

# China's Economic Transformation

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# Preface

In the twenty-first century, economic integration and the increase in the economic and political influence of Asian countries relative to the rest of the world are two important driving forces shaping world events. China plays a very important role in both developments mainly because of the increasing size of its economy. It is therefore necessary for anyone concerned with the development of the world to understand China's economy.

The purpose of this book is to introduce the reader to the workings of the Chinese economy. It is written both for undergraduate and graduate students as a textbook and for the general reader who wishes to understand the Chinese economy. It describes the process of economic transformation in China in its various aspects. Understanding this transformation process is essential to understanding the current economy of China.

I combine historical-institutional and a theoretical-quantitative approaches to study China's economy because neither one by itself can provide a complete picture. The former approach is favored by area specialists and historians. The latter is familiar to economists. These approaches complement each other. Without a solid understanding of the historical-institutional background, one can make serious errors in applying a theoretical-quantitative model to the Chinese economy. On the other hand, understanding the history and institutions without the benefits of a theoretical and/or quantitative analysis is not sufficient either. The first four chapters of this book provide a historical-institutional background, while many of the remaining chapters are theoretical and quantitative, including chapters 5–9, 11, 12, 14, 15, 17, and 19. Chapters 7, 9, 10, 11, 13, and 15–22 contain historical-institutional material as well. Hence the two approaches are integrated in this book. By studying the Chinese economy in this way, one forms a clear picture of the dynamic and continuing process of transformation from a planned economy to a market economy.

Historians and area specialists have raised objections to those economists who believe in universal laws in economics and apply them to the study of the economies of all countries alike, without regard to the special historical and cultural setting. Economists have expressed disappointment at area studies that fail to take advantage of the powerful tools of economic analysis. In this book I suggest that economic

tools can be applied to China provided that the researcher carefully examines whether the basic assumptions are consistent with the realities of Chinese society. Examples of integrating institutional material with theoretical or quantitative analysis are provided in chapters 2, 5–9, 11, 14, 16, 17, and 19. Nor can economic tools be properly applied without considering the institutional setting. One hopes that the application of economic tools to China and other countries with sharply defined cultural-institutional settings will help extend the field of economics by suggesting new tools and concepts of analysis when existing ones are found to be inadequate. This topic is discussed in chapter 22.

Because this book deals with the process of economic transformation it is of interest to readers studying transitional economics. Perhaps the word “transformation” better describes the economic changes in China than the word “transition.” The latter word may imply that the process will reach a definite, terminal state, whereas in the Chinese case the final form that the economic system will take remains unknown. Unlike most studies in economics, this book pays special attention to changes in economic institutions. Economic transformation and transition have attracted general attention since economic reforms started in China in the late 1970s and in eastern Europe and the former Soviet Union in the early 1990s. Historically, institutional changes have come about when the same profit motive and economic self-interest that explain behavior under a given set of institutions have also motivated the design of new institutions to make more money. However, the economic transformation that has taken place in China is to a significant extent an act of the Chinese government aimed at modernizing the Chinese economy, although private profit motives also play a role. In chapters 2, 3, and 4 respectively we study China’s planning system, the economic reform process, and the problems in reforming the state sectors. Economic transformations are also discussed in chapters 10, 20, and 21, which deal respectively with the government’s effort to develop the western region and to set environmental policies, to build the institutions of a modern legal system, and to improve the educational system. In chapter 16, we study the nonstate sectors including the township and village enterprises that have evolved through profit motives in a Chinese institutional setting.

Theoretical-quantitative analysis is applied to the study of economic growth (chapter 5), economic fluctuations (chapter 6), macroeconomic policies (chapter 7), economic effects of the Great Leap Forward and the Cultural Revolution (chapter 8), consumption (chapter 9), population (chapter 11), human capital (chapter 12), the banking and financial system (chapter 13), Shanghai stock price determination (chapter 14), the behavior of state enterprises (chapter 15), the nonstate sectors (chapter 16), foreign trade (chapter 17), and foreign investment (chapter 18). Chapter 22 concludes by summarizing several important institutional characteristics of the Chinese economic system that are different from those of a western market economy, providing challenges for further study. It also discusses the prospects of continued economic growth in the twenty-first century based on the momentum of historical forces.

