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Understanding China's historical development: The profit and the risk that China's stock market provides investors

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ABSTRACT

The purpose of this paper is to describe China's unique historical development that transformed the Celestial Empire into the largest economy in the world in the beginning of the nineteenth century, with a GDP that exceeded that of Western Europe, Japan, the US and Russia combined, and the decline during the 'Century of Humiliation', and Mao Zedong's communism that culminated in the 'Three Bitter Years' from 1958 to 1961 that produced the large famine with an estimated death of 20 to 30 million people. After this disaster, aggravated by the 'Cultural Revolution' that followed, came the amazing growth started by Deng Xiaoping's economic reforms in 1978, that is only comparable to the United States emergence as an economic giant during the nineteenth century. China's sustained growth, at an astounding 10 percent per year over the last 30 years, is without precedent. Many economists predict this growth rate will continue at 7 to 8 percent per year for several decades. This extraordinary sustained growth was partially fueled by the formation of its rapidly expanding financial market, and the profit and risks that its stock marked provides investors.

Keywords: China's historical development, China's social-capitalism, China's economic growth, Risks to China's growth, China's remaining poverty, China's bureaucracy and corruption, China's stock market, China's mutual funds China's unsustainable growth

China's stunning growth

In the past thirty years, China has transformed itself from an economical and technological backward nation into one of the world's most dynamic economies. It has opened its doors to new ideas and techniques, introduced competition to all aspects of production, strengthened its commitment to widespread education, and taken advantage of the opportunities offered by its World Trade Organization (WTO) membership. In December 2001, China officially joined the WTO. The results have been dramatic for both China and the United States (US). From 2001 to 2005 the US exports to China rose from United States Dollars (USD) 19 billion to 41.8 billion and imports from China rose from USD 102 billion to 243.5 billion (Malkiel and Taylor, 2008, p. 51). The Chinese are now the third trading nation in the world behind only of the US and Germany.

The Chinese have one of the highest savings rates in the world, around 50 percent of the Gross National Product (GDP), that contrast sharply with the United States were the saving rate is essentially zero. In other words, the Chinese save more than they spend. People in the United States do exactly the opposite. As a consequence the Chinese economy is awash in capital from savings looking for investment opportunities. This capital has been used for modernizing production, which in turn has increased profitability, and generated more capital. The government also took advantage of the abundance of capital to improve the country's infrastructure that in turn fuels economic growth. China now has the only commercially operated Maglev train in the world. The train operates in Shanghai between the city and the airport at speeds up to 260 miles per hour using magnets to elevate it above the track.

Some impressive statistics illustrate the recent success of the Chinese economy. China has been the fastest-growing major nation for the past quarter of a century with an average GDP growth rate above 10%. Its per capita income (GDP per head) has grown at an average annual rate of more than 8% over the last three decades drastically reducing poverty, but this rapid growth has been accompanied by rising income inequality. As a result China is now the second largest economy in the world after the US with a

GDP of USD 7.8 trillion in 2008 when measured on purchasing power parity (PPP) basis. It is the third largest after the US and Japan with a nominal GDP of USD 4.4 trillion in 2008 when measured in exchange-rate terms, overtaking Germany in 2008 according to the International Monetary Fund (April 2009). The Chinese foreign exchange reserve is now around USD 1.3 trillion, and China is the largest investor in US treasury bonds. According to some estimates 80% of the Chinese foreign exchange reserve is in USD.

In the modern era, China's influence in the world economy was minimal until the late 1980s. At that time, economic reforms started in 1978 began to generate significant and steady growth in investment, consumption and standards of living. China now participates extensively in the world market, and its private companies, like Lenovo, started to play a major role in the world economy. China has become the world's second largest consumer of luxury goods surpassing in 2008 the US and second only to Japan. The demand for luxury items in China is growing at the fantastic rate of 20% annually. China has an estimated 18 thousand billionaires, 440 thousand millionaires, and a fast rising middle class of around 250 million who have high purchasing power and are eager to spend in luxury goods (Morisset and Lee 2008). China now has 170 cities with more than 1 million habitants compared to the US that has only 10 such cities. There are over 400 million Chinese subscribers to wireless phone services that represent 100 million more that the entire population of the US (Malkiel and Taylor, 2008, p. 44).

China's history

It is important to review China's history to get a background understanding of the unique hybrid economy that it has constructed in the last three decades. This unique construct has its dangers for investors that we will present in the section we discuss the perceived risks of the Chinese economic model. For simplicity's sake, we can divide China's history into eight major periods: Warring feudal states, Celestial Empire and Confucianism, Colonialism and a Century of Humiliation, Westernization movement, Bourgeois Revolution, Mao's communism, Cultural Revolution, and Deng Xiaoping's social-capitalism.

Warring feudal states

Before China was unified by the emperor Qin Shi Huang (259-210 BC) in 221 BC the country was divided into dozens of viciously warring feudal states. This period is illustrated by the impressive displays of the constant wars between the feudal states in China's National Museum in Beijing. In this turmoil, arose the man that with his philosophy had the greatest influence on China' future cultural development: Confucius (551-479 BC). Through conceived out of wedlock and raised in poverty, Confucius managed to become an accountant in the state of Lu and eventually was named its justice Minister. Disgusted with the brutality and greed surrounding him, he resigned from his post and began a long journey around China, lobbing unsuccessfully many different rulers for political reform. After twelve years, he returned home and spends the last year of his life teaching a large number of students, and writing and editing a set of Chinese classics (Malkiel and Taylor, 2008, p. 16), including the 'Book of Odes', 'Book of History', 'Book of Rites', 'Book of Changes', 'Book of Music' and the 'Spring and Autumn Annuals'. Confucius own statements were compiled into a book entitled 'The Analects' by his disciples. Of these, only the 'Book of Music' was lost.

The period from 722 to 221 BC was a golden age for ancient Chinese history. In this period various schools of thought emerged and contended, including the Confucian school. It was also in this period that the scholar-bureaucrat class emerged as the elite class, a position it maintained for more than 2 thousand years. An interesting example of this period is the Jixia Academy of the State of Qi that attracted representatives of the various schools of thought. The Duke Xuan (375-358 BC) of Qi was an enlightened ruler providing board and lodging, as well as government subsidies for experts and scholars coming to give lectures, and never inquiring about their backgrounds. This was an era when "one hundred schools of thought contended and a hundred flowers blossomed." The scholars debated in forums, wrote books to expound their doctrines, and left behind many splendid classic works of scholarship.

Celestial Empire and Confucianism

Unfortunately, when Qin Shi Huang ruled as the First Emperor of unified China from 221 to 210 BC, his Prime Minister Li Si ordered that all books except those on medicine, fortune telling and tree planting be burned. So, all the classics of the various schools of thought were destroyed. Emperor Wu Di (156-87 BC) of the Western Han Dynasty that defeated the Qin dynasty in 207 BC made Confucianism the orthodox doctrine of the state, while other schools of thought were deemed heretical. He set up an educational system of training the future official with Confucian classics. These scholar-bureaucrats helped the emperor organize the society according to the doctrine of Confucianism and manage the country with the thoughts and philosophy of Confucianism. The magnificent Han dynasty oversaw a powerful and unified great empire. Relying on its military strength and brilliant culture it dominated the east as the Roman Empire dominated the west. The capital was in Chang'an, it was called Western Han to distinguish it from East Han, which was established later and took Luoyang as the capital.

During the Sui Dynasty (581-618) was established the Ke Ju, the national examination system for selecting talented young people to be scholar-bureaucrats and thus make their contribution to the management of the country. The system allowed talented young people to change their social position through their personal efforts. This national examination system is still the main approach of the Chinese education system today in selecting young talent.

The natural creativity and ingenuity of the Chinese people flourished, with the result that they developed porcelain, gunpowder, the wheelbarrow, the compass, the stirrup, the spinning wheel, and the paper. And yet China never seemed to capitalize on these discoveries, despite the fact that that it is reputed to have the highest gross national products in the world by the seventeenth century. At the time, when Great Britain was laying the groundwork for European industrial revolution, there was a stillness and immobility within China (Malkiel and Taylor, 2008, p. 19). The Celestial Empire saw itself as the world's premier entity in size, population, age and experience, untouchable in its cultural achievements and sense of moral, spiritual, and intellectual superiority. The Chinese lived, they thought, at the center of the universe. The Chinese emperor was the "Son of Heaven." Those who represented him and administered for him, the scholar-bureaucrats, were chosen by the competitive national examination system in their proficiency in Confucian letters and morals. They embodied the highest Chinese culture, its prestige, its wholeness and sublimity. Such cultural triumphalism combined with petty downward tyranny made China a reluctant improver and a bad learner (Landes, 1998, p. 335-336).

