IPL instituto politécnico de leiria

working paper

China's challenges to future sustainable economic growth and the implications for the United States

Ronald J. Degen
International School of Management Paris

2009

Glob advantage

Working paper nº 45/2009

globADVANTAGE

Center of Research in International Business & Strategy

INDEA - *Campus 5*

Rua das Olhalvas

Instituto Politécnico de Leiria

2414 - 016 Leiria

PORTUGAL

Tel. (+351) 244 845 051

Fax. (+351) 244 845 059

E-mail: globadvantage@ipleiria.pt

Webpage: www.globadvantage.ipleiria.pt

WORKING PAPER Nº 45/2009

Outubro 2009

Com o apoio da UNISUL Business School

China's challenges to future sustainable economic growth and the implications for the United States

Ronald Jean Degen
Ph.D. Candidate at the International School of Management Paris
Vice Chairman of Masisa Chile

Address:
E-mail: degen@lomasnegras.com
Phone: +55 41 9918 9000
Cabanha Orgânica Lomas Negras Ltda.
Caixa Postal 95
Campo Alegre, SC
89294-000 Brasil

Ronald Jean Degen is in the Ph.D. Program of the International School of Management in Paris, and the Vice Chairman of Masisa in Chile. He was a Professor at the Getúlio Vargas Graduate Business School of São Paulo where he pioneered the introduction of teaching entrepreneurship in 1980 and wrote the first textbook in Portuguese on entrepreneurship published in 1989 by McGraw-Hill. He just published a new textbook on entrepreneurship that was published in 2009 by Pearson Education

China's challenges to future sustainable economic growth and the implications for the United States

ABSTRACT

The 'stunning comeback' of China after almost two centuries is one of the most significant trends affecting Western economies, particularly the United States (US). None of the key drives that have promoted China's growth are really at risk if the Chinese government does not deviate from its present economic policy and keeps up gradual refinement of its unique and effective social-capitalist model. The real risks to China's future growth are remaining poverty, the unbalanced and unsustainable growth model, bureaucracy, and the corruption of government officials. China's government is taking determined steps to solve these challenges. The great challenge for the US is its large accumulated debt with China, and the need for additional borrowing to finance its massive economic stimulus plan. There is little doubt that US will (after solving the financial crisis of 2008 with China's help) continue to be one of the most powerful nations in the world. Nevertheless, it will have to learn to share the world leadership with other countries, particularly with China, Europe and other fast growing developing countries. Gone is the absolute dominance of the US (in terms of ideas and money), and its use of the International Monetary Fund and World Bank as vehicles to spread its influence and market economy model over the developing world.

Keywords: China's economic transformation, China's social-capitalism, China's challenges to economic growth, China's remaining poverty, China's corruption, China's unsustainable growth model, US accumulated debt, inflation and devaluation of the dollar.

China's 'stunning comeback'

The stunning comeback of China, after almost two centuries, is restoring its status as the largest economy of the world during the 21st century. This comeback has had a significant impact on Western economies, particularly that of the United States (US).

At the beginning of the 19th century, China's Celestial Empire was the largest economy in the world, with a Gross Domestic Product (GDP) that exceeded that of Western Europe, Japan, the US, and Russia combined (Malkiel et al., 2008, p. 21). At this time, when Great Britain was laying the groundwork for European industrial revolution, there was a stillness and immobility within China. The Celestial Empire saw itself as the world's premier entity in terms of size, population, age and experience; and as untouchable in its cultural achievements, as well as its moral, spiritual, and intellectual superiority.

China's splendid history

The Chinese developed porcelain, gunpowder, the wheelbarrow, the compass, the stirrup, the spinning wheel and paper. They built huge ships to navigate and trade all over the Pacific and Indian Ocean, almost a century before the Europeans. They may have discovered and mapped America before Columbus (Menzies, 2002) and Leonardo da Vinci's inventions may have been copied from the Chinese (Menzies, 2008): and yet China has never seemed to capitalize on these discoveries.