This book is based on my study of the subject since 1980 through research, teaching, and working with Chinese educators, economists, and government officials. I have used the material in an undergraduate course on the Chinese economy at Princeton University. The course started in 1986 when it covered only the topics of

chapter 2 and parts of chapters 3, 9, 11, 12, 17, and 18, as contained in my *The Chinese Economy* (1985). The remaining material draws on my research since, as partially reported in *Understanding China's Economy* (1994) and in more recent writings cited in the references. In writing this book I have benefited from questions and critical comments from students through the years. About 20 percent of the material (including parts of chapters 5, 6, 8, and 14 in particular) is technical and mathematical. The general reader can skip the technical material and read the text only.

I would like to thank Patrick Bolton, Simon Chen, Paula Chow, Vida Chu, Shouwei Hu, D. Gale Johnson, Lawrence Klein, and Chia Yu Shen for reading parts of the manuscript, and especially Kan Chen for reading the entire manuscript and making suggestions for improvement. The remaining errors are my own responsibility. Annamarie Scarpati has assisted in many respects in the preparation of the manuscript with skill, efficiency, and enthusiasm. It has been a pleasure to work with Al Bruckner of Blackwell Publishers, who has handled the publication of this manuscript at all stages with a remarkable professionalism that is based on his vast knowledge and experience. Financial support from the Gregory C. Chow Econometric Research Program of the Department of Economics at Princeton University is gratefully acknowledged.

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# Contents

List of Figures and Tables	x
Preface	xii
 Introduction: The Transformation of China's Economy	 1
<b>Part I: Historical Background and General Survey</b>	<b>7</b>
1 Economic Lessons from History	9
1.1 Introduction	9
1.2 Significant Events in Major Historical Dynasties	10
1.3 The Republic of China, 1911–	16
1.4 Summary of Historical Lessons	21
2 Experiments with Planning and Economic Disruptions	24
2.1 The Communist Party Rises to Power	24
2.2 Historical Review: 1949–78	26
2.3 A Model of the Chinese Planned Economy	28
2.4 The Behavior of Economic Units in a Planned Economy	32
2.5 Output Planning in Theory and Practice	35
2.6 Organization and Administration of Economic Planning	40
3 Economic Reform up to the Mid-1990s	46
3.1 Why Economic Reform Started in 1978	46
3.2 Agriculture	48
3.3 Reform of State-owned Enterprises	49
3.4 Price Reform	51
3.5 The Banking System	52
3.6 Foreign Trade and Investment	53
3.7 The Nonstate Sectors	53

---

3.8	Institutional Infrastructure	54
3.9	Reform Policies Similar to Those of Taiwan	55
3.10	Reasons for the Success of China's Economic Reform	58
3.10	Summary	62
	Appendix: China's Geography	63
<b>4</b>	<b>Further Reform: Problems and Prospects</b>	<b>68</b>
4.1	Introduction	68
4.2	Enterprise Reform	69
4.3	Banking Reform	71
4.4	Foreign Trade and Investment during the Asian Financial Crisis	75
4.5	The Impact of WTO Membership	77
4.6	Prospects for Reform	83
	<b>Part II: Analysis of the Macroeconomy</b>	<b>87</b>
<b>5</b>	<b>Economic Growth</b>	<b>89</b>
5.1	The Neoclassical Model of Economic Growth	89
5.2	Data on Output, Capital, and Labor	90
5.3	A Review of Regression Analysis	93
5.4	Estimating Production Functions for China	96
5.5	Use of the Neoclassical Growth Model to Forecast GDP	99
5.6	How Large will the Chinese Economy be in 2020?	102
<b>6</b>	<b>Economic Fluctuations</b>	<b>105</b>
6.1	The Multiplier-Accelerator Model of Economic Fluctuations	105
6.2	Dynamic Properties of the Multiplier-Accelerator Model	108
6.3	An Econometric Method for Estimating Parameters of Linear Stochastic Equations	110
6.4	Estimating a Multiplier-Accelerator Model of the Chinese Economy	111
6.5	Econometric Models of the Chinese Economy	114
<b>7</b>	<b>Macroeconomic Policies</b>	<b>117</b>
7.1	Introduction	117
7.2	Monetary Policy	119
7.3	Estimating a Dynamic Equation to Explain the Inflation Rate	124
7.4	Basic Facts about Government Revenue and Expenditure	125
7.5	Fiscal Policy	126
<b>8</b>	<b>The Effects of Political Movements on the Macroeconomy</b>	<b>129</b>
8.1	Specification of a Dynamic Optimization Model of the Chinese Economy	129
8.2	The Solution of the Dynamic Optimization Problem	132
8.3	Statistical Estimation	136
8.4	Measuring the Effects of Two Political Events	140