The peace and serenity of Confucius's teaching, a powerful centralized government, and a perfected and rigorous civil service examination system in which anyone could participate, no matter how humble his social background created a monolithic society that dampened competition and scientific advancement. Education became viewed as the path to advancement in civil service rather than an instrument for encouraging free inquiry and the consequent development of science and technology. The best and the brightest opted and were selected into government services, and shunned going into commerce. This because in the Confucian ranking the scholar-bureaucrats are at the top, followed by the farmers, the artisans, and, last of all, the despised merchants. In China, the road to social status and riches led to government employment where the term "kowtowing" was coined. By contrast, in Europe commerce and mercantilism opened a unique path to riches, where creativity and daring were the 'sine qua non' of success.

Despite all this, and its rigid bureaucracy and complacency, China was the largest economy in the world at the beginning of the nineteenth century. Its GDP was roughly a third of the world output. Indeed, China's output exceeded that of Western Europe, Japan, the US, and Russia combined. Because of its self-sustained wealth, strong government, and insularity, the country's ruling classes became imbued with a feeling of superiority and a conviction that there was no need to pay attention to what was going on elsewhere. Thus China was totally ignorant of the enormous change occurring in Europe as a result of the industrial revolution (Malkiel and Taylor, 2008, p. 21).

Colonialism and a Century of Humiliation

During the eighteenth century Europe was embracing technology and new production methods. In particularly Great Britain with its rapid increase in production efficiency, needed to expand into overseas markets. In 1792, Britain send an envoy, George McCartney, to see Emperor Qianlong (1711-1799) of the Qing Dynasty (1644-1912) to improve the terms of trade in with China and to open up trading posts in coastal cities. The proposal from the rapidly rising British Empire met with no interest, and the Imperial Qing Court prepared an edict stating that China with it vast resources had no need for any goods that the British could provide. Lord McCartney was dismissed and told to leave China immediately. The Imperial Qing Court gave further orders to all governors not to allow the British to carry out trade or business, aside from the sole approved trading post for Europeans in the southern city of Guangzhou (Malkiel and Taylor, 2008, p. 22-23).

The allowed limited trade with the British of Chinese tea for silver continued and was highly profitable for all those involved. As trade flourished, a substantial amount of the world reserves of silver were flowing to China, and as a consequence the international price of silver increased. For this reason, the British started substituting the expensive silver for opium, a cheaper commodity grown on plantations in India under a British-sanctioned monopoly that determined that the opium produced could only be sold in China. This new trade of tea for opium was extraordinary profitable for the British, but for the Chinese the results were calamitous, with thousands upon thousands of Chinese becoming addicted to the drug.

The Imperial Qing court tried to curtail the trade of opium that was creating a widespread opium dependency and a substantial outflow of goods and money from China to purchase the drug. The British ignored these attempts and encouraged the sale of opium to China because of the high profits involved. Finally in 1838, Emperor Dao Guan (1782-1850) appointed

Lin Zexu (1785-1850) as imperial commissioner to stop the trade of opium that was devastating local life and economy ordered a complete ban on opium. In early 1939, Lin Zexu arrived in Guangzhou and confiscated and burned 2 million pounds of opium on the Humen Beach in a large ceremony. The British traders upset by the heavy financial loss incurred lobbied their government for retaliation, and the First Opium War broke out. The British navy and marines invaded in 1840, under the command of George Elliot (1784-1863), China's southern coast under the pretense of free trade and the protection of British citizens (Jin, 2003, p. 188).

The Chinese with their outdated military technology were defeated by the British, and in 1842 the imperial envoys Qi Ying (1790-1858) and Yilibu (1772-1843) were forced to sign the 'Treaty of Nanking' with the British plenipotentiary Henry Pottinger (1789-1856) on a British warship anchored at Xiaguan, Nanjing. The treaty provided an indemnity of twenty-one million silver dollars, the cession of Hong Kong, and opening of five trading ports – Guangzhou, Xiamen, Fuzhou, Ningbo, and Shanghai. Besides this the treaty also estipulate that the traffic on export and import customs on British goods to be fixed by mutual agreement, and no intervention by the Imperial Court in opium trade. In the following year (1843) the 'General Regulations' and the 'Supplementary Treaty of Hoomun Chai' were signed giving the British the right to conduct trade, renting land and constructing houses at the five ports, and the unilateral most-favored-nation treatment in China. Such unequal treaties severely infringed on the sovereignty and territorial integrity of China (Jin, 2003, p. 189).

To aggravate the Chinese humiliation, the American and the French hearing about the success of the British troops threatened to use military force to obtain similar concessions. Under this treat Qi Ying signed the 'Treaty of Wang-hea' with the American envoy extraordinary and minister plenipotentiary Caleb Cushing (1800-1879), and the 'Treaty of Whampoa' with the French special envoy Marie Melchior Joseph de Lagrene (1800-1862) giving both countries similar privileges as those given to the British. Not even this resounding defeat and humiliation changed the innate feeling of superiority of the Celestial Empire's Court. They saw no reason to change, and innovation was not encouraged (Jin, 2003, p. 188).

The decline and corruption of the Imperial Qing Court governing the country caused people to constantly stage uprisings across the country. The Taiping Rebellion started in 1851 by Hong Xiuquan (1814-1864) inspired by Christianity and the idea of one God as being the only true divine being, created the Heavenly Kingdom of Taiping, and in 1953 captured Nanjing and transformed it in its Capital (Yang, 2003, p. 191-192). Taking advantage of the situation, the British initiated in the spring of 1857 the Second Opium War using at as pretext the seizure in 1856 of a pirate vessel by the Chinese navy that was registered in Hong Kong. The French joined the British using as a pretext the killing of a French Catholic priest. The Anglo-French army marched into Peking in 1860, now on Beijing, burned down the Summer Palace with its large Easter art collection, and the Imperial Qing Court had no other way but to sign another unequal treaty the 'Convention of Peking', with Britain, France, America, and Russia. These treaties were followed by other countries, including Germany and Japan. The treaties established foreign concessions and military bases on Chinese territory (Jin, 2003, p. 189). From then on, the westerns powers spread out their invasions of China in all directions and submitted long humiliation of colonialism.

Westernization movement

After the defeat in the Second Opium War the general believe emerged in China that in order to resist the invasion of the heated foreigners they had to buy foreign warships and cannon as well to learn to make machines and firearms. The Imperial Qing court therefore in the end of the nineteenth century started buying foreign arms, importing machines, recruiting foreign technicians, opening up mines and factories, employing foreign officials to train armed forces and sending students to study abroad to achieve China's rejuvenation. This modernization movement was summarized by Zhan Zhidong (1837-1909) as "Chinese learning as the base, and Western learning for application" (Jin, 2003, p. 192). The modernization depended completely on foreign personnel, machinery, production technology, and raw materials, and the arms and warships produced by them were of very low quality.

There was shortage of funds and the lack of support by basic industries made the Imperial Qing Court realize that the wealth and strength of the Western powers depended not only on advanced weaponry but also on economic power. Thus under the slogan of “striving for wealth” and “strength and prosperity is based on wealth”, they started setting up some civilian industries. At the beginning, most civilian industries were government-supervised and merchant-managed. Among them were the China Merchant Steamship Navigation Company, Kaiping Coal Mines, China Telegraph Office and Shanghai Textile Mill (Jin, 2003, p. 193). Over time, other enterprises were created with co-management by government and merchants and some entirely private industries.

The closing of the nineteenth century saw also the Sino-French (1883-1885) and the Sino-Japanese (1874-1895) Wars. The French captured Vietnam and the Japanese Taiwan, the islands under its jurisdiction, Penghu islands and Liaodong Peninsula. In both cases the Chinese were forced to sign treaties accepting these conquests under humiliating conditions. After the conclusion of the Sino-Japanese Wars in 1995, China felt the treat of being partitioned by colonizing nations (Jin, 2003, p. 194-195).

