (World Bank, 2008:7).

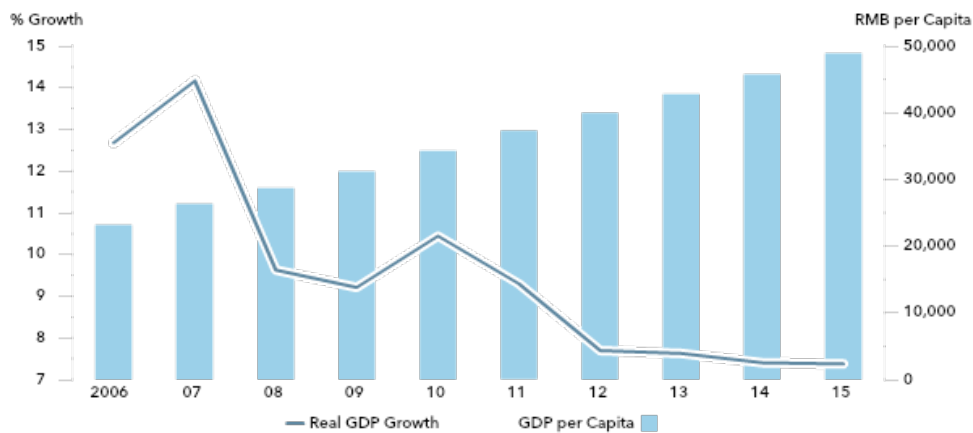


Figure 1: Real GDP Growth and Per Capita GDP: 2006-2015

Source: Euro monitor International; Note: Data for 2014 and 2015 are forecast (GDP per capita are in constant 2013 prices).

East Asian crisis did slow down growth rates in the region in post-1997 period. However, then China was less integrated into the region’s economy. As a result, a lot of capital and technology was diverted towards China into upgrading its infrastructure, which besides removing what is called critical obstructions to growth process, also provided avenues for higher rates of return on investments (Vincelette et al 2011). This led to a rapid increase in inputs into the economy i.e. China invested a high proportion of national income compared to many developing economies. In the past three decades, economic development in China has been largely dependent on investment. To maintain the growth of investment, China must sustain higher rates of profit, which most likely could be achieved with the

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help by reducing labour share of income to sustain profitability. Overall labour has experienced a decline of its share from 51.4% in 1999 to 42.2% in 2007 (Qi, 2014).

The policy initiative towards very high capital investment, which accounted for 54% of the growth lead of the East Asian countries over the developed industrialised countries and for 62% of the lead over the developing countries. High capital investment seems far more important than productivity increases in explaining East Asian countries growth lead over advanced industrial countries. China's pattern of very high capital accumulation seems most advanced case of the Asian success. As Vu argues, "The pattern showing the stronger expansion of fixed investment relative to GDP was even more notable for China, which was the most rapidly growing economy in the region during 1990-2010" (Vu, 2013: 196). Further Vu notes, "The emergence of Asia... is the great economic achievement of our time. This has created a new model of economic growth built on globalization and the patient accumulation of human and non-human capital" (Vu, 2013, p.vii).

There is no doubt that China has experienced phenomenal growth. Despite its so-called weak institutions, which are seen to be so crucial by the mainstream economists for rapid growth and efficiency. Furthermore, neo-classical economists base their arguments on efficiency criteria, while overlooking distributional consequences. In order for growth to be sustainable for longer periods, it should involve the continuous introduction of new products along with increased investment in high technology; infrastructure and diversification of the economic activities. China has experienced rapid growth rates for more than three decades, also has a massive investment of around 40%-50% of the GDP and a closer integration into the world economy.

The Chinese 'reform and opening up' process began with exceptionally high levels of investment as a proportion of GDP and this has been on a rising trend. Although other factors are important, this is the main driving force behind the differential in growth and the change in living standards. Table 1 shows that China's investment as a percentage of GDP has been much higher than the other emerging economies such as India (Siddiqui, 2014a). We also find that total amount of investment has risen in China's case between 2006 and 2010; while for India it has declined slightly for the same period. (See Table 1) Compared to major developed economies i.e. G7, China's domestic investment is more than double (Siddiqui, 2009c).

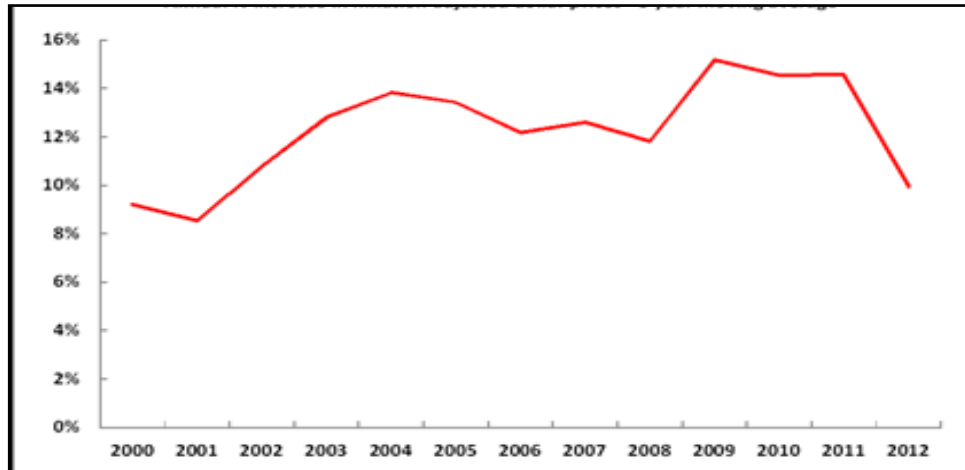
**Table 1:** *Gross Capital Formation (investment) as percentage of GDP*

	2006	2007	2008	2009	2010
China	43	42	44	48	45
India	36	38	35	36	32
G7 average	21	21	20	17.5	17

**Source:** World Bank Database, 2011a



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**Figure 2:** China's Fixed Investment (annual % increase in inflation adjusted dollar prices – 3 year moving average)

**Source:** United Nations, National Accounts Statistics, 2014; World Bank, 2014.

The proportion of national output going to investment is quite high compared to other emerging economies and nearly twice of the average of developed countries. The high rate of investment in the economy allowed the exploitation of low paid workers. Along with the high rate of savings and better increased availability of bank finance led to further availability of capital to be invested domestically. The huge increase in spending in infrastructure, rising employment and along with massive expansion of credits led to maintain the domestic demands in the economy and to certain extent lessened the consequences of the 2008 financial crisis (Siddiqui, 2009b). From 2000 to 2010 the investment grew annually around 13.3%, as shown in Figure 2, while the share of private consumption rose only to 7.8%. As a result the share of private consumption in GDP declined from 46% to 34% for the same period. (Wolf, 2011) Moreover wages as a proportion of national income declined from 56.5% in 1983 to 36.7% in 2005.

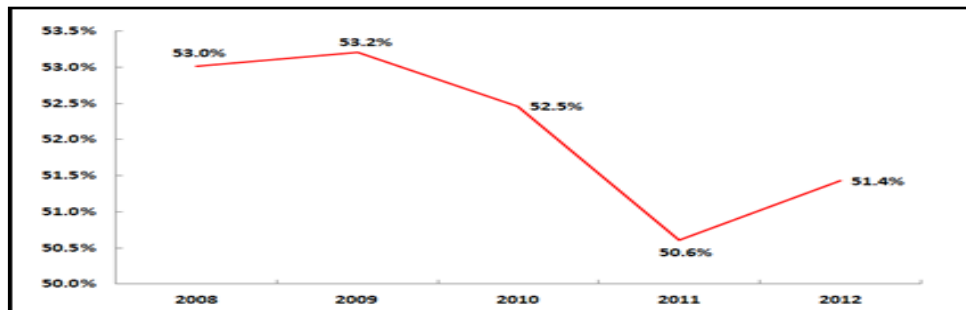
The public sector still leads in investment spending. However, in recent years private sector investment and research and development spending has been increasing. The growth performance of the economy depends on technical progress also called total factor productivity (TFP). Along with this, investment in higher education on biotechnology and agriculture is taking place both by the public and private sector, meaning that TFP growth will be higher in future. In 2008, a government stimulus package of US\$ 570 billion was injected, in addition to the state controlled banks, to increase their industries and local government.

China's has a remarkably high rate of saving, which reached 50% of GDP in 2013. This seems to be more than the country can invest at home, meaning that it has to resort to exporting some of its saving overseas. Credit in China has increased from about 100% of GDP in 2008 to about 135% of GDP in 2013 (The Economist, 2014). China's high investment has been financed by rising credits. However, this increased in credits has not resulted in rapid inflation. Because investment was largely took place in raising productive capacity of the economy. Martin Jacques (2009) argues that China has a distinctive culture, history and civilisation, which is rooted in its long history on the organisation of the economy, society and government and as China improves its economy, these views and her experiences will be most likely reflected in the formulation of its future policies.

China's savings have increased rapidly particularly during the last decade e.g. from 37% in 2000 to 50% of GDP in 2008. Corporate saving rose sharply reaching at peak in 2004, since then it slightly fell. However, household saving has risen to

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25% of their income in 2008 (Yongding, 2012). As shown in the Figure 3 China's total savings rate has fallen from 53.2% of GDP in 2009 to 51.4% of GDP in 2012 and further to 50% in 2013. It is important to note that total savings are not only those of households but also company savings and the 'negative savings' of the government budget deficit.



**Figure 3:** Savings as a percentage of national income in China

Source: Development Indicators, World Bank, 2014.