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8.5	Conclusions	144
<b>Part III: Topics in Economic Development</b>		<b>147</b>
9	Consumption	149
9.1	Trends in Per Capita Consumption	149
9.2	Household Expenditure Patterns	153
9.3	Rural Per Capita Consumption Expenditures in 1998 by Province	161
9.4	Consumption of Housing in Rural and Urban Areas	162
9.5	Forecasting Demand for Computers	163
10	Western Development and Environmental Policies	168
10.1	Inequality in Per Capita Consumption and East-west Disparity	169
10.2	Developing the Western Part of China	170
10.3	Environmental Policies	176
10.4	A Study of Industrial Pollution	178
11	Population	181
11.1	The Role of Population and Human Capital in Economic Development	181
11.2	Chinese Population and its Rate of Growth	183
11.3	Population Policy	186
11.4	Evaluation of China's Population Policy	189
11.5	Economic Explanation of the Birth Rate	191
12	Human Capital	194
12.1	The Importance of Human Capital and its Measurement	194
12.2	Labor Supply and Demand	196
12.3	Investment in Human Capital	202
12.4	Measuring the Rates of Return to Schooling in China	210
12.5	Health Services	212
<b>Part IV: Analysis of Individual Sectors</b>		<b>217</b>
13	The Banking and Financial System	219
13.1	Commercial Banks	219
13.2	The People's Bank	221
13.3	Factors Affecting the Functioning of the Banking System	223
13.4	Possible Weaknesses of the System	225
13.5	Possible Directions of Reform	227
13.6	The Financial Condition of Commercial Banks and the Bad-loan Problem	229
13.7	Other Financial Institutions	229
13.8	The Role of the Chinese Government in Reforming the Financial System	233



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<b>14</b>	<b>Shanghai Stock Price Determination</b>	<b>237</b>
14.1	Introduction	237
14.2	A Model of Stock Price Determination	238
14.3	Empirical Findings from the Shanghai Stock Exchange	241
14.4	Comparison with Findings for Hong Kong and New York Stocks	245
14.5	Concluding Comments	246
<b>15</b>	<b>The Behavior of State Enterprises</b>	<b>249</b>
15.1	Organization of a State Enterprise under Central Planning	249
15.2	Planning and Operations of a Large-scale State Enterprise	253
15.3	A Simple Model of a State Enterprise under Central Planning	257
15.4	A Simple Model of a State Enterprise after Initial Reform	260
15.5	State Enterprise Restructuring in the Late 1990s and its Effects on Enterprise Behavior	263
<b>16</b>	<b>The Nonstate Sectors</b>	<b>268</b>
16.1	Relative Growth of Nonstate Sectors	268
16.2	Private Enterprises Prior to 1949	270
16.3	Economic Conditions for the Growth of Township and Village Enterprises	270
16.4	Econometric Measurement of the Relative Efficiency of State Enterprises and TVEs	273
16.5	Characteristics of a Free-market Economy	274
16.6	Characteristics of the Chinese Market Economy	277
<b>17</b>	<b>Foreign Trade</b>	<b>281</b>
17.1	Some Statistics of China's Foreign Trade	281
17.2	Explanation of Trading Patterns under Free Trade	282
17.3	The Determination of Foreign-exchange Rates	288
17.4	China's Foreign Trade Policy	293
17.5	Chinese Foreign Trade Problems in the Early 1980s	296
<b>18</b>	<b>Foreign Investment</b>	<b>304</b>
18.1	The Role of Foreign Investment	304
18.2	Historical Developments	306
18.3	The State of Foreign Direct Investment (FDI) as of 1999	307
18.4	Policies for the Regulation of Foreign Investment	310
18.5	Opportunities and Problems for Foreign Investors	312
18.6	How Attractive is China for Foreign Investment?	316
18.7	The Impact of WTO Membership on Foreign Investment	317
18.8	A Proposal to Increase Foreign Investment from Taiwan	318