Some of the missionaries that swarmed into China aroused successive rebellions since they took people’s farmlands, coerced government, monopolized legal practice, and incited scoundrels to ride roughshod over the people. The peasants began their struggles against these aggressions and Yi He Quan became an organization to support such struggles. This organization attracted people that were against foreigners and official corruption. These people were taught to practice boxing. In autumn of 1898, the Catholics in Liyuan village of Guanxian County, Shandong destroyed the Yuquan Temple in order to build a Catholic church. The villagers called in the help of the Yi He Quan to protect the temple. The villagers then set fire to the Hongtaoyuan church and hoisted the flag “support the Qing to expel foreigners” in the Jiangjia village of Guanxian county. This started a rebellion that destroyed churches and attacked

Catholics and drove away missionaries, and so won support of the populace. On the second half of 1899, the Yi He Quan and other similar organizations renamed themselves as Yi He Tuan, and by 1900 had spread all over the Beijing and it could even be found in the northeast, northwest and southwest regions of China. Empress Dowager Ci Xi (1825-1908) had a grudge against Japan and Western countries and supported the Yi He Tuan to destroy the foreigners (Jin, 2003, p. 198). This started what is commonly known as the 'Boxer Rebellion'.

The United States, Britain, France and Germany in April 1900 presented a note to the Imperial Qing Court for it to suppress the Yi He Tuan movement in two months. In May all the foreign envoys in Beijing held a meeting and decided to send an allied force to suppress the Yi He Tuan. The army of over 2 thousand men organized by Britain, the United States, Germany, France, Russia, Japan, Italy and Austria send toward Beijing was defeated by the Yi He Tuan and the Qing Imperial Army. At the same time, allied warships attacked and occupied the Dagukou Fort. This decided Empress Dowager Ci Xi to declare war against foreign powers. As a consequence a large allied army burned and looted Beijing and Empress Dowager Ci Xi gave instructions to negotiate appease the allies. The allies that also had declared war on China – Britain, United States, Germany, France, Japan, Italy, Russia, Austria and those that declared war but did not send troops, like Spain, Belgium and Holland – presented an outline of a peace agreement to the Imperial Qing Court. In 1901 the Imperial Qing Court signed the "International Protocol of 1901' by witch it would pay an indemnity of 450 million that with interest amounted to 980 million teal of silver n, establish a 'legation quarter' where to be stationed, dismantled the fortresses along the way from Dagukou to Beijing, forbid Chinese troops to be stationed twenty li of Tianjin and allow foreign troops to the way from Beijing to Shanghai. This protocol turned China into a semi-colony under joint-jurisdiction of the foreign powers (Jin, 2003, p. 199).

Bourgeois Revolution

From the sixteenth century onward two totally different groups of foreigners successfully entered and influenced China. The first were the missionaries who began arriving in the sixteenth century. These missionaries, specially the Jesuits, in order to demonstrate the rightfulness of their beliefs sought to prove the superiority of their culture by introducing new forms of education and technology. Jesuits introduced and build clocks and other mechanical devices, translated and disseminated Western science, and even supervised the Imperial Bureau of Astronomy and foundries producing astronomical instruments and heavy artillery. The second influx of foreigners arrived in the eighteenth and nineteenth centuries. These came primarily to make money, looked down on the Chinese, did not learn the language, and clustered geographically in enclaves where their governments had obtained extraterritorial rights. While the Chinese resented the humiliation imposed by these foreigners, they were also impressed by their accomplishments and wealth. Shanghai, for example, was little more than a fishing village when the British took it as treaty port in 1842. Within five decades it was the largest commercial city in the Far East and trailed only London and New York as a financial center (Malkiel and Taylor, 2008, p. 25-26).

The bourgeois movement against the Manchu Qing Dynasty was led by Sun Yat-seen (1866-1925), a medical doctor and political activist active in Guangzhou and Macao, that in 1894 established in Honolulu the Xing Zhong Hui (Society for the Revival of China). He proposed to “drive out the Manchu, restore China, and establish a united government”. He staged several uprisings that failed. In 1905 Sun Yat-seen amalgamated revolutionary groups in Tokyo to form the Zhongguo Tong Meng Hui (Chinese Revolutionary League) with the program to “drive out the Manchu’s, restore China, establish a republic and equalize landownership”. He was elected president of the league, set up an executive group with the head of Huang Xing (1874-1916), and created the Min Bao (People’s Journal). In the first issue of the Min Bao Sun Yat-sen put forward the ‘

Principle of Nationalism' , the ' Principle of Democracy' , and the ' Principle of the People Livelihood', which called for the Chinese people to overthrow the Qing rule, and the establishment of an independent republic (Jin, 2003, p. 208).

The Tong Meng Hui organized many armed uprisings. Local revolts gained momentum against taxation, robbery of rice, and the struggle for restoration of the rights of railways and mines held by foreigners. The insurrection finally was successful and defeated the Qing Imperial Troops and captured Wuchang City, and subsequently Hankau and Hanyang were also occupied. The victorious army declared the independence of the Hubei province. Shortly afterwards many other provinces declared independence, and when Sun Yat-sen returned to China from abroad in December 1911, the provincial delegates convened in Nanjing and elected him Provisional President, and declared 1912 as the first year of the republic. On January 1, Sun Yat-sen took the office, and on February 12, the child Emperor Puyi (1906-1967) of the Qing Dynasty was forced to declare abdication, ending the Qing rule that lasted more than 2 thousand years. The revolution that created the Republic of China is called by historians the 'Revolution of Xinhai' because it occurred in the year Xinhai according to the Chinese calendar (Jin, 2003, p. 209-210).

Based on the Tong Meng Hui (Chinese Revolutionary League), Sun Yat-sen, Huang Xing, Song Jiaoren (1882-1813), and others established Kuomintang (the National People's Party) in Beijing. Sun Yat-sen was made director, and Son Jiaoren was put in charge of the management of the party. In the national elections held in February 1913, the Kuomintang won the majority of seats and gained the right to organize the parliament. This upset Yuan Shikai (1859-1916) who had been the head of the Qing Dynasty Cabinet and had held its military power in its hand. He had Son Jiaoren assassinated; raised lots of money from the banks of Britain, France, Germany, Japan, and Russia send his troops to get rid of the revolutionaries. This forced the Kuomintang, under the leadership of Sun Yat-sen, launched the 'Second Revolution with determination to suppress Yuan Shikai. These efforts were fruitless and Yuan Shikai ordered the Kuomintang to dissolve, suspended parliament, the provincial assemblies, abolished the 'Provisional Constitution', and reinstated the imperial system of government with himself as emperor in December 1915 (Jin, 2003, p. 214-215).

The restoration of the monarchy by Yuan Shikai aroused strong opposition and isolated by the majority, including his subordinates, he had to declare the end of the imperial system on March 1916, and he died shortly afterwards in June. After the death of Yuan Shikai, the Beijing government was under control of various Northern Warlords; some backed by foreign powers, and with led to constant transfer of regimes, political chaos, frequent wars, and great suffering of the people (Jin, 2003, p. 215).

In 1922 the Kuomintang was reorganized in a conference in Shanghai, and in 1924 the First National Congress of Kuomintang was held in Guangzhou with the attendance of the Communist Party of China founded in Shanghai in 1921. At this congress, Sun Yat-sen's tree 'People's Principles, namely nationalism, democracy and the peoples livelihood were explained in a new way, and the Central Executive Board of the Kuomintang was elected, which included the Communist Party. In 1926, with the purpose to unify China again, the 'National Army', under the command of Chiang Kai-check (1887-1975), started the 'Northern Expedition' against the 'Northern Warlords'. At around this time the Kuomintang started to disintegrate with the murder of Liao Zhongkai (1877-1925), the right hand of Sun Yat-sen who died of his illness the same year, the purging of party, and other incidents. In 1927 Chiang Kai-check in Shanghai and Wang Jingwei (1883-1944) in Wuhan simultaneously carried out reactionary coup d'états. The purging of the Kuomintang that followed marked the end of its cooperation with the Communist Party in China (Jin, 2003, p. 214-215).

Mao's communism

In April of 1927, the Nanjing National Government was set up with Chiang Kai-check as its Chairman, and in July of the same year, the Wuhan National Government was created with Wang Jingwei as its head. The Ning of Nanjing and the Han from Wuhan confronted each other for legitimacy. In August of the same year, Chang Kai-check having suffered a defeat in

'Northern Expedition', and pressed by the Wuhan Government, was forced to resign and move to Japan. In November of the same year, the Nanjing Government led by Li Zonggren (1891-1969) defeated Tang Shengzhi () who held Wuhan. In January 1928, Chiang Kai-check returned and resumed his post as commander-in-chief of the National Army and launched another 'Northern Expedition' and defeated Zhang Zuolin (1875-1928) who held Beijing. The son of Zhang Zuolin, Zhang Xueliang (1901-2002), after his father's death, under the treat of the Japanese, declared obedience to the Nanjing Government in which he was followed by the warlords of the southwest provinces. Thus the Kuomintang expanded its rule over the whole of China in 1928 (Jin, 2003, p. 224).