Saving rates gone up in China compared to pre-reforms period, perhaps due to decline in the availability of public provision of pension and health care for the rural population; also the post-reform period privatisation of urban housing and the expansion of investment opportunities opened new avenues to make money (Ma, & Yi, 2010) For most of the products, consumer prices are determined by market forces, despite the fact that government still regulate prices of telecommunications, energy, utilities and financial services. Corporate savings have contributed the larger part of total savings. As Ma and Yi (2010) found that savings amounted to 53% of GDP, out of which savings by firms were 18.8%, government 11%, and households' contribution was 23.4% in 2008.

The higher growth in China has largely taken place due to higher rate of investment. The investment rate in China (as a share of GDP) has fluctuated around 35-45%. In infrastructure, which played a critical role, it has averaged 19% of the GDP for last two decades. It is often said that China can offer this because it has attracted a large amount of foreign capital. However, a closer look at it, we find that foreign capital has accounted for only 3-5% of GDP in China for the same period, in recent years it has reached peak at 8%. In the period 2000-2010, foreign capital accounted for only 6% of domestic investment. It is now known that most of the foreign capital inflows did not add to domestic investment, but has largely led to further accumulation of international reserves, which, for instance, is increasing at the rate of US\$ 100 billion annually.

The rapid rise in foreign investment in the 1990s has been mainly due to the overall trend of the amount of FDI into the developing countries rising during this period; in the post-Tiananmen square period political stability was restored and China was seen as less risky by foreign investors; FDI was also boosted by the creation of SEZs in the coastal regions of south-east along with special tax concessions, land-leasing legislation and other attractive measures for investors in capital regions. All these measures did make China a very attractive place for foreign capital. The inflows of foreign capital had increased as the country opened new areas for foreign investors, which were not available before, like finance, telecommunications, and other services. It dramatically rose in the 1990s, which coincided with the overall inflow of capital into developing countries' economies surging (Lardy, 1995). The rising domestic market has continued to attract manufactures, but rises in labour costs and, more recently, rises in strikes in foreign companies, could encourage foreign companies to move to lower cost countries

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like Vietnam, Bangladesh and Thailand (Davies, 2012). China's share of exports in GDP has decreased from 39.1% in 2006 to 29.4% in 2010. The country's growth is highly dependent on export markets. Due to low productivity, China compared to other developing countries requires to maintain low wages in order to be internationally competitive. As a result in 2008 thousands of factories closed down in Guangdong and moved to interior regions in China or to Vietnam (Davies, 2012).

**Table 2:** China's Capital inflows and outflows, 2008-2010 (billions of US\$).

	2008	2009	2010
Flows of Foreign Investment			
% world inward	6.2	8.0	8.5
% world outward	2.7	4.8	5.1
Stocks of foreign investment			
% world inward	2.5	2.6	3.0
% world outward	0.9	1.2	1.5

**Source:** Davies, Ken (2012) Inward FDI in China and its Policy Context, Columbia University. URL: <http://hdl.handle.net/10022/AC:P:15269> Series: Columbia FDI Profiles.

In recent years, new trends can be seen with the outflows of Chinese capital, see Table 2. It has been largely through state and its sovereign wealth fund (i.e. China Investment Corporation) - private enterprise only accounts very small proportion i.e. 0.6% of the total outward of capital (Clark & Monk, 2011). China has become a major participant in international capital markets. The amount of foreign capital outflows grew from modest amount of a few hundred millions of US dollars in the 1990s to several billions by 2013. China had an advantage factor due to its proximity to Hong Kong and Taiwan. It is well established now that capital, technology and expertise from both countries played a very important role in modernising and establishing the manufacturing industries in the coastal regions. I mean to suggest that capital, technology and experiences from the competitive environment contributed positively in Guangdong and Fujian provinces. Also China had long past experience of entrepreneurship, commerce and trade. Jiangnan and Guangdong provinces already had advanced capitalist production prior to the industrial revolution in Western Europe. (Xu & Wu, 1985)

As industrial output rose in 1990s, the composition of Chinese exports changed from labour intensive low tech products such as textiles, toys and shoes to higher value products such as computers, mobile phones and machine tools etc. According to official statistics China's net exports declined from 8.8% of GDP in 2007 to 2.6% in 2011. At the same time the share of investment over the same period, from 42% of GDP to 48%, which appears to be higher, compared to both emerging and developed economies. China's growth rates have slowed down from 10 % in the past decade to 7% in 2013.

China's economic expansion has been phenomenal and by 2005 it had become the world's leading producer of important products such as more than 100 kinds of various manufactured products, including 50% of cameras, 30 % of TVs and 25% of washing machines, 20% of fridges. Domestic consumption in China has also increased rapidly as Waldmeir and Reed (2011) notes, "No country on the earth has ever bought so many cars in so little time as China" (Waldmeir & Reed, 2011). China's growth in exports has been much more rapid, involving dramatic increase in world market share. In Latin America too China's exports have risen sharply in recent years. For example, imports by Brazil have increased more than 18-fold within the last ten years and account for 12.5% of China's exports. For example,

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trade with India has risen sharply as well, from US\$ 3 billion in 2000 to US\$ 62 billion in 2011, making China India's largest trading partner. China's major export markets are still the US and EU, which accounts for respectively 18.4% and 19.7% of its total exports in 2011.

In Latin America imports of steel were surging in 2012. Latin America imported US\$ 3.51 billion worth of steel from China. Such a recent development now threatens the value chain of industry in Mexico. For instance, Mexican imports of rolled sheets from China increased by nearly 141% during the 2011-12. The reason behind this rapid change is that Chinese automakers soon plan to assemble, produce and export vehicles to Mexico and take advantage of the NAFTA treaty. Also overall demand for steel is increasing because of the expanding automobile industry in Mexico whose output is exported to North American markets. China also imports raw materials from Latin America such as copper, crude oil and agricultural products such as soybeans and exporting cheap manufactured goods to the region. Moreover, the Mexican manufacturing sector is increasingly facing threats from China's cheap exports. Exports by foreign subsidiaries are largely for carrying out product assembly of imported parts and components. Also Chinese exporting companies are using parts and components supplied by or purchased from foreign subsidiaries. Total processed exports rose to US\$ 57 billion in 1994, which was about 50% of the Chinese total exports. These foreign owned companies are producing products like machinery, electronics and textiles.

Efficiency gains are occurring not only from economies of scale, but from increased international competition, which is leading towards technical exchange and managerial and organisational efficiencies. It is well known that China's exports have risen dramatically for the last three decades. Not only has the commodity composition of exports items changed towards manufactured goods, but also increasing productivity has spread to state owned industries. Moreover, government has played an important role in coordinating economic activities, while insulating them from external shocks and facilitating Chinese firms taking over foreign companies to access brand names, technology and foreign markets.

### 5. Renminbi and Exchange Rate

Chinese currency RMB (Renminbi) has often been said to be undervalued and created huge trade surpluses for China (Krugman, 2010). The US dollar-Renminbi exchange rate policy is of pegging Renminbi against the dollar at a level that keeps China's exports relatively cheap. The United States complain that it gives Chinese firms an advantage and argue that Chinese currency should be allowed to float freely on markets, meaning substantial revaluation of Renminbi. China had fixed the exchange rate at 8.27 RMB per US dollar in 1997. In 2005 the officially fixed RMB-dollar rate ended due to US pressure. This led the RMB to appreciate immediately and it has been subject to gradual appreciation since then. In 2007 the Chinese government allowed foreign currency to be held by private individuals and domestic companies. However, this did not lead to a rapid increase in demand for foreign currency because strong domestic growth and the expectations of RMB appreciation kept the currency speculation and potential capital flight in check.

China is now starting to face the shadow banking sector's contribution to credit growth becoming more pronounced. During the last decade the experience of India and China provided a useful lesson for developing countries in the importance of some sort of financial regulation and gradual liberalisation. Dornbusch and Helmers (1988) argues that running a current account surplus means exporting capital. It does not make much sense for developing economies country to lend

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money to developed economies and their capital resources need to be used for their domestic investment (Siddiqui, 2013b). Increased investment would lead to the improvements of living conditions and incomes of their people. Following this arguments, for example, China as a developing economy with a low per capita income GDP, should be running a current account deficit. China lending money to developed countries seems beyond the economic logic. China lends money to US at much lower returns, for instance, US companies' average returns on investment in China was 33%, while China's return on US government securities was less than 3% in 2008. Due to a recent slide of the US dollar, China's net foreign exchange reserves have experienced losses in value.

China has a current account surplus of the balance of payments and its surplus has contributed to the building up of its foreign exchange reserves. This has created huge trade surplus and China has become the largest holder of foreign exchange reserves. Its trade surplus is invested via the purchase of government debt. The East Asian crisis shows us that financial and capital market liberalisation was adopted hurriedly without properly putting a regulatory framework into place. Those developing countries such as China and Malaysia, with strong controls on capital flows were less adversely affected (Siddiqui, 2012; Stiglitz, 2000).

Changes in the financial accounts have had impact on the exchange rate. Under such circumstances the RMB rate experienced downward pressure and it led to depreciation of the currency from 6.30 to a US dollar in April 2012 to 6.41 in August 2012. However, the rate reverted and RMB appreciated again to 6.31 to 1US dollar by January 2013. The Chinese balance of payment (BOP) witnessed spectacular increases in its trade surplus, along with a huge rise in net capital inflows into the country. Trade surplus did experience a slight fall in 2009 due to financial crisis in US and EU countries. In 2012 the Chinese government agreed to a daily trading limit of the currency against dollar was officially widened from 0.5% to 1%. This was supposed to bring an increased role for market forces and also encourage wider use of the currency in international markets. Capital market liberalisation encourages speculation and may lead to short-term speculative capital flows. It is said foreign investment is crucial because such investment brings with it capital resources such as new technology, access to foreign markets, trains personnel, improves overall human capital and raises the degree of competition in domestic markets (World Bank, 1999).