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<b>Part V: Studies of Economic Institutions and Infrastructure</b>	<b>321</b>
<b>19 Use or Misuse of Assets</b>	<b>323</b>
19.1 Introduction	323
19.2 Laws of Asset Management	325
19.3 Managing One's Own Person	328
19.4 Managing Physical Assets	330
19.5 Managing Collections of Assets under the Responsibility System	332
19.6 Concluding Comments	335
<b>20 The Legal System and the Role of Government</b>	<b>338</b>
20.1 The Legal System prior to 1949	338
20.2 The Legal System since 1949	340
20.3 The Role of the Legal System in a Market Economy	343
20.4 The Economic Role of Government	345
20.5 The Government's Decision Process	348
<b>21 The Education System and Policy</b>	<b>352</b>
21.1 The Education System prior to 1949	352
21.2 The Education System after 1949	353
21.3 Education Policy	354
21.4 Economics Education	357
21.5 Concluding Comments	365
<b>22 Taking Stock and Looking Ahead</b>	<b>367</b>
22.1 Taking Stock	367
22.2 Prospects for the Chinese Economy up to 2020	379
<b>Conclusion: Lessons for the Study of Economic Transformation</b>	<b>386</b>
<b>Index</b>	<b>394</b>

# Figures and Tables

## Figures

3.1	Contemporary China	64
8.1	Observed and simulated residual 1	135
8.2	Observed and simulated residual 2	135
8.3	Observed and simulated output (in log)	141
8.4	Observed and simulated consumption (in log)	141
8.5	Observed and simulated capital (in log)	142
8.6	Observed and simulated Solow residual (in log)	142
15.1	Organization of the First Lathe Factory, 1957	250

## Tables

1.1	Chinese domestic product by origin, in constant 1933 and 1952 prices	19
3.1	China, gross industrial output value by ownership, in billions of current yuan	54
4.1	China's gross domestic product and its major components	78
5.1	Data on GDP, labor, and capital	94
5.2	Regression equations with AR(1) errors, mainland China	97
5.3	Sources of and contributions to GDP growth for various sample periods, mainland China	98
7.1	Data on inflation and its determinants	120
8.1	Some sensitivity analysis parameters	137
8.2	Effects of the Great Leap Forward	138
8.3	Simulation/observed level in 1992	143
8.4	Simulation/observed level in 1992	143
8.5	Simulation/observed level in 1992	143
9.1	Per capita consumption and urban wage rate	150

9.2	Rural consumption expenditure per capita and its components by province, 1981	154
9.3	Per capita consumption expenditures of peasant households surveyed in 1978–81	156
9.4	Elasticities $b$ for four expenditure groups with respect to total expenditure, and adjusted elasticities for food	158
9.5	Rural consumption expenditure per capita and its components by province, 1998	160
11.1	Annual birth rate, death rate, and natural growth rate of the Chinese population, 1952–98	184
11.2a	Comparison of male and female births in Suixi and Huaiyuan counties	187
11.2b	Comparison of male and female births in selected communes in Huaiyuan county, 1981	188
12.1	Number of employed persons in China	198
12.2	Student enrollment by level of school, 1949 to 1981	204
12.3	Estimates of wage equations	211
13.1	Monetary aggregates: major financial indicators	224
13.2	The number of companies listed in Chinese stock markets	233
14.1	List of companies and observation numbers	242
14.2	Estimates of parameters of equation (14.3) explaining log stock price	243
15.1	Cost and profits of First Lathe Factory of Beijing	256
15.2	Cost breakdown for no. 2 general purpose lathes	257
17.1	Total Chinese imports and exports	282
17.2	Illustrative input coefficients for two production processes	284
17.3	Illustrative input coefficients for three production processes	288
18.1	China's utilization of foreign capital	307