The Communist Party did not accept the rule of the Nanjing Government, and in August 1927 Zhou Enlai (1898-1976) and others led the 'Nanchang Uprising' that was defeated. In September the 'Autumn-harvest Uprising with Mao Zedong (1893-1976) had to turn to the countryside due to heavy losses. The army then was reorganized, and the principle of the Communist Party leadership over the army as well as the Soldier Committee was established to administer the army in a democratic way. This new organization was the base for the 'People's Red Army' that developed into a 60 thousand men strong army by 1931 extending their influence over 11 provinces. In November 1931, the First All-China Soviet Congress of the Soviet Chinese Republic was convened in Ruijin, Jaiangxi Province, and it proclaimed the Provisional Central Government of the Chinese Soviet Republic. From then on the Soviet red areas and the Kuomintang controlled white areas coexisted (Jin, 2003, p. 224-225).

The Kuomintang Government carried out a series of economic and cultural reforms within their area. They took back the administrative power over the railways from foreigners, creating state-owned railways, increased the railways and roads, promoted the reform and unification of the currency, facilitated the recovery and development of the agriculture, industry and commerce. As a result, the Chinese economy increased and prospered. By contrast the Chinese Soviet Republic was a state of the workers and peasants' dictatorship with the aim of demolishing all the feudal past, getting rid of the influence of foreign powers in China and unifying China. Mao Zedong was appointed Chairman of the Central Executive Committee, and Zhu De (1886-1976) the Chairman of the Revolutionary Military Committee. The Nanjing Government National Army led by Chiang Kai-shek launched four encirclement attempts of the Red Army on the central base area in Jiangxi without success. In the fifth attempt in October 1934, the Red Army was forced to retreat from Jiangxi, and started the epic 'Long March' that crossed more than ten provinces within two years and covered 25 thousand kilometers from south to north (Jin, 2003, p. 225-226).

The Japanese that had received after the First World War the German concessions in Northeast China wanted more, and in 1931 invaded Manchuria, in 1932 sent troops into Shanghai and obtained further concessions in the city, and in 1937 set out to conquer the whole country. In December 1937 they occupied Nanjing, the capital of China at the time, and committed one of the most appalling atrocities of World War II with the objective to completely crush the Chinese will to fight. This objective was not met, and the invasion motivated the Kuomintang and the Communist Party, that had been engaged in a civil war, to join forces temporally. Due to their better equipment the Japanese troops prevailed, the Chinese army retreated everywhere, and half of the Chinese territory was occupied by the Japanese. The Chinese under both parties started a 'War of Resistance'. With the defeat of the Japanese in September of 1945, Mao Zedong took advantage of the postwar chaos and the widespread resentment against what had become the corrupt and incompetent rule of the Kuomintang Government under Chiang Kai-check and established the People's Republic of China in 1949. Foreigners left China and 2 million followers of the defeated Kuomintang fled to Taiwan. With that, Mao Zedong called the end of the 'Century of Humiliation' of foreign domination (Malkiel and Taylor, 2008, p. 28).

Under Mao Zedong's leadership, China adopted a Soviet-style planned economy with rigid government control, and asked Russian experts to participate in China's development. The adoption of Marxism, a European philosophy, and the invitation of Russian experts to help rebuild the country was a ironic contradiction to the rejection of foreign domination by the

Communist Party of China. The economic progress that followed between 1942 and 1952 was made possible because the country was so devastated by the civil war and the Japanese occupation that the repair of the infrastructure, the distribution of land from landlord to peasants, and the introduction of the Renminbi, a currency based on the traditional centuries-old Yuan, generated considerable economic activity that fueled this progress. After obtaining stability by what was called systematical ‘neatening’ of the country, the Communist Party of China began a series of Five-Year Plans, following the Soviet Marxist model. In the First (1953-1957), all private owned establishments were taken over by the government, the whole economy was under direct control through state-owned enterprises (SOEs), and agriculture-communes that farmers were forced to participate (Malkiel and Taylor, 2008, p. 29-30) .

With the purpose to accelerate the economic development, Mao Zedong created a new system, that he called the ‘Great Leap Forward’. The new system was formalized in the Second Five-Year Plan (1958-1962), and called for the implementation of a variety of unproven and unrealistic techniques to boast agricultural and industrial production. The diversion of unskilled labor to industrial and infrastructure projects, the lack of personal incentives, and the appearance of regional draughts and floods let to sharp drop in grain production lead to a large famine, probably the largest such tragedy in Chinese history, with an estimated death of 20 to 30 million people. At the same time, profound divergence between the Russia led by Nikita Khrushchev (1894-1971) and China under Mao Zedong emerged and the Russian’s withdrew their experts and stopped the shipment of vital parts to the jointly developed factories. This left hundreds of large Chinese project in trouble and strengthened their distrust of foreigners (Malkiel and Taylor, 2008, p. 30-31).

Cultural Revolution

After what became known as the ‘Three Bitter Years’ of the ‘Great Leap Forward’ Mao Zedong was forced to take a more backseat role by the Politburo meeting in 1961. The Communist Party then made a pragmatic readjustment of the economy which lasted from 1961 to 1965. Mao Zedong was not happy with a secondary role, and in 1966 with the backing of the true believers in the purity of the communist revolution retook the leadership, developed the third Five-Year Plan (1966-1970) and started the ‘Cultural Revolution’. These new initiatives of Mao Zedong created ten years of confusion and repression. In the ‘Great Leap Forward’ peasants were told to make steel, in the ‘Cultural Revolution’ skilled workers and the educated youth were sent to work in the fields. Moderate and pragmatic politicians were purged and exiled, among them Deng Xiaoping (1900-1996), who was sent to a tractor in rural Jiangxi Province (Malkiel and Taylor, 2008, p. 32).

The Cultural Revolution was a catastrophic decade for China, the economy was in chaos, its cultural heritage was irreparable damaged, and the enrollment in colleges and universities was suspended and the existing students sent to work in the fields by the Red Guards under Mao Zedong’s sponsorship. With Mao Zedong’s death in September of 1976 the Central Committee Political Bureau of the Communist Party decided to end the ‘Cultural Revolution’, and Deng Xiaoping became the new leader in China (Jin, 2003, p. 247 and 251).

Deng Xiaoping and social-capitalism

Deng Xiaoping demanded in May 1977 the eradication of past errors, in May 1978 the Party School of Central Committee issued the historical article ‘Practice is the sole criterion of testing the truth’, and in December of the same year the Third Plenum of the Eleventh National Party Congress Central Committee started the first step toward overall economic reform and opening-up to the world (Jin, 2003, p. 251). The irony is that the ‘Cultural Revolution’ laid the basis for the success of Deng Xiaoping’s economic reforms. Things had gotten so bad under the radicals, that everyone wanted change. To this day, the generation that lived under Mao Zedong still has strong memories of the hunger they endured.

In the first years of the economic liberalization, entrepreneurship flourished in China and corruption increased. Unemployment rose as inefficient state owned enterprises were forced to adapt to the new competitive environment. Students with their new freedom began protests for political reform. These protests culminated in the demonstration at the Tiananmen Square in Beijing in the summer of 1989. Den Xiaoping believing that an uncontrolled political reform, such as was being conducted in the Soviet Union, would be disastrous for China, decided to repress the demonstration. He was right because a year later the Soviet Union dissolved into many different states. At the same time the Communist Party hard-liners felt that Den Xiaoping was to soft and progressive and in a fierce political in fights forced internal repression and economic retrenchment. Foreign investment stopped, and the economic activity was reduced sharply.

In defiance of the hard-liners, Den Xiaoping in 1992, at the advanced age of 92 year, made the epic 'Southern China Tour' reminding people that the old days were not good, and that the conditions in the future should be much better. He advocated that the pace of the economic reform must be accelerated. During the trip he told people that: "To get rich is glorious!" The people responded with enthusiasm, and the hard-liners in Beijing could not ignore the message. With this trip, Den Xiaoping restarted China on its remarkable transformation to become the second largest economy in the World behind only the US, in GDP measured on purchasing power parity (PPP) basis.

China's opening of the economy incorporate the humiliating lessons of the past dealings with the West, and is being done under strict Chinese terms and conditions. China is determined to maintain its economic and diplomatic independence as it develops its unique model of social-capitalism. This model so far has brought tremendous wealth and opportunity to its people. It is also clear that the economic reforms started by Den Xiaoping, is a unique experiment that still needs further refinement in the quest for China to return to its rightful position as one of the World's leading nations. There are tremendous economic and social challenges and risks to be overcome in the future to reach this goal, particularly in improving the livelihood of the entire population of over 1.3 billion, and not only that of the privileged minority.