Contrary to this, mainstream economists argue that the role of state should be minimal since external influence could distort the allocation mechanism, and dampen investment incentives. This could result in lower growth and ultimately lead to Pareto inefficiency. Mainstream economists see capital liberalisation as same as the arguments for trade liberalisation, which logically seems to be incorrect. Capital market liberalisation brings greater instability in developing countries, primarily due to the fact that capital flows are markedly pro-cyclical, exacerbating economic fluctuations. Stiglitz has expressed, "Capital market liberalisation exposes countries to vicissitudes associated with changes in economic circumstances outside the country; a sudden change in lenders' perception concerning "emerging market risk" can lead to huge capital outflows, undermining the viability of the entire financial system" (Stiglitz, 2000: 1079-1080). He further warns that "Key issues are not capital flowing into the country but flowing out. "China was able to pursue active counter cyclical macro-policies, staving off a recession and maintaining robust growth of close to 8% because of capital account restrictions provided it some room to manoeuvre. It had no need to raise interest rates to levels that killed the economy in order to "save" it from capital flight" (Stiglitz, 2000: 1080).

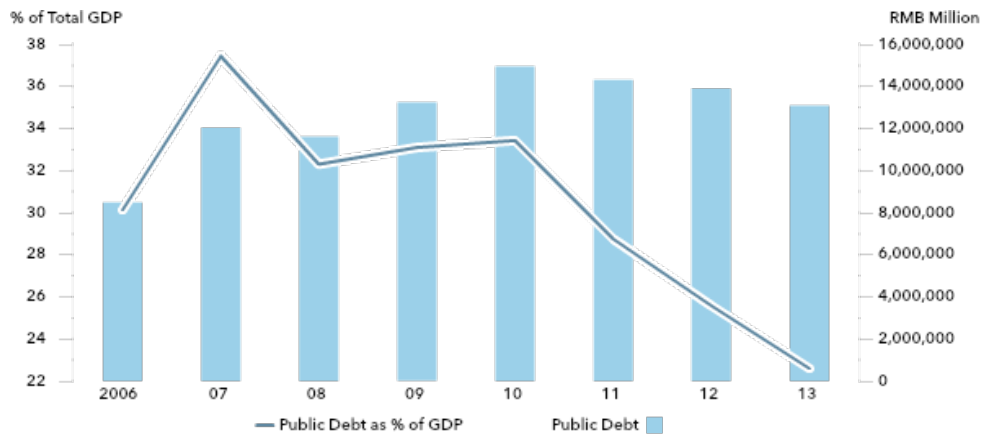


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China has remained outside of financial liberalisation and its banking sector is completely under government control and focuses on internal credit markets. Management of Renminbi is still country's sovereign decision, rather than being completely left to market forces. Capital liberalisation may lead to another adverse effect on growth. The developing countries are advised to maintain adequate reserves to protect themselves from the volatility of the international financial markets. The reserves should be in foreign currency and falling levels could send panic signals to investors and thus could have an adverse impact on market confidence.

The country witnessed unprecedented investment and export-led growth from 2001 to 2008, but since then a weakening in export demand due to financial crisis has had a negative impact. To correct this situation the Chinese government launched a massive fiscal stimulus through investment in infrastructure and housing sectors, which has got its own limits. It is largely financed by local authorities via local government finance systems, exposing local governments' finances to the vagaries of the land-lease markets. Under such circumstances, financial stability may have assumed a much greater priority than growth per se.

The rising domestic debt issues in China seem not to have received enough attention. Domestic debts have been rising in China in recent years. See Figure 4. However, first we will consider how housing costs have continued to rise in metropolitan cities especially in western regions. For instance, apartment prices in Beijing and Shanghai rose between 50% and 60% just between 2009 and 2012. It seems that property bubble is developing. Average house prices are more than ten times the average household's income in 2012. The local government has accumulated huge debts i.e. 27% of the country's total income. Easy credits have also been provided to state owned enterprises and according to an estimate around 40% of which remain loss making (Evans-Pritchard, 2011).



**Figure 4: China's Public Debt from 2006-2013**

**Source:** Euro monitor International; **Note:** Data are in constant 2013 prices

Corporate debt has risen in recent years. According to Standard and Poor's recent estimation on the size of corporate debts, it was US\$ 12 trillion or 120% of the country's total output in 2013. A large part of these loans has been financed with investment in trust products issued by the banks. According to the People's Bank of China (PBC) loans provided by the trust companies increased by an average of 23% annually to reach US\$ 2.9 trillion or 30% total credit given last year (Financial Time, 14<sup>th</sup> March, 2014).

The second largest loan receivers were local governments where the money was borrowed from sources like the China Development Bank and also from trusts to

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finance infrastructure and other developmental projects in the provinces. A large amount of credits has been channelled into the real estate sector, which could be speculative for the most part. Recently, lower demand has meant that a large number of these properties are unoccupied. This means property prices will increase at a lower rate than expected. Investments are financed by credits that need to be repaid.

However, recently China has chosen to liberalise its financial sector rather than controlling the speculative capital. This seems to be the biggest financial challenge the Chinese government will face in the future. The financial system in China still remains heavily under the control of state and the authorities control financial flows to regulate the volume of credit as well as direct credit to priority sectors in the domestic economy. China seems to be sceptical about capital account liberalisation. The recent history of emerging economies shows that capital flows are strongly pro-cyclical and have been biggest single cause of financial instability. This could have a large impact on economic performance.

Rising corporate debt and debt default is a big challenge facing China, which I think has not been properly focused on and examined. The recent two cases of debt default, although not very major, are illustrative of overall rising corporate debt, which was estimated to be US\$12 trillion in 2013. Most of these loans are provided by the trust companies and account for 30% of the credit advanced last year. For instance, in March 2014 Shanxi Haixin Iron and Steel Company, the largest private steel producer in China, defaulted bank loans of US\$ 3.57 billion. It prompts speculation that such development has an adverse impact on the country's economy, precipitated by an internal meltdown of the banking sector despite the fact that it was a relatively small steel producer compared with state owned companies. Earlier small companies such as Shanghai Chaori Solar Energy Science and Technology failed to repay its debt commitment of US\$ 14.5 million. This could indicate an emerging trend, which could, potentially spiral into a debt crisis. So far China has refrained from capital account convertibility and the value of Renminbi is managed by the central bank. Moreover, the banking system is fully under national control and focuses on the internal credit market and working to meet the need of domestic businesses (Wolf, 2014a).

On the mounting issue of China's debt and credit cycle Hyman Minsky points out that panic can take hold of financial markets following a period of stability, while others adhere to the view that China's huge debt possesses no major problems to the future development of the economy (Wolf, 2014b). A rising proportion of investment was being funded by debt, but returns were falling. It is also true that Chinese private sector agents have borrowed to fund investment rather than consumption. Firms are the main borrowers and the country is not dependent on foreign creditors and also the Renminbi is not freely convertible into foreign currency. China has also imposed exchange control. Domestic creditors cannot take their money out of the country. Unlike Japan in early 1990s, China has a relatively underdeveloped economy and vast amount of labour and resources are underutilized. China adopted a policy towards the financial and banking sector, similar to that adopted earlier by Japan, because Japan had witnessed an impressive growth between 1950 and 1991. Japan's financial policy was geared as an instrument of industrial policy designed to transfer surplus capital to the big industries with active state intervention and close cooperation between politicians, bureaucrats and businesses. Bank-centred corporate governance model where banks played a significant role in the growth and management of big companies was applicable (Hutton, 2006).

One obvious way of dealing with these bubbles is to take the excessive liquidity out through tighter monetary policy and financial regulation. This will require a

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policy in favour of more sustainable increase in consumption based on increased wages and productive investments and that will raise productivity and expand the ability to produce. Increasing financial regulation will force the banks to lend to more productive and efficient enterprises. Such few isolated cases may develop into a bigger problem especially when large excess capacities financed with the easily available credits, potentially posing problems in the future. The existence of excess capacity and falls in demand could occur due to a slowdown in domestic growth and the global economy. Such increasing excess capacity is not only found in steel sector, but also solar power and real estate. Such policies are surprising because just a few months earlier government intervened to bail out an investors' trust product or security issued by China Credit Trust, one among several "shadow banking" companies. It attracted investment of US\$ 490 million, but proved risky because it was backed by loans to coal mining company, which went bust, although losses to investors such as foregone interest and principal capital were fully repaid (Wolf, 2014b; Davies, 2012). Of course, according to mainstream economist's opinion, it is contrary to sound market discipline and a healthy credit market to intervene in this way!

Despite this potential default, in China debt default has not been common feature and has been very rarely seen in the past. China has witnessed a huge credit boom in the last few years, especially after the global financial crisis. Potential default was seen as less important because government in the past intervened to bail out potential defaulters and thus remove any adverse signals to the markets. In the past state was seen as standing as guarantor against any forthcoming financial difficulties, which is important instrument for sustaining investment led growth. This in turn encouraged a belief that the state implicitly guaranteed to come the aid of an ailing business to safeguard the economy and the financial sector. However, recent events show a change occurring in government policy, allowing market forces a greater impact, increasing the potential of actual private sector business default (Wolf, 2014b; Evans-Pritchard, 2011).