Possessing a powerful centralized government, based on the peace and serenity of Confucius's teaching, China perfected a rigorous civil service examination system in which anyone could participate, regardless of social background. This created a monolithic society that nevertheless dampened competition and scientific advancement. Education came to be 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 were selected into government services, and shunned commerce. This trend occurred because in the Confucian social ranking places scholar-bureaucrats at the top, followed by the farmers, the artisans, and, last of all, the despised merchants. By contrast, entrepreneurship has been celebrated in Europe as opening a unique path to riches, where irreverence, creativity and daring were the ‘sine qua non’ of success. In this way, China imposed isolation upon itself, and remained uninvolved in the enormous change occurring in Europe as a result of the industrial revolution.

However, this immobility of China did not mean that it did not understand the market economy, or the importance of foreign trade and capitalism. Professor Chow (2007, p. 22) has explained that China has a long history of a market economy, the operation of which was well understood as described by the great historian Sima Qian (ca. 135 or 145 BC to 86 BC) in the Han dynasty (2006 BC to 220 AD). Foreign trade flourished in the Tang dynasty (618 to 907 AD), as evidenced in the ‘Silk Route’, and during the early Ming dynasty (1368 to 1644 AD) extensive overseas exploration and trade stimulated economic development, which permitted enormous construction projects, including the ‘Forbidden City’ in Beijing. China had evidenced a fairly mature form of capitalism since the Song dynasty (960 to 1279 AD) and is attributed with the first generally circulating paper money (dates from Chinese chronology: Jin, 2003, p.255).

China’s ‘Century of Humiliation’

From the second half of the 19th century, China’s economic importance in the world began to decline. Western colonial powers, led by England, took advantage of their superior military technology to exploit and plunder China, forcing it to submit to colonial dominance, in what the Chinese historians call the ‘Century of Humiliation’ (Malkiel et al., 2008, p. 23-28). This exploitation ended with Mao Zedong’s (1893 to 1976) communism in 1949. The adoption of the Soviet Marxist Economic Model by Mao Zedong (promoted by him and his followers as the ‘Great Leap Forward’), was a disaster, culminating in the ‘Three Bitter Years’. These years (from 1958 to 1961) produced the largest known famine in the world, with an estimated death of 20 to 30 million Chinese. After this disaster, and aggravated by the ‘Cultural Revolution’ that produced a decade of confusion and repression (from 1966 to 1976), came unprecedented economic growth, initiated by Deng Xiaoping's (1904 to 1997) economic reforms in 1978 (Malkiel et al., 2008, p. 29-39). This growth, at an astounding average of 10 percent per year over the last 30 years, is only comparable in its global significance to the emergence of the United States as an economic giant during the 19th century (dates from Chinese chronology: Jin, 2003, p.255).

Deng Xiaoping's economic liberalization

When Deng Xiaoping took control of the Communist Party in 1978, he initiated reforms to the planned economy system introduced by Mao Zedong, toward establishing a more market-oriented economy. These initial reforms were partially a continuation of the 'Four Modernizations' (these were science and technology, agriculture, industry and defense) initiated by Premier Zhou Enlai (1898 to 1976) in 1964, and interrupted by the 'Cultural Revolution' in 1966 (Chow, 2006, p. 47). In 1978, China was ready for these reforms: the excesses of the 'Cultural Revolution' made the Communist Party and the government extremely unpopular; in distancing themselves from it they were able to regain the support of the people. The communist party of that time understood the need for change after the disaster of the 'Great Leap Forward' (the planned economy system copied from the Soviet Marxist Economic Model by Mao Zedong), and the economic success of the 'Four Asian Tigers' (Taiwan, Hong Kong, Singapore and South Korea) during this time indicated to them (and to the Chinese people), that market economies were more efficient for generating growth and progress than the planned economies of the Soviet or Eastern Bloc.