The uniqueness of the Chinese social-capitalism economic model developed by Deng Xiaoping lies in the fact that it is not a marked economy, where prices and transactions are solely determined by individual consumers and producers, or a planned economy, where all prices and transactions are under government control. These two extremes are the capitalist and the socialist economic models. China is refining its particular social-capitalist economic model in the middle of these two extremes, with a mixture of state-owned and private-owned enterprises under a complex bureaucratic government structure. Another extraordinary insight by Den Xiaoping clearly stated in his historical 'Southern China Tour' of 1992 with the now anthological phrase: "To get rich is glorious", is the need to promote and support entrepreneurship to fuel economic growth and progress. He echoed in his way Schumpeter's (Schumpeter, 1942) thesis that without entrepreneurs acting as 'agents of creative destruction' there is no real economic growth and progress, and that the pure socials model was doomed because it did not promote entrepreneurship.

China's future challenges

To evaluate the future challenges and risks to China's unprecedented economic growth over the past three decades we have to understand the key factors responsible for this extraordinary accomplishment. The study *China: The Balance Sheet (2006)* conducted by C. Fred Bergsten and his colleagues under the auspice of the Center for Strategic and International Studies and the Institute for International Economics (cited by Malkiel and Taylor, 2008, p. 47) pointed to five factors as key to China's stunning transformation: "The embrace of marked forces, the opening of the economy to trade and inward direct investment, high level of savings and investments, the structural transformation of the labor force, and investment in primary school education." Of these key factors that promoted China's growth, none is really at risk if the Chinese government does not deviate from its present economic policy and keeps up its refinement of its unique social-capitalist model. The real risks to China's future growth are the remaining poverty, the unbalanced and unsustainable growth model, and the bureaucracy and corruption of government officials. These three major risks to China's future will be examined in sequence.

China's remaining poverty may lead to unrest

Since Den Xiaoping started the economic reforms in 1978 more than 600 million Chinese have been lifted out of poverty, an extraordinary achievement. The living conditions of the people have been dramatically improved over these years, with income levels growing steadily at a fast pace. Between 1978 and 2007, urban disposable income per capita increased from 343.4 Yuan to 13,785.8 Yuan, while rural incomes grew from 133.6 Yuan to 4,140.4 Yuan—a more than six-fold increase in both even after adjustment for inflation. The share of food in spending for urban and rural residents fell from 57.5 percent to 36.3 percent and from 67.7 percent to 43.1 percent, respectively, between 1978 and 2007. The emphasis in overall spending has shifted from a focus on basic needs such as food and clothing, to more diverse consumption patterns including housing, travel, education, culture, health, and so on. The rate of extreme poverty in rural areas has fallen from 250 million to 14.79 million people, while public goods and services such as universal primary education, public and basic health care, cultural facilities, etc. have been greatly expanded (United Nations in China, 2008, p. 9).

Unfortunately not all are equally benefiting from this extraordinary progress, and China's income inequality is widening. The per capita income ratio between urban and rural residents dropped from 2.6:1 in 1978 to 1.9:1 in 1985 first, then rose to 3.3:1 in 2007. China's income inequality is now the second highest in Asia, and is reaching levels that pose risks for the sustainability of future development. Such gaps are particularly critical in view of the increasing burden placed on individuals in paying for things such as health care and higher education, implying that income inequalities lead to disparities in access to key public services (United Nations in China, 2008, p. 13-14). The Chinese income inequality, on the other hand is still low compared with Latin America where it has created strong political instabilities in Venezuela, Ecuador and Bolivia, and is threatening other countries.

The rise of inequality is the natural result of the market forces that have generated China's strong growth. Arthur Levis (1954), the first black to win the Nobel Prize in Economics, noted that: "Development must be inegalitarian because it does not start in every part of the economy at the same time." The reason, according to the Levis model (1954, p. 140-141), is the dualism of the labor market. One group, the modern, industrial, capitalist, formal or urban, can capture the full benefits of the economic development; and the other, the subsistence, informal, traditional, agricultural, or rural, will benefit less from this development. This is exactly what happened in China. Prior to Deng Xiaoping's reform of 1978, there was almost no financial reward for education, and in most cases taxi drivers made more money than university professor's. This changed dramatically with the economic reforms. The financial rewards for education rose dramatically, leaving the uneducated, and specially the rural population behind. This trend can obviously be reversed if the whole population has reasonable access to education.

With wider access to education, a greater share of the population gets educated, and inequality will tend to be reduced over time. In practice, this simple solution is very difficult to implement in developing countries and particularly in China with an enormous rural population of 55 percent of its total population of 1.3 billion. In comparison the rural population of Brazil is only 17 percent, and the rural population of the US and Japan are 21 percent (China Economic Review, 2009).

The better access to education and the wage gap between the privileged urban population and the rural population has driven a high volume of rural-urban migration as can be attested by the rapid growth of the Chinese cities. In the pre-reform China a system existed that completely restricted the mobility of the population. This system still exists today and nobody can move from one location to another without receiving permission from the receiving community. This system has avoided the creation of slums around the Chinese cities like the ones that sprung up around most

Latin America cities, but also denied to a large portion of the population the access to upward mobility. This barrier to upward mobility for the underprivileged rural people are the consequence of the usual practice for city officials to give access to migrants from the countryside that are skilled or that have money to buy this access.

Reversing this widening income gaps and so avoids political unrest of the underprivileged, especially from the rural areas, is difficult, and is one of major challenges for the Chinese Government in the coming years. In the last years there has been an increasing grumbling among those left out of the current economic boom, as attested by the frequent headlines about police cracking down on protestors in Chinese villages. These unrest, however are very different from those in Latin America, were anger is directed against free market economies and foreign investments. In China people appear to be fully convinced of Deng Xiaoping's assertion: "To be rich is glorious!" The Chinese seem to want education, and their share of the country's growing wealth generated by the free market economy.

The Chinese government is well aware of the problem, has been promoting the growth of the economy at a very fast pace, with the purpose of spreading wealth to a continuous growing share of the population, and so avoid political unrest. The economic crisis of 2008 and 2009 represents a risk to the Chinese economic growth solution to maintain political stability. The crisis also created the additional risk of unrest in the cities, as consequence of the rising urban unemployment, particularly of the large contingent of students that are leaving the universities and are not finding adequate jobs, this year alone, more than 6 million new graduates are entering the employment market (The Economist, April 11th 2009, p. 40).

China's unbalanced and unsustainable growth

The extraordinary growth of the Chinese economy was based on three economic drivers: Net exports; domestic consumption; and public and private capital investments. In 2007 net export contributed 21.5 percent to GDP growth; domestic consumption contributed 39.7 percent; and gross capital formation 38.8 percent according to the preliminary numbers from

The National Bureau of Statistics of China (People Bank of China, Annual Report 2007, p. 18).The two drivers, exports and capital investments, cannot continue to grow at the historical rates. China's reliance on exports to fuel growth has become unsustainable because of the 2008 and 2009 worldwide economic crisis, particularly with regards to trade imbalance with the US, and the enormous ever-growing-trade deficit accumulated by this country. This trade imbalance will certainly not be politically acceptable in the future by the US Congress; rising protectionist sentiment may lead to legislation restricting China's exports to the US, and thus affect negatively China's future GNP growth. Foreign capital investment in China that, generates GNP growth, will almost certainly also decline in the future. The overinvestment in public and private Chinese enterprises will inevitably leads to diminishing returns of the invested capitals, and the consequent disinterest of domestic and international investors.

The Chinese Government knows that they must change emphasis on the growth drivers of the GDP if they want to continue growing at a similar pace as they did over the last thirty years. They cannot longer rely on exports and foreign capital investments to the same degree as they did in the past. There is also the problem of the huge increase in global current account imbalance, with the consequent emergence of huge surpluses in emerging economies, led above all by China. The debtor countries, particularly the US, have to stabilize their economies. They cannot continue with an indefinitive rise in government debt or profligate private borrowing. If they continue increasing debt this will inevitably led to defaults. Their only alternative is for debtors to earn their way out with a big rise in net exports. This means that China must expand strongly demand for imports relative to supplying exports (Wolf, Financial Times, June 9 2009). Economists believe that such shifts in the growth drivers are both feasible and likely as domestic income rises.