### 6. Trade and Comparative Advantage

The mainstream economists, given their support for neoliberal policy strategy to achieve higher growth rates, would prioritise dismantling quantitative restriction on imports, reducing import tariffs, convertibility of currency, reducing red tape and so on. Contrary to these suggestions, China largely ignored these recommendations and was slow to open its trade i.e.it followed step-by step liberalisation policies. The development of new technology and globalisation led to a huge transformation in global trade and impetus was given to global fragmentation of production. Under this, manufacturing process is divided into many stages. The fragmented production is carried out in different locations in several countries in order to cut down the costs and achieve economies of scale. Under such circumstances each country specialises in different segments of the economic production chain. This led to fragmentation of production and in the past decade or so trade is dominated by trade in components (Das, 2012; Nolan, 2002).

With the adoption of reforms, some argue that Chinese business have specialised on the basis of comparative advantage as advocated by David Ricardo in 1817 (Das, 2012; Lardy, 1995). However, China did not follow a rigid policy, as many developing countries did, by specialising and export of primary commodities. However, China has used this as a short term strategy and moved towards greater diversification and higher value commodities in its export sector. For instance, China began in the 1980s by exporting mainly labour intensive manufactured goods on the basis of Heckscher-Ohlin model; this mainly consisted of goods such

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as textiles, footwear and toys. However, in the 1990s exports items increasingly moved to higher value products. As a result, from 1980 to 1999, overall exports increased from US\$ 4.3 billion to US\$ 54 billion, an increase of 10.22 times. In 1980, on the eve of Chinese reforms, total trade was US\$ 20 billion and its share of the world's trade was only 0.6%. It rose to US\$ 475 billion, when China became the 7<sup>th</sup> largest trading country in the world in 2000 (Vu, 2013; Hausman & Klinger, 2006).

However, in each successive decade since reforms were undertaken, China initially exported processed primary goods (i.e. labour intensive and light manufacturing goods) and such products accounted for three-fourths of its exports, which are said to be suitable for production in low income countries. But for the last two decades, China did not follow comparative advantages theories, but moved towards the production of advanced technological goods such as electronics. As Rodrik notes, "China has ended up with an export basket that is significantly more sophisticated than what would be normally expected for a country at its income level" (Rodrik, 2006:1)

Production and exports of various commodities require specific capabilities such as human resources, institutions, availability of markets etc. (Hausmann & Klinger, 2006). China began setting up export-processing zones as a strategy to learn from foreign firms; at the same time global restructuring was taking place and China did benefit from it. The most important legislation regarding FDI was the Equity and Joint Venture legislation of 1979. This resulted in increased incentives for investors in China along with low wages and tax concessions amongst others. Even today foreign owned businesses are the largest contributors of total exports followed by joint ventures and domestic companies. China continues to rely heavily on foreign businesses for transfer of technology and they also account for larger share of its exports. However, China has been able to bargain effectively with foreign companies because of its large market size (McKay & Song, 2010).

Taiwan and Korea had extensively used state owned enterprises (SOE) in creating rapid economic development a few decades earlier. For instance, Korea's steel producer POSCO was set up in the early 1970s, as SOE in a country that does not have raw materials (iron and coal) at a time when such an act was a clear defiance of comparative advantage; the country then had, as its main export items, labour intensive products such as textiles and wigs. However, POSCO became the most efficient steel producer in the world within a decade after it was established and now it is the second largest steel producer in the world (Chang & Singh, 2003).

China's rapid expansion in electronic exports in 1990s, for example, was due to foreign companies and increased participation in the global value chain. Of course, the government's previous experience in central production and planning, (especially by providing excess to education, health care and egalitarian land distribution) underpinned the process (Siddiqui, 2014b). Rodrik (2006) argues, "Domestic firms play a significant role in China. In fact, 100% foreign owned firms are rarity among the leading players in the industry. Most of the significant firm tends to be joint-ventures between foreign firms and domestic (mostly state-owned) entities" (Rodrik, 2006:19). Similar points have been emphasised by other studies. Felipe et al (2013) finds, "For developing countries to move fast in the product space and reach the core. They often need to defy their comparative advantage as determined by their factor abundance. China's impressive progression and growth after the introduction of market reforms cannot be understood without factoring in the capabilities that had been developed and accumulated over the three decades under the planning system and prior to the introduction of the market reforms. Without these capabilities, entrepreneurs could not respond to the incentives created by the market reforms" (Felipe et al, 2013: 809). Even during

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2008 financial crisis, China still maintained its growth rate with the help of domestic fiscal stimulus and did manage to certain extent offset the contractionary effects of reduced exports.

The rapid economic development of the Chinese economy for the last three decades or more has been based on China's ability to accumulate new and more complex capabilities and diversify and upgrade its exports. This economic policy was not due solely to the impact of market forces, but in large part, to other various factors including the government's strategic policies, strong will to catch-up and the favourable international environment. This does not mean that the high growth trajectory will continue indefinitely, of course.

Economic reforms began with the adoption of dual-track price system. It provided incentives and played a positive role in the decision making in state owned enterprises. As a result, entrepreneurial spirit had been encouraged and productivity gains were made. (Yao, 2009) It began with reforms in collective farming and soon after, in the mid-1980s, reforms were also initiated in state owned enterprises including more emphasis and more incentives for workers to improve efficiency and state-owned enterprise was opened for foreign capital. This led to a rise in inflows of foreign capital into China. The government's liberalisation measures were meant to increase participation in the global economy through trade and investment.

In the early 1990s, there was a considerable shift towards higher value manufacturing such as computers, electronic goods, telecommunications and machine tools. These goods took over a large share of exports. At the same time total spending on research and development (R&D) was steadily increased. As a consequence of government policy, the share of high technology in exports rose from 6% in 1992 to 29% in 2008 (WDI, 2010). Tariff and non-tariff trade barriers have been further reduced when China joined the WTO in 2001. With this the country committed to liberalise domestic markets including the financial sector, banks and insurance. Along with this it has undertaken the tasks to reform its legal system by making it compatible with international norms and regulations. In addition, reforms of state owned banks were carried out.

The question arises how large Chinese companies (also known as 'national champions') would compete after the country joined the WTO. China's accession to the WTO has resulted in further trade liberalisation. However, Chinese trade liberalisation was undertaken from a position of strength and not weakness.

In China the share of capital goods export has steadily increased. It means that sustained development of capital goods industries. It seems to have contributed, including other factors, to its competitiveness in export of labour intensive manufacturing (Rodrik, 2006). China has witnessed the largest growth in industrial production in recent decades and the country has become the single largest production centre for several products in terms of volume. The pace and period of China's ascent as a manufacturing country has been astonishing (McKay & Song, 2010). By 2007, China exported more than US\$800 billion worth of goods i.e. triple within five years. From 2005 to 2009, with the end of textile quotas, for example, Chinese garment exports to US market rose by 450% (Engardio, 2007).

China's manufacturing sector has expanded enormously during the last three decades, which has contributed positively to its overall economic development. Manufacturing is expected to offer better prospects for export incomes not only due to the fact that it allows for rapid productivity growth and expansion of production and employment but also to the fact that it helps to maintain price stability as volume of production increases, thereby avoiding the declining of terms of trade that have been experienced by majority of the developing countries in the recent past. China has become a very competitive manufacturing exporter and its exports



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have risen more than 860% since 1990, while its share in international trade in manufactured goods has increased from only 2% to 12% within the last three decades (Engardio, 2007). With each successive year, we find that China's export products have become more diversified. The manufacturing sector played an important role in enhancing China's share in the world economy and China was able to move to the "centre of the world economic affairs through manufacturing led development" (McKay & Song, 2010).

The past experiences of East Asian countries show that development entails a shift from dependence on agriculture into reliance on the manufacturing and service sectors. This is known as structural transformation. This helps to maintain fast sustained growth in the economy, which could lead towards a significant structural transformation, as it is taking place in China (Chang, 2006). Sustained growth results in structural transformation. For instance, in China the share of the agricultural sector in total GDP has declined from nearly 60% for 1952-1978 to currently more than 10%. But still agriculture is the largest employer i.e. it employs 40% of the total labour force (Felipe et al, 2013; Islam, et al, 2006; Hausmann, & Klinger, 2006).

China's exports of manufactured goods constitute an increasing proportion of high tech goods and it has become the world's biggest exporter of high technology products, having overtaken the US in 2004. Most of China's high tech exports are of electronics goods and their technological content reflects their large import content in high tech parts and components. China's dependence of foreign technology is further illustrated by the fact that it ranks third in the world for net payments of royalties. Moreover, high tech exports are still dominated by foreign companies. However, Chinese firms have been raising their positions in the domestic markets, taking advantage of presence of foreign suppliers.

Many developed countries including the US, Germany, Japan and South Korea had used their state-owned enterprises to develop their strategic industries (Gerschenkron, 1962; Amsden, 1989). In the very beginning the US model was not neoliberal as we see today. In the 1950s under Eisenhower, the top income tax rate was 92%. In US entrepreneurship was always backed by state intervention. The successful industries in the US were created by the state, and did not evolve from individualistic entrepreneurial culture as often suggested. All the top technology, which provided US firms with leadership, were at least financed in the beginning by the US defence industries e.g. computer development in early days was financed by the Pentagon, similarly semi-conductors, as well as aircraft e.g. the US air force heavily subsidised its military aircraft, and later on these technologies helped the US aircraft industry (Chang, 2002).