# Introduction: The Transformation of China's Economy

This book is about the transformation of China's economy into a market economy with its special characteristics. It deals with the process of transformation and the special features of the Chinese economy. It contains much of what I have discovered about China's economy and the economics of institutional transformation from research, teaching, traveling, working with Chinese educators and government officials, and observing the Chinese society simply by talking to Chinese friends and citizens since 1980. As an introduction I would like to make three sets of observations. The first is about the economics of institutional changes. The second is about China's government, and third about China's historical and cultural traditions. In the remainder of this book the reader will find these observations elaborated upon in more detail.

In the study of economic transformation, the role of the government needs to be stressed. Thomas Jefferson has aptly remarked that the government is the best which governs the least. However, in the process of an economic transformation promoted by government, the government has to play an important role, even if Jefferson's statement is valid when a set of economic institutions is well established. The economics of transformation is related to the economics of transition, since both deal with changes in economic institutions. A possible difference is that the latter conveys a notion that the economy is in a temporary state of transition to some ideal state, such as a special form of market economy. The former does not carry a notion of a known final stage of transformation. It studies the process of economic transformation without a definite statement regarding the final state.

Secondly, besides understanding the important role of the government it is important to understand the role of the remaining sectors which may support or reject the reform measures introduced by the government. These sectors may also play an important role in initiating reform of their own, sometimes even guiding government reform policies, and sometimes serving as a supplement to government reform. The former is illustrated by the introduction of the household re-

sponsibility system in Chinese agriculture from the grassroots, and the latter by the rapid growth of township and village enterprises in China as a supplement to state-owned enterprises.

Thirdly, if one is to understand the important roles of the government and the nongovernment sectors and their interaction in shaping the transformation of an economy, it is necessary to understand the historical, cultural, and institutional factors that affect the actions of government officials and the people. Government officials and the important players in the nongovernment sectors are guided in their behavior by historical and cultural factors, in addition to economic calculations. Economic reform in China and Russia has taken different directions partly because of the differences in historical and institutional factors. For example, China's reform in the agricultural sector succeeded because Chinese farmers in 1978 still remembered private farming – the commune system was introduced in China only in 1958. Collectivization of agriculture in the Soviet Union took place in the early 1930s and Russian farmers in the early 1990s did not know how to operate as private farmers. It was difficult to privatize the agricultural sector in Russia. The success of agricultural reform in China provided the economic foundation for reform in other sectors.

Concerning the historical institutions of China, there is a long tradition of the use of social networking known as *guanxi*. *Guanxi* determines many social interactions, including economic transactions. It affects the reform of the legal system, as we will see in chapter 20. There is also an established bureaucratic tradition which affects the behavior of government officials and of state-owned enterprise managers. This tradition, further modified and developed under the government of the People's Republic of China, affects the reform of the banking and financial system, of state-owned enterprises, and of the nonstate sectors, as we will see in chapters 13, 15, and 16 respectively.

A fourth feature of the economics of transformation is that, since the government plays such an important role and the government's reform policies depend on historical and institutional factors, many aspects of the transformation process need to be studied as isolated events. Economists, following the lead of natural scientists, would like to find general laws that can be applied to explain economic behavior in general, regardless of time and space. There are such laws in economics, some of which will be illustrated in this book. However, while laws can explain economic behavior under a given set of economic institutions and may even be valid for a variety of economic institutions, they do not as a rule explain why economic reform started in China in 1978 and why it proceeded the way it did. The explanation has to rely on the historical circumstances in 1978. The nature of the economic reform that followed was subject to the constraints of the historical, institutional, and political factors affecting the actions of the Chinese Communist Party leaders. It also depended on the personal characteristics of the leader, Deng Xiaoping, himself.