The consumer spending in China today is around 40 percent of GDP versus 70 percent in the US. Even while maintaining a high savings rate, the Chinese can increase substantially their consumption (Malkiel and Taylor, 2008, p. 86). This consumption growth will be pushed by the younger generation, the 'young emperor generation', also called the 'me generation'. This generation born after the market reform started in 1978, and after the 'one child' policy was introduced in 1979, grew up spoiled by their parents, that doted on their single child, assisted enthusiastically by the grandparents. They are self-centered, frequently self-indulgent, and the most avid and savvy consumers. These young yuppies are driving the demand in China, buying everything from expensive watches to imported cars (Degen, 2009, p. 1 and 6).

There is the possibility for China to continue growing the economy for a while longer with substantial investment in infrastructure. There are still large investments required for the development of the western region of the country. The vast investments made in the last 30 years in infrastructure to develop the country are credited with allowing China to grow at a much faster pace than India.

China's bureaucracy and corruption

Corruption of officials that profit personally from public office exists all over the world in some degree or other, and Transparency International (TI), a nonprofit organization uses surveys the world's countries on their perceived level of corruption. Based on the surveys they rank the countries in terms of the degree to which corruption is perceived to exist among public officials and politicians. The scores range from zero for highly corrupt countries to ten for highly clean ones. Of the 180 countries surveyed by TI in 2008, China was rated as 72nd with a score of 3.6, at the same level as Bulgaria, Macedonia, Mexico, Peru, Suriname, Swaziland, and Trinidad and Tobago. While China is not among the worst countries, the low rating reflects the fact that it has a serious problem of corruption. Gregory Chow (2005, p. 4), the noted China Scholar from Princeton University, wrote: "The major factor that will hinder further economic reform in China, in my opinion, is the bureaucratic behavior and corruption of government officials. I can easily predict that further reform is gradual and slow, as in the past, mainly because there is inertia due to vested interests of the bureaucracy and because culture is difficult and slow to change."

China's corruption problems have attracted worldwide attention in the last 30 years, because the economic reforms introduced by Deng Xiaoping in 1978, that generated the extraordinary economic growth and wealth of today's China, became tainted with it. But corruption is not new in China, as attested by the constantly staged uprisings against the corruption of the Imperial Qing Court, and was even encouraged by the British during the 'Century of Humiliation' to promote the extraordinary lucrative opium trade. The economic reforms and the fast growth have created new opportunities and much higher incentives, for illicit connections between wealth and power, according to Johnston (2001, p. 1).

Farhoomand and Woo (2006, p. 6-15) explain that corruption is an extremely complex social behavior, and identify six key forms of corruption in China:

1. **Government or insider control of corporate mechanisms encourages power manipulation within and outside the organizations.** Managers who belong to a government or insider network, and are rewarded with an appointment by the network, may seek ways to line their pockets by using their positions to support the network that appointed them, and for personal gain. This way internal corrupt power networks are formed in a short period of time, mainly in state owned enterprises (SOEs), but also in some private corporations where controls are lax.
2. **Non alignment of the personal interest of managers with that of the shareholders of companies.** Managers advance their personal profits or interests at the expenses of the shareholders of the companies. This form of corruption may occur in many forms, including the 'moral hazard' of western financial managers that generated the 2008 world crisis.
3. **The under-developed legal system leads to ambiguity to what commercial bribery is increasing opportunities for corruption. G**iving potential customer's kickbacks, including cash and luxuries, are a long-standing practice of doing business in

China, and it is difficult to distinguish whether they are bribes or legitimate commissions.

4. **Government officials in order to secure their social status and not to be left out of the money-generating opportunities created by the economic reform build corrupt relationships with businessmen.** Government officials create bureaucratic difficulties to sell facilities to their cronies. Besides taking bribes, extorting money or requesting kickbacks, they are able to profit directly by investing in the stock market or in real estate through personal connections, creating policies, and using privileged information.
5. **Abuse of the 'guanxi' network.** In the Chinese business world 'guanxi' is understood as the network of relationships among various individuals that cooperates together and support one another. The concept is very much one of "You scratch my back, I'll scratch yours." In essence, it means exchanging favors, which are expected to be done regularly and voluntarily. Businessmen in China know that maintaining guanxi with government officials is important, as they have decisive or influential powers to authorize projects, issue trading licenses, approve loans and obtain listing for companies. For this reason, in many cases become synonym for corruption and other wrongdoings like nepotism, bribery and fraud, and may be hard to distinguish from normal relationship marketing.
6. **Lack of basic social values.** The long history corruption of the Imperial Qing Court, the foreign invasion, corruption and exploitation during the 'Century of Humiliation , the disaster of Mao Zedong's 'Great Leap Forward', the repression of the 'Cultural Revolution', and Deng Xiaoping's words "To get rich is glorious" spread out as a popular reform slogan all over the country. All these negative influences and Deng Xiaoping's slogan motivated the people to forget Confucius teachings, and work for self-enrichment instead of working for the common good of the country and its population.

Paradoxically, writes Johnston (2001, p.7), these forms of corruption may also have helped overcome some of the conflicts between state power, represented by its bureaucrats, and the forces promoting the economic reforms, represented by the fast emerging entrepreneurs. Corruption served as a kind of lubricant that motivated government bureaucrats to modify and adapt government policies that would have hindered the economic reforms by giving them extremely attractive opportunities for collusion with the entrepreneurs that promoted China's extraordinary growth.

Corruption may have helped lubricate the economic reforms but over the longer term it has potentially explosive consequences for China's economic and political future, as Johnston (2001, p. 8) and Minxin (2007, p. 1) points out. Illicit practices such as bribery, kickbacks, theft, and misspending of public money cost at least 3 percent of GDP, according to Minxin (2007, p. 1). It is also undermining the legitimacy of the ruling Chinese Communist Party, widening income inequalities between those that are benefiting from the economic reforms and those that are being marginalized, and so fueling social unrest by inciting popular resentment against the highly-visible new rich class of profiting bureaucrats and entrepreneurs.

The problem of defusing the potential negative economic and political consequences of corruption is not unique to China. Unfortunately, corruption is a common problem to all the new emerging economical powers known as BRIC (Brazil, Russia, India and China). The solution for these countries is a systematic and focused effort to promote transparency in the political processes and government bureaucracies. Growing transparency in politics and government is the only way to systematically reduce incentives and opportunities for corruption. The required changes are not easy to promote, because of the many conflicting interests, particularly from those benefiting from the murky situation. Historically the process of promoting transparency has been long and difficult, and frequently motivated by considerable political unrests and conflicts, as is seen in some countries in Eastern Europe, Latin America, Asia and Africa.

China wants to show the world that it is recuperating its past greatness and sophistication, and that the ‘Century of Humiliation”, ‘Three Bitter Years’, and the “Cultural Revolution’ are things of the past. It already has demonstrated its future grandeur by successfully sponsoring the 2008 Olympics in Beijing and will continue by sponsoring the 2010 World Expo in Shanghai. China possesses a government that can carry out whatever it deems necessary to realize its goals.

China’s government is taking determined steps to alleviate environmental degradation, income inequality, and is encouraging the transition from an economy dependent on exports to one where internal consumers play a much larger role. The same determination has been shown in raining in corruption, as demonstrated by the many crackdowns on corrupt government officials. The Chinese know that if they don’t control corruption, the governing Communist Party will lose its control over the country as did in the past the Imperial Qing Court, and the Kuomintang government of Chiang Kai-shek. For these reasons, we believe that the risks exist and are a real treats to China’s future, but can be overcome by the pragmatic and determined Chinese government. The Chinese approach to political and economic development has been, and will probably continue being one of trial and error. Government officials describe this trial and error process as being similar to “crossing a river by feeling the stones underneath.”

Now having covered China’s history, its stunning growth, and the future challenges to this growth, we will review how these factors influence the opportunities and risk of its unique stock market and other investments.

China’s opportunities and risks

The availability of capital resources is fundamental for any economy to sustain real economic growth. Without sufficient capital, enterprises capable of increasing production and productivity will be curtailed, and the economic growth rate will be reduced. The abundance of capital and the speed of the allocation process are essential for the development of the economic production process of a country and its long-run rate of growth. A wellfunctioning stock market plays this critical role, supplying and allocating the needed capital to enterprises, in the required speed for them to grow, and so sustain the real economic growth of the country. The stock market has three fundamental roles: Providing an outlet for individual saving; supplying these savings in form of equity to enterprises to fuel their expansions; and signaling managers the cost of capital, and direction of future investments in their pursuit of the best returns for the invested capital.