According to the *Economist*, after independence both China and India had adopted 'inwards looking' policies (also known as 'closed economy' policy). Economic reforms in China began with the ascending to power by Deng Xiaoping in 1978 and thereafter the government welcomed international trade, overseas investment and foreign technology. Since then massive changes have taken place in average living standards in China which are still only one sixth of those of the USA at PPP exchange rates; but the gap is much smaller than a few decades ago. China enjoyed an average of 3.3% higher GDP growth rates per person than the USA in the period 2000-08. The *Economist* noted, "Economic catch-up is accelerating. Britain's economy doubled in size in the 32 years from 1830 to 1862 as increased production spread from cotton to other industries. America's GDP doubled in only 17 years as it overtook Britain in 1870s. The economies of China and India have doubled within a decade" (The Economist, 2011:4-6).

The Chinese entrance into the global market is taking place in a unique global situation, where a handful of giant companies have grown so as to generate an

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unprecedented degree of concentration through mergers and acquisitions. As a result, a small number of giant firms are operating in strongly branded market segments. Chinese companies face immense competition and difficulties in catching-up with already powerful global companies, which dominate both global markets and supply chain segments.

China is following the harsh logic of primitive capitalist accumulation. In China state owned sectors are already creating nearly one half of national output. The country is going through a brutal accumulation process described as a 'Lewis' model of industrialisation, where economic development is taking place with an unlimited supply of labour at subsistence wage, which demands an authoritarian political structure. For instance, "In Britain during the take-off into capitalist industrialisation after mid-18th it took around 100 years before the rural reserve army of labour was absorbed into the modern sector. This provided strong downward pressure on urban wage rates, with no significant trend improvement in unskilled worker's real wages between 1750 and 1820s at the earliest. There was a prolonged phase of capital accumulation during which there was a widening of income disparities and no diminution of absolute poverty. Capitalist accumulation was accompanied by harsh measures of social control to maintain social order" (Nolan, 2005:8-9).

China had large professional civil servants, selected by the competitive examination of which Confucian philosophy and ethics was the foundation. Artisans and merchants performed an essential function in promoting division of labour to benefit expanding domestic markets and international trade. However, in social ranking they were below civil servants and peasants. Moreover, there was no official representation of their sectional class interests at government levels. Chinese merchants never developed as independently from the state in the way the mercantile class did in medieval Europe (Bairoch, 1982).

Openness to the global economy benefits various regions and sectors differently. Some win some lose. Winners recognise the benefits of integration with the international markets, while losers experience deteriorating control over policies and resources and they expect central government to compensate through active fiscal policies in their favour. Inequality has reached new levels never seen since 1950 and the gap between both urban and rural and coastal and interior regions is far greater than ever before. Without doubt, income inequality has increased. The Gini coefficient is officially around 0.48, while other researchers give a Gini coefficient of around 0.6. Those who work in urban areas enjoy not only higher incomes but increased power and influence and a western cosmopolitan life style, while the vast majority of the rural population, including unskilled and semi-skilled workers, alongside farmers in both rural areas and industrial zones are increasingly marginalised economically, socially and politically. During the late 1980s and 1990s Hong Kong proved to be an important source of large capital investment and technical transfer to China. Hong Kong entrepreneurs began shifting their industries across the border as Guangdong had lower labour and land costs. As a result, by 2000 manufacturing employment fell in Hong Kong to 250,000 from 900,000 in 1981.

Steel industries, for example, played a successful strategic role during the early industrialisation period in Germany, Japan and Korea. All these countries in the past had very competitive steel industries. To achieve internationally competitive and efficient steel industries, these countries have followed various policy measures including subsidies, preferential credits and tax breaks (Amsden, 1989, Chang, 2006). In China, until recently, all domestic steel industries were under state ownership and therefore it was not difficult to encourage merger and consolidation. Despite these policy measures, state intervention in China has been

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less than successful so far mainly due to institutional incapability on the part of government (Sun, 2007). As Sun notes, “the persistence of industry fragmentation puts the domestic [Chinese] steel sector in striking contrast to the sweeping industrial and corporate changes in its global counterpart during the same period. That is to say, whereas the global steel sector has undergone a rapid consolidation process in which a handful of highly competitive steel have emerged over the last several decades, ... its Chinese counterpart has remained, and even became more fragmented from the late 1980s to early 2000s, so that a majority of steel firms chronically operate below the MES, with potential EOS unexploited” (Sun, 2007:609-610).

The increase in industrial concentration in US and EU markets was driven by encouraging measures such as mergers and acquisitions during 1994 and 2004. In Japan, for example, during this period, the concentration ratio of top four (CR4) in Japan was as high as 75%, in the Korean steel sector a monopoly company POSCO, alone accounted for 63.3% of the national crude steel output in 2004 (Sun, 2007). The international comparison regarding industrial restructuring experiences shows that UK was able to consolidate the 14 largest private steel firms into one giant SOE, the British Steel Corporation in the 1960s; France did it in the 1980s with one SOE giant, Unisor and Korea achieved this aim with the family controlled ‘chaebol’, POSCO. It seems that Chinese were unable to achieve the same success in industrial restructuring despite their rich experience of central planning and state control. Sun argues, “The use of strategic industrial policy implies the creation of economic rents by the state through various policy tools, ranging from investment subsidies to trade barriers, so that industrial catch-up can be achieved more quickly than if the case were determined by the functioning of pure market forces... the state must ensure that the rents it deliberately creates are concentrated on the small number prospective ‘winners’ it picks” (Sun, 2007:616). The industrial restructuring experience of China clearly shows a substantial part of state-created rent is being allocated to firms those with obsolete capacity should have exited the market. Sun concludes, “the structural fragmentation of the state governance that prevents the concentration of generated rents, and the poor coordination with in the bureaucracy that arises from the incentive mismatch between the central and local authorities, constitute the most important institutional obstacles to effective industrial restructuring” (Sun, 2007:621).

Most recently, in China, big business consolidation is taking place especially in the steel and pharmaceutical sectors. The Shongang, which used to be state owned, has grown into the third largest steel plant, while Sanjiu has become the second largest pharmaceutical company in China. They have grown under peculiar Chinese bureaucracy. Strategic industrial policy was under the Ministry for Metallurgy Industry (MMI), which in 1997 was replaced by State Bureau of Metallurgic Industry (SBMI).

Prior to the joining the WTO, China’s tariffs on steel imports were reduced from 23.8% in 1992 to 12% in 1996. However, new non-tariff barriers were brought in 1996 to protect steel industries from flood of imported steel; they included import registration and channelling of steel imports through selected SOEs. The government took the initiative to develop four leading steel companies – Baogang, Shougang, Angang, and Wugang – into world class steel companies and aimed to achieve 40% of their share of domestic output from these firms. Shougang also launched overseas expansion and by 1994, it had 26 overseas subsidiaries in 13 countries, including Hierro iron mines in Peru. This helped to guarantee the supply of raw materials through possession of huge iron ore reserves. Sanjiu’s expansion and rapid growth was linked to its location in Shenzhen SEZ areas. It was an SOE and was initially based on traditional Chinese medicine

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production. Its new business strategy was based on entrepreneurial skills, product choice, quality control and marketing.

The experience of Shougang and Sanjiu has had profound implications for the future development of the Chinese steel and pharmaceuticals industries and how the large SOEs have been reformed. The development of Shougang and Sanjiu shows how the Communist Party pushed its organisational skills and past experiences to make this market economic transition possible and provided the necessary incentives and initiatives to contribute towards building up a powerful group of market-oriented business organisations. The experience of these two industries challenges traditional theories of firm. The experience of these giant companies also suggests that government mediated mergers and acquisitions and excessive diversification did reduce number of employees, which may, in turn, have contributed to increased long term comparative advantage and the building up sufficient economies of scale and achieve MES internationally (Nolan & Yeung, 2001).

After China joined WTO, the issue was whether the country's large businesses could compete with large global EU companies and US. China joining the WTO has had a significant effect on its large firms. It may be that Chinese firms may have to improve their efficiency as US automobile industries did two decades ago due to increased competition from Japanese automobile industries (Nolan, 2002). There might be different perspective as well, as Nolan (2002) suggests, "China's large firms will generally be unable to compete on global level playing field with the world's leading system integrations. China should, therefore, focus on improving the position of its indigenous firms within the global value chain of the world's leading companies" (Nolan, 2002:120).

Soon after the Second World War, the Japanese government introduced a number of initiatives to support the building of business conglomerates known as *Keiretsu*, who soon developed into global giant companies. As a result, by 1988, Japan had 20 of the world's largest corporations in the fortune 500 list. Looking at the other countries' experiences, the Chinese government aimed to adopt various industrial policy measures so that Chinese companies would be able to compete globally. "In our world today economic competition between nations is in fact between each nation's large enterprises and enterprise groups...our nation's position in the international economic order will be to a large extent determined by the position of our nation's large enterprises and groups" (Chinese State Council, WU Banguo, August, 1998, cited in Nolan, 2002:121).

The large companies in China include: Aerospace firm AVIC; Dongbei; in automobiles—Yiqi, Erqi and Shanghai, and in steel – Angang, Baogang and Shougang. China may have had great success in GDP growth, but has not still produced its own global brand names. By way of example, despite all the government encouragement and big domestic markets, AVIC did not succeed in competing with Boeing and Airbus and now all Chinese civilian aircraft are imported. Sanjiu is a very popular brand within Chinese markets but has had a lot of difficulties in overseas markets. R&D is seen as crucial in this sector because of its ability to generate advancements and expansion. For example, compared to big global pharmaceuticals companies such as Glaxco Welcome, Novartis and Merck, the Chinese firm, Sanjiu has negligible R&D spending.

The world's giant oil companies with the massive merger drive in the 1990s such as Chevron/Texaco, BP/Amoco/Arco, and Exxon/Mobil were able to control greater resources and oil reserves. They also have integrated oil refineries and petrochemicals along with highly efficient logistic systems, while Chinese oil companies are still highly protected. Foreign companies within the last two decades

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have increased joint ventures and thus improved their positions in Chinese markets and oil production.