In the first years of the economic liberalization, entrepreneurship flourished in China, bringing an increase in corruption. 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, and these protests culminated in the demonstration at the Tiananmen Square in Beijing in the summer of 1989. Den Xiaoping believed that an uncontrolled political reform (such as was being conducted in the Soviet Union), would be disastrous for China, and decided to repress the demonstration (Malkiel et al., 2008, p. 38). His decision was justified a year later, when the Soviet Union dissolved into many different states with a corruption riddled market economy that is yet to provide the expected benefits to its people. At the same time, some members of the Communist Party felt that Den Xiaoping was too soft and progressive, and the resultant fierce political in-fighting forced internal repression and economic retrenchment. For these reasons, foreign investment was withdrawn, and economic activity was reduced.

Den Xiaoping: "to get rich is glorious!"

In 1992, in defiance to traditionalists in the Communist party, Den Xiaoping (at the advanced age of 92) made the epic "Southern China Tour", reminding people that the old days were not good, and that conditions in the future should be much better. He advocated that the pace of the economic reform be accelerated. During the trip he famously told people that "to get rich is glorious!" (Malkiel et al., 2008, p. 38). The population responded with enthusiasm, and his detractors in Beijing could not ignore the message. With this trip, Den Xiaoping restarted China on its remarkable transformation, leading to it becoming the second largest economy in the World (with a GDP only surpassed by the US), when measured on the basis of purchasing power parity (World Bank, 2009). As China has begun to engage in the global economy, there is an awareness of the humiliating lessons of past dealings with the West, and thus this expansion is undertaken according to strict terms and conditions; China is clearly determined to maintain its economic and diplomatic independence as it develops its unique model of social-capitalism.

While this model of social-capitalism has brought tremendous wealth and opportunity to its people, it is also clear that the economic reforms started by Den Xiaoping are a unique experiment that still requires further refinement as China continues to return to its 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 toward improving the livelihood of the entire population of over 1.3 billion, and not only that of the privileged minority.

China's unique social-capitalism

The unique nature of the Chinese economic model of social-capitalism as developed by Deng Xiaoping, lies in the fact that it results in neither a market 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, and this change is occurring in the context of a complex bureaucratic government structure.

Another insight by Den Xiaoping was the need to promote and support entrepreneurship, in order to fuel economic growth and progress (encapsulated in his famous saying "to get rich is glorious!"). His approach echoed Schumpeter's (1942) thesis that without entrepreneurs acting as 'agents of creative destruction', there is no real economic growth and progress; the inference is that the pure socialist model was doomed to failure, because it did not promote entrepreneurship.

China's stunning success

In the past thirty years, China has transformed itself from an economically and technologically 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. The results of this have been dramatic for both China and the United States (US). From 2001 to 2008 the US exports to China rose from United States Dollars (USD) 19.2 billion to

71.5 billion, and imports from China rose from USD 102.3 billion to 337.8 billion (Table 1). The Chinese in 2006 displaced the US as the second trading nation in the world, and are now only behind Germany (WTO, 2009).

Table 1. China's trade with the United States (USD billions)

	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008
US Exports	13.1	16.3	19.2	22.1	28.4	34.7	41.8	55.2	65.2	71.5
% change	-8	24.4	18.3	15.1	28.5	22.2	20.6	32.1	18.1	9.5
US Imports	81.8	100	102.3	125.2	152.4	196.7	243.5	287.8	321.5	337.8
% change	14.9	22.3	2.2	22.4	21.7	29.1	23.8	18.2	11.7	5.1
Total	94.9	116.3	121.5	147.3	180.8	231.4	285.3	343	386.7	409.2
% change	11	22.6	21.4	21.2	22.8	28	23.3	20.2	12.7	5.8
US Balance	-68.7	-83.7	-83	-103.1	-124	-162	-201.6	-232.5	-256.3	-266.3

Note: US exports reported on FOB basis; imports on a general customs value, CIF basis

Sources: US International Trade Commission, US Department of Commerce, and US Census Bureau (copied: http://www.uschina.org/statistics/tradetable.html).

Currently, the Chinese have one of the highest savings rates in the world, around 40 percent of the Gross National Product (GDP) (Figure 1). This contrasts sharply with the US, where the saving rate is close to zero. In other words, on average, the Chinese save more than they spend, while in the United States spending has, on average, overtaken saving. 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, and this has in turn fueled economic growth. For example, 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.