China's unique stock market

The Chinese recognized early that Deng Xiaoping's reforms alone could not sustain economic growth. To sustain growth capital investments were required, and a process had to be established to ensure that needed capital could be provided. The government started by permitting the issuance of shares in an attempt to get capital for rural enterprises in 1979, followed in 1982 with the establishment of the Shenzhen Special Economic Zone for shareholding companies, in 1986 with the first security exchange in Shenyang, in 1990 with the Shenzhen and the Shanghai stock exchanges, and in 1991 with the National Electronic Trading System (NETS). In 1992 Deng Xiaoping undertakes his 'Southern China Tour', and affirms that China can try out stock markets. This comment started an intense sequence of activities. In 1993 state-owned enterprises (SOEs) adopt new accounting principles based on International Accounting Standards, and the government initiated a stream of measures to improve transparency and governance of the listed companies and suppress stock manipulation by investors (Walter and Howie, 2006, p. XVII-XXXX).

The China Securities Regulatory Commission (CSRC) is the chief regulatory body that oversees the Chinese stock market. Besides the role of regulating trading, the CSRS helps to determine the quotas given to foreign investors that permit them to buy limited amounts of local Chinese shares (Malkiel and Taylor, 2008, p. 110-111). This because a distinctive feature of the stock market is its confusing literal alphabet soup of share designations that indicate where the shares are traded and who can buy them. If this is not enough there are tradable and non tradable shares. The tradable can be purchased by private investors, and non-tradable controlled by the state or governments agencies. The non-tradable shares were created to ensure that the state retains control of the SOEs. The Chinese stock market is the only stock market in the world in which the majority of the listed companies are SOEs.

The existence of the state-owned shares created two significant risks that have concerned investors. The first is the risk of managers of the SOEs making decisions that interest government, and eventually may go against the best interest of the private shareholders. The second is the risk that the state makes its share in a SOE tradable, and so by increasing suddenly the supply reduces the value of the shares held by private shareholders.

The shares listed and trading in the Chinese stock exchanges are described below in alphabetical order (Malkiel and Taylor, 2008, p. 115-119):

A shares – Available to local investors. This is the predominant class of shares held by the Chinese public, are traded in yuan, and represents approximately 30 percent of the total shares traded in China. The investors in *A shares* in China are predominantly individual rather than institutions. This contrasts with the United States were over 70 percent of stock ownership is held by institutional investors. Originally only Chinese nationals were allowed to own this type of shares, but under the Qualified Foreign Investors Program, initiated in 2002, a limited number of foreign institutional investors are permitted participate, theses permits are for determined quota of *A shares*, and are renewed annually. There are also limits of *A shares* these foreign investors may acquire in a single company, and there are also restrictions on the repatriation of the invested funds;

B shares – Available to foreign investors. These shares are traded in Hong Kong dollars on the Shenzhen exchange, and in U.S. dollars on the Shanghai exchange. The Chinese Government is considering the termination of trading in the *B shares* market because the problem created of the *A and B shares* of the same company typically trade at different prices. The different prices are the consequence of arbitrage trading between the two types of shares not being possible. There is no arbitrage trading because Chinese mainland nationals have no access to *B shares* and foreigners have only a very limited access to *A shares*. Besides this the number of *B shares* is small and consequently practically illiquid;

H shares – Available to Hong Kong investors. The lack of interest of foreign investors in *B shares* let the government to establish in 1993 the H shares. These shares are from Chinese mainland companies that are listed on the Hong Kong Stock Exchange, and are traded in Hong Kong dollars. The Chinese government approval is required for a SOE to list its shares internationally, and in general the companies approved to be listed on the Hong Kong exchange are the showcase companies in China. Because the Chinese residents cannot freely convert yuan to Hong Kong dollars, they are practically excluded from investing in China's largest and most profitable companies. To solve this problem the government gave permission to major companies to list on the mainland, as well as on the international stock exchanges. This created the so-called 'Red Chip' shares in Hong Kong, that are the shares of Hong Kong listed companies that have a Chinese mainland shareholder holding of at least 35 percent of total shares. This arrangement permitted that non-listed Chinese companies purchase dormant Hong Kong listed shell companies, insert mainland assets into the Hong Kong 'Red Chip' shares companies, transform these companies into the holding companies, through a so-called 'reverse takeover'. These holding companies with access to international financing, in turn can be used to acquire more Chinese assets. Gome, the dominant home electric appliance retailer in China, did exactly this to go public and finance its extraordinary growth (Jin, Liao, Guo & Zhu, 2007);

N shares – Chinese Shares traded in the United States. The Chinese government chose some of the best performing Chinese companies to be listed on the New York Stock Exchange, and in the case of high-tech companies on the NASDAQ. The designation *N shares* is a reference to the first initials of these two stock exchanges. These shares are generally traded as American Depository Receipts (ADRs), which means that trade takes place in U.S. dollars, and dividends are also paid in this currency;

L shares – Chinese shares traded on the London Stock Exchange;

T shares – Chinese shares traded on the Tokyo Stock Exchange; and

S shares – Chinese shares traded on the Singapore Stock Exchange.

As mentioned before the same company can be listed with more than one type of shares, and because arbitrage is restricted, these shares may be traded at different prices in the local and international markets.

Efficiency of the Chinese stock market

The term efficiency is used in two contexts; the first is operational or internal efficiency, and the second is the pricing or external efficiency of the stock market. In an operational efficient stock market, investors can obtain information and transaction services as cheaply as possible. On the other hand, pricing efficiency refers to a market where prices at all times fully reflect all available information that is ‘relevant’ to the valuation of shares, that reflects the expected return from holding the shares. The expected return over some holding period is equal to expected cash distribution plus the expected price change, all divided by the initial price.

Fama (1970, p.383-417) classified the pricing efficiency of a stock market into three categories: weak, semi-strong, and strong, based on the hypothesized ‘relevant’ information that prices of the shares should reflect:

A weak efficient market means that the prices of the shares reflect past prices and trading history of the shares; a semi-strong efficient market means that the price of the shares fully reflect all public information, which includes but is not limited to historical prices and trading patterns; and a strong efficient market means that the prices of the shares reflect all information, whether or not it is publicly available.

The classification of the pricing market efficiency carries strong implications for the investment strategy that investors may wish to pursue. These investment strategies may vary from simply buying and holding shares in weak pricing efficient market, where share prices can be predicted based on past historical prices and trading patterns; to a strategy of indexing, which simply seeks to match the performance of some financial index in a strong pricing efficient market, where share prices cannot be predicted on the basis of past historical prices and trading patterns. The fast growth and popularity of exchange-trade funds (ETFs) that trade on a stock exchange follow the indexing investment strategy, is proof that this strategy is profitable, and is preferred by investors that want to avoid the perils of choosing individual shares. The semi-strong pricing efficient market where share prices can be predicted based on past history and trading patterns, but these predictions may be adjusted by some new public information, allows for professionals investors, insiders, and information manipulators to develop strategies to beat the market.

According to Burton and Taylor (2008, p. 132-133) the Chinese *A shares* market often fails the test of weak price efficiency, and so probably is a semi-strong price efficient market where professionals, insiders, and information manipulators can use trading strategies to beat the market. They also found that the H shares market has been a weak efficient market in the past, and that there are indications that he is reasonably strong efficient at present time. Burton and Taylor (2008, p. 147) conclude their evaluation of the Chinese stock market with the following conclusion:

> *Though manipulation and fraud have been rampart in stocks listed on the Chinese markets, there is now a concerned government-backed effort to change that situation. Still, local Chinese investors would do*

well to seek and follow the professional investment advice of local firms with proven track records. Those outside China who wish to invest directly in the booming economy will find that Chinese shares listed on foreign markets are reasonably efficiently priced and can easily be acquired through exchange-trade funds.

They conclude (2008, p. 177-178) by pointing out that China will likely be the fastest growing economy in the world over the next two decades, that before the present financial crisis the Chinese stocks traded in international markets appeared to be moderately priced relative to other equities around the world, and at this moment investors could reasonably anticipate long-run double-digit returns by purchasing them. This assessment made by these authors in July 2007 is probably outdated by the world financial crisis, but the basic facts are still valid.

China's investment strategies

China is the investment place to be, and those that invest now in the fast growing economy will certainly be generously rewarded in the future. To buy individual Chinese stocks the investor must be very familiar with the risk associated with the target company. This is difficult because reliable information on the companies is hard to get by somebody living outside China. For this reason investors should consider investing in broadly diversified funds.

Mutual funds

Burton and Taylor (2008, p. 206) recommend that most investors will be better off participating in Chinese investments through mutual funds. These funds package together a portfolio of stocks and then sell shares that represent interests in that portfolio. An important distinction between then concerns whether they are 'open-end' or 'close-end' funds.