The world's largest economy, the USA, has had a long period of growth in 20<sup>th</sup> century through innovation and technical change, which has helped its industries to create comparative advantage and at the same time facilitate shifts from low to high value added activities. Kaldor (1967) argues that technological change facilitates long-term growth. He emphasises that increasing returns are crucial in manufacturing and in driving economic growth. However, mainstream economists discouraged such strategies as price-distorting interventions by the government (Hayek, 1982). Rather they backed 'free trade' and specialisation. It is said that capital mobility would be advantageous and would result in a capital inflow that would benefit developing nations. Economic convergence could be achieved and this will lead to an equalisation of interest rates and wages as capital flows from developed to developing countries (Bhagwati, 1982). Convergence leading to increase in wages and incomes, equalise in countries involve in trade as suggested by the Heckscher-Ohlin model.

Since the 1980s 'free trade' policies have been promoted by the international financial agencies and mainstream economists have been justified in the name of market, efficiency and competition, which is expected to stimulate economic convergence in developing countries. Despite such claims there no evidence to support the assertion. Even successful East Asian economies have not achieved growth by total adoption of free market policies (Rasiah et al, 2013; Wade, 2004; Stiglitz, 2000). It is widely acknowledged that US leadership in high tech, defence and electronics were achieved by large-scale government intervention in R&D and often through defence industries who championed key areas of innovations.

In China, foreign capital was invited through various government initiatives and foreign investors were encouraged to invest in export sectors. The government realised that various policy measures needed to be taken both for domestic and overseas companies' including a further increase in exports and moving from low value to high value industries (Naughton, 2007).

The importance of trade has grown which is demonstrated by the rising share of its exports of manufactured goods. For instance the manufactured goods share in exports rose from only 0.8% in 1980 to 1.9% in 1990, 4.7% in 2000 and 13.5% in 2010. By 2010, China had overtaken Japan, US and had become the world's leading exporter of manufactured goods. (Rasiah et al, 2013) Export industries have grown rapidly in coastal areas – Anhui, Guangdong, Guangxi, Liaoning, Shandong and Tianjin and also other provinces such as Sichuan and Shanghai.

Within manufacturing, China's share in global exports of textiles accounted for 34%, for office equipment 28.3% and for telecommunication 26.2% in 2010. China's textiles share of the world exports rose from 4% in 1980 to 6.9% in 1990, to 10.3% in 2000 and 29% in 2010. Also its export share of capital goods and chemicals expanded gradually; chemical exports share rose from only 0.8% in 1980 to 1.3% in 1990 to 2.1% in 2000 and to 4.3% in 2010 and for iron and steel rose from 0.3%, to 1.2%, 3.1% and 7.3% respectively. The uninterrupted industrial growth and transformation was possible due to government policies, which aimed at industrial catch-up and increased savings which, in turn, were generated by high investment and a stable exchange rate (WTO, 2010; Naughton, 2007)

Carrying out macroeconomic reforms and building up institutions is important for rapid economic growth. We find that the manufacturing sector along with investments and exports have played an important role in rapid growth rates. Market reforms were not undertaken as recommended by the IMF and World Bank, but was carried out in an unorthodox manner as suited to the domestic economy. Reforms were essentially based on changes in the price system and inter



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alia brought about a determined price system (Das, 2012). At the same time increased focus was put on outward oriented growth strategy by facilitating the creation of special economic zones with the aim of attracting foreign investors. The government slowly moved the Chinese economy towards a market economy and took appropriate measures, particularly economic liberalisation, institutional transition and structural transformation (Naughton, 2007).

### 7. Chinese Economy in Global Perspective

Prior to our discussion of the Chinese economy from a global perspective, it would be interesting to quote *The Economist*, regarding the ups and downs in the Chinese economy in the recent past: “For most human history economic power has been determined by demography. In 1700 the world’s biggest economy and (leading cotton producer) was India, with a population of 165 million, followed by China, with 138million. Britain’s 8.6 million produced less than 3% of the world’s output. Even in 1820, as the industrial revolution in Britain was gathering pace, the two Asian giants still accounted for half of the world’s GDP. The spread of purpose-built manufactories like Quarry Bank Mill separated economic power and population, increasingly so as the West got richer... By 1870 the average income in Britain was six times larger than India or China” (*The Economist*, 2011:4-6). By the 1850s European supremacy over Asia had been established, in particular after the opium war in 1839-42, looting and burning of the Summer Palace in 1860 and finally the defeat of China by British and French armies. China suffered humiliation during the 19th century at the hands of European powers.

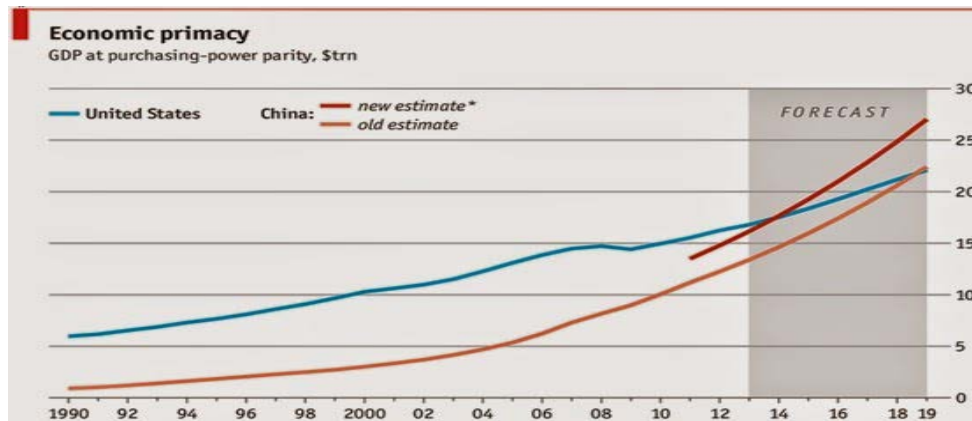
Since 1978, income per person has risen around 8% annually in China, which means a doubling of incomes after every nine years, despite the fact that the country lacks complete private property rights and is run by the one party rule (Jacques, 2009). Since 1980 China’s GDP has doubled after every nine years and it is now 30 times larger than in 1980. The country has become the second largest economy in the world and the largest exporter. This is remarkable in many ways. However, despite the rapid increase China’s GDP was US\$5.9 trillion in 2013, only 40% of the United States’ 14.4 trillion US\$. Moreover, the GDP per person is quite revealing, China’s US\$4260, only 9% of the United States’ US\$47240. In 2013, China’s GDP was US\$9 trillion, which is larger than 154 countries economies combined. However, in income per capita terms it is still not a rich country i.e. at market exchange rates it is only 13% of the US and ranks below that of more than eighty other countries (*The Economist*, 2014).

China has witnessed long-term average GDP growth rates of around 10% for the last three decades in real terms. It has not experienced any major setback or interruption to its growth from the global financial crisis. One of the most distinguished contemporary economic historians, Angus Maddison predicts that by 2030 China will overtake the USA as the largest economy in the world (Maddison, 2006). Following on the beginning of the 2009 financial crisis, China has performed better than any of the advanced economies – in the last five year its economy grew by 78%, while the US by 8% (*The Economist*, 2014).

However, another estimate shows even more optimism. According to IMF Report (2011) China is expected to overtake the US as the largest economy by 2016. The prediction was made on the basis of PPP purchasing power. However, it is known that the PPP measurement is not a good deflator for inter-country price comparisons. Figure 5 shows the change in the IMF’s own estimates and forecasts of the level of Chinese GDP and US. Previously the IMF’s projections were that China would surpass the US as the world’s largest economy in 2019. Its revised

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estimates are that this will now occur at the end of this year. From 2015 onwards, when anyone refers to the world's largest economy this will be China, not the US.



**Figure 5: IMF Estimates & Projections of US & China GDP, PPP \$ trillions**

Source: International Comparison Programme, IMF, 2013; Economist.com/graphicdetail

Although China has emerged as world's second largest economy, it is still classified as developing country. The rapid growth of its economy has critically affected the developed economies in various ways. With a population of 1.3 billion it has often been seen as one of the most significant emerging markets, and has been increasingly integrated into world markets. China's internal resources are limited and therefore China has signed various socio-economic cooperation agreements with African countries, especially in mineral and oil areas. At the same time, its higher population level means that per capita GDP is still much below countries like Britain or the US, although this gap too is narrowing rapidly. The World Bank (2014) suggests that the Chinese GDP is now higher than that of the US. Bank estimation is based on PPP measures of national income, which is supposed to adjust for differences in costs between countries. However, China's population is 1.3 billion, while at that of US is only 316 million. On the basis of PPP measure, China's GDP per capita is only US\$9,800 while the US is US\$52,000 in 2013 (Wade, 2014).

Chinese per capita incomes are still way below those of the US. China's GDP is still around one-fifth of the size of the US as it has a population four times larger than the US population. But the divergence in these trends is also marked. The population of the US has been growing more rapidly than China, while the US economy has been growing much more slowly. The Chinese economy has been growing by over 5% more than the US over a prolonged period and Chinese per capita GDP has been growing by over 5.5% more than the US. This growth gap increased during the slump but was resumed again in 2013, when Chinese GDP grew by 7.4% and the US grew by 2.3%. This led to two effects. The first is that in the same 40 year period Chinese per capita GDP has gone from being approximately 5 per cent of the US level to over 20 per cent by 2008. The second effect is that the growth in population is only a small fraction of the overall contribution to Chinese growth, while it is a very large contribution to US growth. This is shown in the Table 3. The effect of compounding means anything that grows annually by 5% will double in size every 15 years. In relative terms, if the current growth gap were maintained the Chinese economy would be double the size of the US economy by not later than 2030. Living standards will catch up later, only because the starting-point is lower.