The discussion of China's historical tradition in chapter 1, of its planning system in chapter 2, its general reform process in chapters 3 and 4, and the transformation of the individual sectors later on in this book illustrates the above important features in the study of the economics of institutional transformation. The individual sectors include consumption in chapter 9, western development in chapter 10, population policies in chapter 11, human capital in chapter 12, the banking and financial system in chapter 13, state enterprises and the nonstate sectors in chapters 15 and 16, for-

eign trade and foreign investment in chapters 17 and 18, and the legal system and the education system in chapters 20 and 21. These chapters emphasize in many places the important role of the government and of the historical and institutional factors affecting the reform process. Many take into account the interaction of government and nongovernment influences, and the nature of Chinese society, including bureaucratic behavior. Such are the important considerations in the study of the economics of institutional transformation.

In this book traditional economic tools are also applied to study the Chinese economy. Examples are a model of aggregate economic growth in chapter 5, theories of economic fluctuations in chapter 6, macroeconomic policies in chapter 7, an econometric study of the macroeconomic effects of the Great Leap Forward movement and the Cultural Revolution in chapter 8, analysis of consumer behavior in chapter 9, population growth and investment in human capital in chapters 11 and 12, and an economic analysis of behavior of individuals controlling state-owned assets in chapter 19. Even if the important concepts of economic incentives and self-interest cannot explain the transformation of economic institutions as isolated events influenced by historical circumstances and political considerations, these concepts can be applied in evaluating the incentive effects and economic efficiency of particular reform measures. Such applications can be found in many places in this book.

What remains to be discussed in this introduction are the nature of China's government and its historical and cultural tradition. People outside China today still think of it as essentially a Communist country having the typical characteristics associated with Communism as it was understood during the period up to 1980. These characteristics include a totalitarian regime in which government leaders attempt to manipulate the people as Chairman Mao did. There is no freedom. There are many labor camps. The government can change public opinion at will by controlling the press and the TV stations. That it is oppressive is evidenced by, for example, the tragic event on June 4, 1989, in Tiananmen Square.

In fact, the Chinese Communist Party and the Chinese government have changed a great deal since 1978. Economic reform has led to openness and more freedom. The Communist Party officially accepted "a socialist market economy" for China in 1992. Although the country is still ruled by the Communist Party, the current characteristics of China's political and economic system are becoming very different from those listed in the last paragraph. Since economic reform started in 1978, the Chinese people have continually gained economic freedom. Economic freedom and economic wealth obtained through the market have given the Chinese people much more political power than before. Foreign trade and foreign investment promoted by the open-door policy have increased the contact of the Chinese people and government officials with the outside world. Both ordinary people and government officials are exposed to modern concepts of law and democracy. Some are even convinced of the virtues of many of these ideas. The government has instituted significant reform of China's legal system, as I shall describe in chapter 19.

Three issues often appear in the Western press when the topic of China comes up. These are the treatment of Tibet, Falung Gong, and certain political dissidents. On Tibet, most Chinese citizens (Han being the vast majority) side with the government in making sure that Tibet remains a part of China. Some Han Chinese believe that certain religious leaders in Tibet use the issue of religious freedom as a means to

promote political independence. I may add that some Chinese citizens believe that China should have more religious freedom than the government allows, even when Christian church attendance has been allowed to increase rapidly in recent years. The vast majority of educated Chinese citizens, including those studying and working in the United States, believe that Falun Gong (a “new religion” in China) is a cult and a menace to society. They tend to support the government in taking punitive actions. On the treatment of political dissidents, it depends on which political dissidents and under what circumstances.

China has its own form of representative government. In the selection of representatives to China’s legislature, members of the People’s Congress are indirectly elected by representatives at the level immediately below, until public election determines the representatives at the lowest street district or village level. Unlike the situation before the 1980s, when members of the People’s Congress only rubber-stamped legislation proposed to them by the State Council at the direction of the Communist Party, members of the People’s Congress today are educated and vote according to their own opinion. Truly democratic public elections are held in villages all over China to elect government officials at the village level, although such elections have not reached higher levels.