The 'open-end' funds are, as the name implies, open to grow the number of shares. When more money comes in, the manager's use the funds to buy more shares and thus create more shares in the fund. These funds are not traded on stock exchanges, and the purchase and redemption of shares are all handled directly by the sponsoring company. On the other hand, 'closed-end' funds are listed on exchanges and are bought and sold like any other stock. The manager of the fund can trade shares within the fund, but usually, as the name closed implies, does not issue new shares after the initial offering. The shares of 'open-end' funds are priced at net asset value, while the price of 'closed-end' funds depends on what other investors are willing to pay for them. These funds come in all sizes and shapes. Some are geographical mutual funds that include those dedicated solely to China.

Burton and Taylor (2008, p. 208) warn that most mutual funds are created for the benefit of the sponsoring companies and not for the inventors in the fund. The sponsoring companies have made a lot of money from their funds, so much that many have gone public and sold shares in their operations. 'Open-end' mutual fund manager make money by charging their investors in three ways: charging a fee to participate known as a 'load fee', charging annual management and transaction fees, and charging a percentage on the profits of the mutual funds as incentive for managing it. Because researching Chinese stocks poses particular challenges, and making transactions in small Chinese companies is far more difficult than shares of United States companies, the fees for emerging market mutual funds tend to be higher than for United States domestic funds.

Index and exchange-trade funds

Index funds are 'open-end' mutual funds that usually have relative low fees. This because once a financial index is selected for the fund such as the Standard & Poor's Index of 500 Stocks and a portfolio of shares in that index is put together there further management involvement required as far as stock selection goes. Exchange-trade funds are 'closed-end' mutual funds. Their fees are similar to the index funds for the same reasons. These funds like the ordinary mutual funds they cover a range of areas, including single countries like China.

Index investing is a passive, low-cost method of profiting from strong price efficient stock market. In the case of China the *A share* market is yet to behave with strong price efficiency, and behaves more like a semi-strong price market with all the implications explained before. This means that the Chinese A shares market is not yet adequate, and so recommended for index investing. However, the Chinese H shares market in Hong Kong and the N shares market in New York are reasonably strong price efficient, and so are adequate and recommended for index investing, either through mutual funds or exchange-trade funds. Investing in these funds is a reasonable low-cost diversified investment strategy for investor to access the stocks of Chinese companies traded in the world markets.

There are today several indexes of listed stocks in Hong Kong and in New York that can be followed by funds investing in Chinese stocks. These indexes are:

Hang Seng Index. This index is the benchmark of the Hong Kong Stock Exchange Market. The Hang Seng Index is one of the best-known indexes in Asia, and is widely used by Chinese fund managers as their performance benchmark, much the same way as the Standard & Poor's Stock Index is used by U.S. fund managers. The index is based on the stock of forty companies that account for about two thirds of the total market capitalization of all stocks listed on the Hong Kong exchange;

MSCI Hong Kong Index. This index is an index created by Morgan Stanley Capital International Inc. (MSCI) is based on most of the stocks traded on the Hong Kong exchange. This index is the basis for some important U.S. mutual funds.

FISE/Xinhua China 25 Index. This index was created by FTSE/Xinhua Ltd. This firm is a joint venture between FTSE, owned jointly by the Financial Times and the London Stock Exchange, and Xinhua Finance Ltd., a Hong Kong based financial services and media company. The *FISE/Xinhua 25 Index* is the most widely known and used index of the joint venture and is based on the twenty-five largest and most liquid Chinese stocks traded on the Hong Kong exchange. Another index of the joint venture is the *FTSE/Xinhua Hong Kong Index* that serves as benchmark for China's Social Security Fund.

Halter USX China. This index is based on all Chinese stocks traded in the United States, including some very small and dubious ones. This index is the basis of the PGJ exchange-trade fund.

BMI China Index. This index created by Standard & Poor's and Citigroup Global Markets is based on over one hundred Chinese stocks traded on either the U.S. stock exchanges or the Hong Kong Stock Exchange, or both. This index is the basis for the GXC exchange trade fund.

NASDAQ China Index. This index is the equivalent of the *FTSE/Xinhua China 25 Index* based on the mainland Chinese stocks that are traded as ADRs in the United States.

Exchange-trade funds based on these indexes have proven to be low-cost and popular vehicles for investing in Chinese stocks. Burton and Taylor (2008, p. 212) point out that ETFs dedicated to China represent a very attractive investment, and present four China-centered funds that trade on U.S. exchanges (2008, p. 234-240) – EWH ETF (iShares MSCI-Hong Kong Index Fund), FXI ETF (iShares FTSE/Xinhua China 25 Index Exchange Trade Fund), PGJ ETF (Power-Shares Golden Dragon Halter USX China), and GXC ETF (SDPR S&P China ETF).

Funds moderate the risk of buying individual stocks

The main reason that investing in mutual funds is less risky that direct investment in individual stocks, besides the risk diversification these funds provide, the low operational efficiency of the Chinese stock markets, that make it very difficult to get good and reliable information on listed companies. Besides this the accounting statements in China are still relatively opaque and the corporate governance of Chinese companies is not yet up to world standards as can be attested by the research and evaluation conducted by Li (2008, p. 162) that concluded: “The general status of Chinese companies’ top management governance is relatively bad.” Peng (2008, p. 25) goes even further and writhes: “The current situation in Chinese corporate governance has caused the lack of even a basic balance in Chinese enterprise. Without such checks and balances these companies can do whatever they want in the market without any restrictions. The interest not only of related parties but also of their investors, such as minority shareholders, cannot be protected.”

Optimal investment strategy in Chinese stocks

Investing in Chinese stocks is finding the right way of profiting from China’s expected exceptional and unique future growth in the twenty-first century, and at the same time avoiding the risks represented by corruption, murky corporate financial statements, shady corporate governance, and complicated opaque government bureaucracy. With such risks it is not surprising that the Chinese stock markets are extremely volatile. For this reason many believe that investing in China is like buying a lottery ticket. You may win a lot of money but the chances are against you.

The fact that investing in China stocks is risky does not mean that investors cannot profit from it. Every investor knows that profits are in most cases directly correlated to risks. Higher profits come with higher risks and lower profits with lower risks. The only way to handle risks is by careful evaluating their probability and consequences, developing a strategy to manage them, and minimize their negative impact if by chance they occur. Burton and Taylor (2008, p. 282-284) three general rules to minimize the risks of investing in Chinese stocks:

1. Diversify broadly by investing in funds rather than in individual stocks.

2. Invest gradually over time, so to lessen the risk of investing in a speculative peak.
3. Be aware of the costs that funds charge, invest in low cost funds, so to maximize your net investment return.

Exchange-trade funds are attractive because besides being diversified, they have particularly low management fees. The best way to buy shares in these funds is through discount brokers. Every fee or charge that can be saved or keep to a minimum means a higher return on the investment.

Summing up

The unique social-capitalism economic model developed by Deng Xiaoping, particularly the liberalization and promotion of the Chinese entrepreneurs, was extraordinary successful in transforming China from an economical and technological backward nation into one of the world's most dynamic nations. There are challenges and risks for China to continue its unprecedented economic growth of the last three decades. The key factors that promoted China's growth are not at risk if the Chinese government does not deviate from its present economic policy and keeps up refining its unique social-capitalist model. The real risk to China's future are the remaining poverty, the unbalanced and unsustainable growth model, and the bureaucracy and corruption of government officials. China's government is well aware of these risks; is taking determined steps to alleviate environmental degradation, and income inequality; is trying hard to rain in corruption, simplify bureaucracy, and make it more transparent; and is also encouraging the transition from export dependent economy to one where internal consumers play a much larger role. For this reason, we believe that the challenges and risks exists and are real treats to China's future, but can be overcome by pragmatic and determined Chinese government.

The Chinese stock market provides the best opportunity for investors to profit from the transformation of China into the economic miracle of the twenty-first century. Since the strongest and most profitable Chinese companies stocks trade in the international exchanges, foreign mutual funds have broad opportunities to purchase attractive portfolios. For this reason they provide an attractive vehicle for investors to profit from investing in Chinese stocks avoiding the substantial risk of investing in individual stocks. Funds offer broad diversification and easy one stop shopping, in many cases through the internet. In general they sell at price-earnings multiples in line with those on world equity markets, but have considerably better long-run growth prospects. Exchange-trade funds are particularly attractive because of the lower costs and consequently higher returns for investors.

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