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**Table 3:** *US, China, GDP, per capita GDP and population growth 1990-2008 (average annual compound rate, %)*

	GDP Growth	Population Growth	Per Capita GDP Growth
US	2.73	1.09	1.64
China	7.97	0.86	7.11

**Source:** Maddison, 2006.

There has been phenomenal growth in the rise of public listed corporations in China; see Table 4. In 2010, public listed corporations accounted for 43% of the country's GDP, compared to just 14% of the GDP in 2001 (Bryson et al, 2012). The question is whether China's production is moving up in value chain and thus challenging the developed countries. In the ICT sector, China is among the major exporters of ICT products, but these are dominated by foreign owned companies. In 2005, about 70 % of ICT firms in China were foreign owned companies or subsidiaries.

**Table 4:** *Chinese Firms in Financial Times Top 100 firms*

Ranking	Company	Market Value (US\$ millions)	Sector
2	Petro China	326,199	Oil & gas producers
4	Industrial & Commercial Banks of China	251,078	Banks
7	China Construction Bank	232,608	Banks
29	Bank of China	145,977	Banks
46	CNOOC	112,560	Oil & gas producers
49	Sinopec	107,906	Oil & gas producers
58	China Life Insurance	94,680	Lie Insurance
63	China Shenua Energy	89,270	Mining

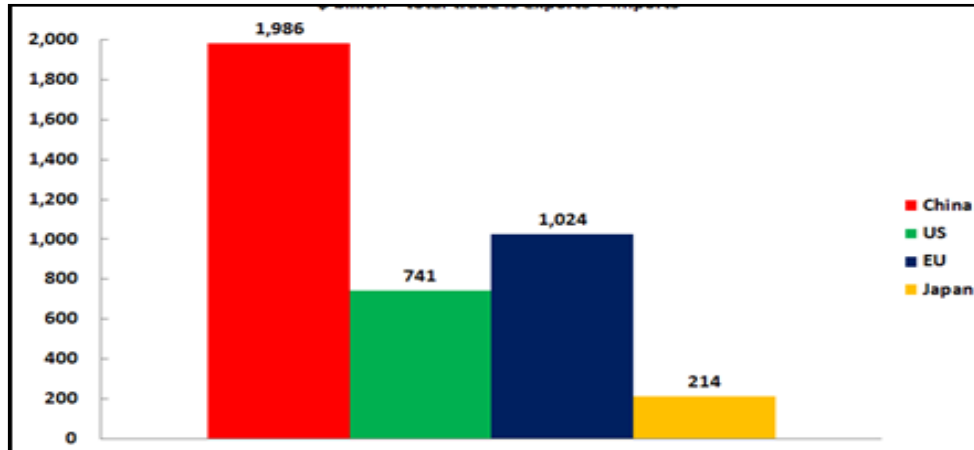
**Source:** Financial Times, FT Global 500 (2011) 25<sup>th</sup> June, London

Between 2007 and 2012 the developed countries' economies grew by 3%, the emerging and developing economies by 31% and China by 56%. We should emphasise that during the recent economic crisis the Chinese economy emerged as the second largest economy in the world as well as the leading manufacturer and exporter in the world (Wolf, 2014a:12).

The scale of the changes in global trade that have taken place since the beginning of the international financial crisis is shown in Figure 6. This illustrates the increases in the total trade of China, the United States, the EU and Japan between 2007, the last year before the crisis, and the end of 2013. China's total merchandise trade in 2013 was US\$1,986 billion larger than in 2007 - China's exports having increased by US\$992 billion and imports by US\$994 billion. In comparison, the increase in US goods trade was US\$741 billion, the EU US\$1,024 billion, and Japan US\$214 billion. Therefore, not only was the expansion of China's trade almost twice that of any other major economic centre, but it was larger than the US\$1,979 billion for the United States, the EU and Japan put together (Wade, 2014; World Bank, 2014). As Rodrik (2009) observes, "The-high growth countries are those that are able to undertake rapid structural transformation from low productivity "traditional" to high productivity "modern" activities. These modern activities are largely tradable products, and within tradable, they are mostly industrial one (although tradable services are clearly becoming important as well). In other words, poor countries become rich by producing what rich countries produce". (Rodrik, 2009:3) He further notes, "...activist policies aimed at enhancing the profitability of modern industrial activities and accelerating the movement of resources towards modern industrial activities. They go considerably

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beyond conventional recommendation to reduce red tape, corruption, and the cost of doing business. They entail in addition (or sometimes instead): explicit industrial policies in support of new economic activities (trade protection, subsidies, tax, and credit incentives, special government attention)” (Rodrik, 2009:4).



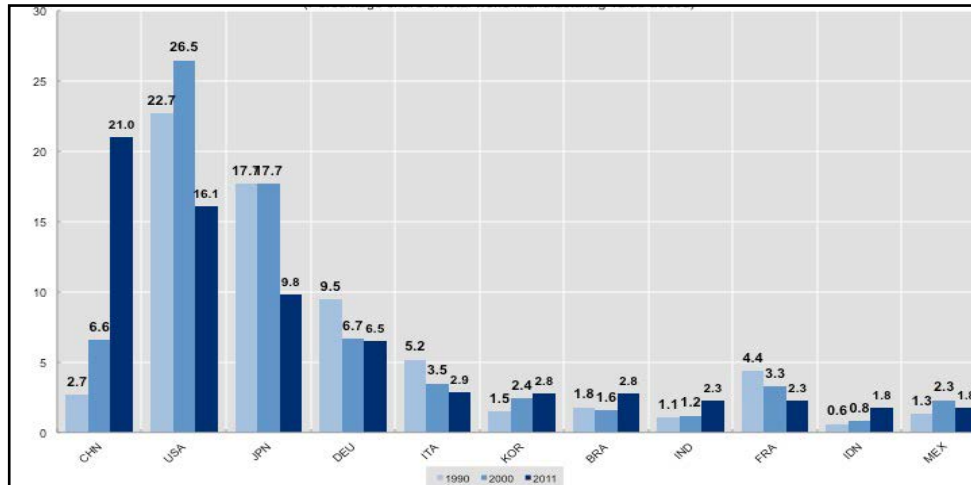
**Figure 6:** Change in Total Trade 2007 – 2013 (US\$ billion)

Source: Calculated from OECD (2013) Main Economic Indicator, Paris. [www.oecd.org/countries/](http://www.oecd.org/countries/)

Taking just a bilateral comparison with the United States in 2007 China's US\$ 2.2 trillion total merchandise trade was only 69 per cent of the United States. By 2013 China's merchandise trade, at US\$4.2 trillion, was 7 per cent bigger than the United States' US\$3.9 trillion. In six years China's trade increased by almost US\$2.0 trillion, compared to a US increase of US\$0.7 trillion - China's trade grew almost three times as much as the United States. The change was even more dramatic for imports. In 2013 China's goods imports were US\$993 billion above their 2007 level, whereas US imports were up by US\$311 billion, the EU's by US\$329 billion, and Japan's by US\$212 billion. China's imports rose by more than three times as much as the United States - and by more than the United States, EU and Japan combined. China was therefore, by a huge margin, the most rapidly expanding market for other countries' exports (OECD, 2013). In 2012 China's exports were 27% of GDP compared to only 14% for the US and 15% for Japan. Consequently China's export sector is almost twice as large a proportion of its economy as is that of the United States.

The economic history of developed capitalist countries suggests that the route to prosperity does not follow from a reliance on small industrial firms. Rather, it is essential, in order to build a prosperous and successful economy, to develop and rely on large manufacturing companies. China is attempting to create large internationally competitive manufacturing companies, who are supposed to take advantage of economies of scale (Rodrik, 2009).

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**Figure 7:** Top Manufacturers in the last twenty years. (% Share of the total world manufacturing value added)

Source: OECD (2013), Paris. [www.oecd.org/countries/](http://www.oecd.org/countries/)

The geography of global manufacturing has changed during the last twenty-five years. In recent years Chinese share of global manufacturing output and exports have increased (OECD, 2010). It is true that China and some other east Asian countries have increasingly participated in the production of manufacturing and exporting products, which just few decades ago was unthinkable. However, we need to look more closely at the evidence on the change of manufacturing geography and its implications. For example, in 1990, when globalisation was launched, the five top manufacturing countries' (i.e. US, Japan, Germany, Italy and France) share in global manufacturing valued added accounted for 57.8% of the total. Of course within the group there were wide differences such as the fact that the US share was 22.7%, while French share was just 4.4% (OECD, 2013). China accounted for just 2.7% for the same year. China's share in the total world's manufacturing has risen sharply from only 2.7 in 1990 to 6.6% in 2000 to 21% in 2011. See Figure 7. By 2000 the aggregate figure of global value added for manufacturing of the top 5 had risen to 61%, with US 26.5% and China 6.6%. China had joined the top 5, while France had dropped out. Moreover, during the last decade significant changes have taken place, especially China's share has rising dramatically to 21% by 2011. In 2000-2011 Brazil's rose from 1.8% to 2.8%, Indonesia's from 0.6% to 1.8%, India's from 1.1 to 2.3% (OECD, 2013).

On the question of global manufacturing exports the picture is not very different. The top 5 in terms of global exports of manufacturing accounted for 42.5% of the total in 1995, with US accounting for 12.5%. China's share then accounted for only 2.8% of the total. However, in 2009 China became leading exporter of manufacturing i.e. 12.9%, followed by Germany 10.3% and US 10.1%. Considering developing countries, excluding China, South Korea's export share witnessed a rise from 3 to 3.7%, India from 0.7 to 1.6%, Brazil 1.00 to 1.2% in the same period (Siddiqui, 2015; OECD, 2013).