No single person, like Chairman Mao during his lifetime, can control the Chinese population the way Mao did. The Chinese people have become more mature politically after the movements of the Great Leap Forward of 1958–61 and the Cultural Revolution of 1966–76. Since China is now open to the outside world the people can no longer be so easily fooled. Beside the differences in historical circumstances, Mao was a Chinese political genius unique in his century. Mao designated Hua Guofang to be Chairman of the Party to succeed him, but leadership fell to the hands of Deng Xiaoping instead. Deng was able to assume leadership because he was supported by the top members of the Party. The point is that election within the Party serves as a process to select the able and to limit the power of a potential dictator. Many outside observers had forecasted trouble in the transitions after the deaths of Mao and Deng, only to find that they were wrong. This is a sign of the stability and resilience of the political leadership at the top.

Another occasion when outside observers misjudged the nature of the Chinese leadership is their very pessimistic forecast for the future of Hong Kong after its return to China in 1997. The situation in Hong Kong has turned out to be vastly different from any dire predictions. Yet another example is the devaluation of the Chinese yuan forecasted continuously by foreign commentators for two years during the Asian financial crisis of 1997–9, a subject to be discussed in section 4.4. There was also the prediction during the period of the Asian financial crisis and afterwards of an impending banking crisis, a subject to be discussed in section 4.3. Suffice it to say that positive information about China since 1978 needs to be incorporated into one’s thinking in forming a balanced assessment of the country.

Consider the life of an average Chinese citizen. There is much more freedom than before. Are there labor camps? Yes, if the term is defined as prisons in which inmates are required to work. Prisons exist mainly to detain people who have committed crimes. There are not many political prisoners because there are not many people who are strong opponents of the government. By and large, the Chinese people are happy; and they are happy with their government. Students from China who have arrived recently



can testify to this point. At Princeton in the late 1990s, one speaker was invited to talk about labor camps in China based on his personal experience in the 1960s. The situation is very different today from what the speaker described. The students from China in the audience felt indignant and jeered him. Part of this freedom is the freedom of any university student to study abroad, even when the government recognizes that many have decided to stay abroad after graduation. People are exposed to TV channels outside the mainland, including in particular those of Hong Kong and Taiwan. The internet and fax machines are available to many people. It is difficult for the government to manipulate news effectively even if it wishes to.

The government requires the support of the population to achieve its program of economic reform and development. For example, in the reform of state enterprises it may be necessary to lay off workers, and the government has to consider the possible effect of discontented workers on political stability. Chinese government leaders, just like political leaders elsewhere, consider maintaining their political power to be more important than almost any other objective. They applied force to disperse students occupying Tiananmen Square because they thought its continued occupation was undermining their authority and threatening the survival of the government. In situations where government power is not threatened, it is reasonable to assume that the government will try to promote the interests of the Chinese people, in addition to their own interests. When the position of a government official or leader is secure, it is his or her desire to serve the country, the possibility of corruption and self-interest notwithstanding. This desire is derived from a Confucian culture that has lasted centuries, and according to which the Chinese were taught to serve their country; and from the ideal of modernizing China generated by humiliation experienced since the defeat in the Opium War of 1840.

The last sentence leads to the third topic of this Introduction, namely, that China's historical and cultural tradition is an important determinant of the country's economic reform process and policies. Several historical cultural characteristics are important in this regard. First, the quality of human capital in the form of skilled and hard-working laborers and entrepreneurs has contributed to economic growth and enabled the reform process to succeed to the extent that market incentives alone cannot. Second, Chinese bureaucracy is at the same time a useful vehicle for guiding economic transformation and a hindrance to economic progress. Third, the traditional way of conducting business through informal social networks and human relations makes it difficult for foreign investors to enter Chinese markets and slows down the introduction of a modern legal system. Fourth, there is an emphasis on the collective welfare of the country as a whole as compared with the freedom of individuals, making the economy more socialistic. Fifth, there is a sense of nationalism. The current Chinese mentality is a combination of pride and the experience of humiliation. They are proud of a civilization that is over 5,000 years old, with distinctions in science, mathematics, arts, furniture, china, literature, philosophy, ethics, and politics. After the Opium War of 1840–1 and until 1945, foreign powers one after another carved up parts of China and forced it to sign unequal treaties giving concessions. Memories of oppression by Western and Japanese imperialism and the need for national independence are two important components of the Chinese mentality. Nationalism manifests itself whenever the country or any of its components appears to be under attack.