According to the statistics, the US exported US\$152 billion worth of goods and services to China, and imported US\$478 billion worth, with a trade deficit of \$326 billion in 2012. China imports a range of capital goods, high technology and raw materials from other countries. However, the domestic value added content of exports is much less than the aggregate export figure suggests. According to OECD, the foreign value-added content in Chinese exports has risen from 11.9% of gross export value in 1995 to 32.6% in 2010 (OECD, 2013). However, when



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analysing foreign value added content, it becomes apparent that 60% is attributed to adding value to the inputs from other countries, primarily developed countries. Therefore, China appears to be a final processing place for a range of manufactured exports from across the world. For example, imports from China are not necessarily from Chinese firms, but most likely from US and EU companies. China's exports of Apple iPhone, Dell computers, Gap shirts, Hasbro toys, Mattel dolls, Nike shoes etc. are in fact, due to the fact that US companies choose to locate production facilities in China or source from China. To produce iPhones in China, Foxconn had to import US billions of dollars of worth of parts from US companies; the rest of the components came from Germany, Korea, and Japan. China receives little return from the process

It seems that the US is losing due to an increased trade deficit and mounting foreign debts, however, US companies are able to invest globally and increase profits and control global markets, which is far from being threatened by the decline of US hegemony. China's trade-to-GDP was about 70% in 2000, making it substantially more integrated than other of the developed capitalist economies such as the UK (37%). China's contribution to the growth of the world economy was merely 0.1% in 1978, however, by 2010 the situation had dramatically changed so that the country had emerged as a key driver of global growth, contributing 33% to it (OECD, 2013).

By 2010, China accounted for 15% of the world's value added in manufacturing industries, which was similar to Japan (OECD, 2013). It is often said that in a span of less than 3 decades China has witnessed the same degree industrialisation and economic development that took nearly two centuries to take place in West European countries. The economic size of the developed countries is changing and their combined GDP accounted for 50% of the world's total GDP in 2001, compared to 60% in 1973.

China's economy was worth of over US\$ 9 trillion in 2013. The economy grew by 7.7% in 2013, but manufacturing fell slightly. The size of workforce and productivity may have had the largest impact on the country's economy. "the country's urban workforce, which produces most of its output, is growing slowly. The age group from which this workforce springs is now shrinking outright. The population of working age shrank by 2.44 million in 2013, having already fallen several million the year before" (The Economist, 2014:63). Consumption, which made the biggest contribution to growth in 2011-12, was overshadowed in 2013 by demand and investment.

### 8. Conclusion

For several decades before 1980, government economic controls and regulations stifled entrepreneurship, private enterprise and brought economic inertia. However, since 1980 the influence of government has been markedly different, The Chinese government still plays a very active role in steering the general direction of the economy. The government initiated all economic reforms; market reforms, openness to trade and foreign capital have unleashed Chinese entrepreneurial energies since the early 1980s. These reforms took place at a time when the global economy was going through huge changes, which proved to be beneficial to China. Moreover, seeing these new opportunities investors from Hong Kong and Taiwan poured their surplus capital and technologies into the SEZs areas. The availability of cheap labour attracted foreign investors, which coincided with the ascendancy of neo-liberalism and trade liberalisation in the developed countries. It provided new opportunities for China. China also had high saving rates.

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However, prior to launching of pro-market reform, China had already invested in critical areas such as education and health care for the majority of its people. A number of radical institutional reforms were carried out, which led to the higher rates of female participation in the labour markets. The government undertook a policy of egalitarian land distribution and mobilised the female population to participate in education and job markets. The Chinese government carried out a comprehensive radical land reform, altering rural asset distribution in the country. It eliminated the centuries-old domination of landlordism and brought greater equality of access to land in the countryside. Along with this, investment in key areas like rural electrification did facilitate the growth of rural industries. Over the past decades China has restructured its economy, raising productivities in agriculture and manufacturing sectors and also it has consolidated and enhanced its position as a major exporter of the manufactured goods.

During the pre-reform period, more than 80% China's population lived in the rural areas; one of the highest proportion in the world. Agriculture was organised on the basis of collectivisation, where people's communes played crucial role. Despite various initial positive changes and an increase in agricultural output, but in the late 1960s rural sector witnessed stagnation. The rural reforms of 1978 led to institutional change in agriculture through de-collectivisation and small-scale enterprises. It allowed farmers to produce whatever it was profitable to produce. As a result, output, productivity and farmers' income rose. Most of this increase in income went into house construction and consumer goods, which ultimately expanded domestic demand. Rural industries grew rapidly. Unlike the economic reforms adopted by Russia in early 1990s, China launched a slow process and the outcome was much better i.e. the economy grew rapidly and the growth was uninterrupted. Within the last thirty years the urban population has increased from 20% to 50% of the total population. Agricultural production has increased and was able to meet rising domestic food demand. Besides increasing food output, and productivity in agriculture sector, rural income levels were increased as well. Despite the fact that Chinese agriculture feeds 22% of the world's population, it only uses 6 % of the world's arable land.

The study finds that China, rather than initially building western oriented pro-business laws such as property rights, reinforcing contract laws and freeing up trade, decided to focus local level support. It first began with the agricultural sector, where until 1978 farm prices and output were fixed by central planning; here government control over prices was removed. Such measures led to the abandoning of communes and family farming was allowed despite the fact that land ownership remained in state hands. Previously farmers were supposed to deliver fixed amounts of their produce to the government, but now after fulfilling the state quota, they were free to sell their surplus at market prices. Farmers saw a new opportunity to make profit and as a result investment, productivity and output rose sharply.

China has achieved a remarkable economic transformation from a poor and isolated country in economic terms in the world into the second largest economy in just thirty-five years, with growth rates of an average of 9.6% per annum. The country launched market oriented reforms in 1978 by lessening government control and opening up markets for private investors. China has not only doubled its GDP and income after every seven years and lifted nearly 500 million people out of poverty; its economy has developed by privatising state owned enterprises. However, the Chinese economy could still be characterised as developing due to the fact that a large number of its population (i.e. nearly 50%) rely on the agricultural sector for their livelihood. Even though the agricultural sector's contribution has declined, it still accounted for 40% of rural employment in 2012.

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To argue that China's success is mainly due to foreign investment is rather simplistic and it is not the MNEs that have built China's institutions and infrastructure. The government has played a crucial role in maintaining social stability and has also addressed market failures, regarding income distribution and has encouraged investment in key areas of the economy such as infrastructure. China's export success is based on number of factors including expansion of the manufacturing sector. Chinese saving rates have been higher compared to EU and US, which allows them to invest in the economy at higher rates. Moreover, some have emphasised that the 'Chinese miracle' is largely due to the labour input of the "floating population" – around 250 million who work away from their native areas and as migrant labour, most of them in Special Economic Zones, until recently in dire working conditions with little political rights (Bardhan, 2010). Migrant workers have benefited from the country's economic boom, but at the same time their incomes have been squeezed by rising food and consumer goods prices and lack of access to public education and health care.

China's overseas investment, compared to US, UK and Germany is still low, but it is increasing rapidly. The amount of capital exports from Chinese companies had reached \$50 billion in 2008, with an annual increase of 60% between 2001 and 2008. China's spending on R&D has been steadily rising since the 1990s and the country has surpassed Japan and became second largest R&D spending country after the USA. It has a labour cost advantage, which seems likely to stay at least in near future. China is still far behind US and EU in terms of income levels and it will be some years before it would be able to do it feasible to consider China matching their living standards. This is the reason China may have at least a 15 - 20 year time period where it will retain cost advantages.

One significant contribution to strong growth performance is that the Chinese economy has emerged as a locomotive of global growth. The growth rate of global GDP has averaged around 3.5% for the last three decades, while the average growth for next decade is likely to be higher at 4% annually because of the contribution made by emerging economies, especially China and India. Although GDP growth rates decelerated in 2008-09 due to the global financial crisis, China still managed to avoid recession and again its rising growth rate has helped to pull a number of economies in the world out of the slump. China still witnessed a 9.2% growth in 2009 (Vincelette et al, 2011). The Chinese boom has entered its fourth decade. In just 30 years China rose from a marginal and insignificant economy to the second largest economy in the world, is itself no less than a miracle (Das, 2012). China seems to be returning to the past when it was centre of the global economy and it contributed one-fourth to world output between 1300 and 1820 (Maddison, 2006). In the late 19th century, when Germany emerged as a large and industrial economy, it caused anxieties in the then economic powers such as Britain and France. They perceived Germany as a disrupter of the established order, it was treated as antagonistic and its economic development was seen to have disturbed the economic and political status quo. There is fear that China might be seen as disrupter of the 21<sup>st</sup> century established economic order, which may lead to international hostility and tension.

The paper finds that the corporate debt has risen in recent years in China. A large part of these loans has been financed with investment in trust products issued by the banks. The second largest loan receiver was local governments where the money was borrowed from sources like the China Development Bank to finance infrastructures and other developmental projects in the provinces. A large amount of credits has been channelled into the real estate sector, and seems to be heading towards the housing and estate sectors and most of it could be speculative. Recently lower demands meant that a large number of these properties are

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unoccupied. This means property prices will increase at lower rates than expected. Investments are financed by credit; which clearly needs to be repaid. This could pose a bigger challenge for Chinese economy, if debt becomes unsustainable (e.g. based on 'housing bubbles'- as was the case in many advanced countries).

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