Figure 1. The Share of export, consumption and gross capital ormation in China in 2007

Source: The People's Bank of China (2008). (Copied: http://www.pbc.gov.cn/english/chubanwu/nianbao/2007/en6.pdf)

Some recent statistics illustrate the growing 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%. In 2005, the Chinese per capita income (GDP per head) was only $1,700, compared with the $42,000 of the US. In 2008, the Chinese estimated per capita income rose to $2,900 and the US rose to $46,700. The per capita income gap decreased from twenty-five to one in 2005 to sixteen to one in 2008. This reduction was accomplished in only three years (World Bank, 2009, April).

As previously stated, 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 the basis of purchasing power parity). The IMF (April 2009) reported that in 2008 China was the third largest economy (after the US and Japan) when measured using exchange-rate: with a nominal GDP of USD 4.4 trillion. 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. The Chinese per capita income has been growing at an average annual rate of more than 8% over the last three decades, resulting in a drastic reduction in poverty. However, this rapid growth has been accompanied by rising income inequality.

China's growing influence

China's influence in the world economy remained minimal until the late 1980s. At that time, the economic reforms started in 1978 began to generate a significant and steady growth in investment, consumption and standards of living. China now participates extensively in the world market, and its larger companies, such as Galanz and Haier, have begun to play a major role in the world economy. Galanz, with its aggressive price strategy based on disruptive innovation, has captured 40 percent of the global market, with a 45 percent share in Europe, and more that 70 percent in South America and Africa. Building on this success, Galanz began to compete in the market for air conditioners and rice cookers, and has stated an aim to be the world's largest manufacturer of these items in the near future (Hexter & Woetzel, 2007, p. 194-195). Similarly, the Chinese appliance manufacturer Haier has become a global competitor, based on an aggressive innovation strategy that focuses on three key capabilities: design, manufacture and distribution. The aggressiveness of Haier's innovation plan can be seen in its stated objectives: two successful intellectual patent applications for every working day. Today, Haier is a dominant player in the appliance world market, selling in over 30 countries, with a product line of 96 appliance categories (DiPaola & Li, 2007, p. 3).

China has become the world's second largest consumer of luxury goods, surpassing in the US in 2008 and currently second only to Japan. The demand for luxury items in China is growing at the 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 & Lee, 2008). China now has 170 cities with more than one million inhabitants, compared to the US, who has only ten cities of this size. There are over 400 million Chinese subscribers to wireless phone services, representing 100 million more that the entire population of the US (Malkiel et al., 2008, p. 44).

Reasons for the economic success of China

To evaluate the future challenges and risks to China's unprecedented economic growth over the past three decades, it is important to understand the reasons for the extraordinary success of the economic reforms started by Deng Xiaoping. As mentioned previously, the Communist Party, government and people where ready for the reforms, however this only accounts for the enthusiastic acceptance of the reforms, and not their success. This success was a direct function of the way these reforms were executed: the Chinese leaders were pragmatic in approach, rather than guided by ideology. The phrase "one should not care whether a cat is black or white as long as it catches mice", attributed to Deng Xiaoping, clearly illustrates this pragmatism and lack of ideological constraints.

The government did not have a formal plan or model for the reforms. Policies were adopted, tested, adapted, or even abandoned through experimentation. This process of learning by trial-and-error was described by Deng Xiaoping using an old Chinese proverb, "crossing the river while feeling the rocks". Due to the lack of a formal planning or models, and the use of experimentation, the reforms were implemented gradually in a step-by-step approach. This 'gradualism' in making the necessary reforms from a planned economy to a Chinese style or pragmatic market economy contrasted substantially with the 'shock therapy' approach adopted by the Soviet Union and some Eastern European countries at that time. These countries, after the fall of the Berlin wall in 1989, adopted a US style liberal market economy immediately, without the necessary preparation and transition. The consequence was significant economic disruption and corruption, with many of their citizens disillusioned with the market economy and supportive of a return to the old communist regimes.

Communist Party leadership

The majority of the Chinese people, and most of the government officials who had lived the planned economic disaster of the 'Great Leap Forward' and the 'Cultural Revolution', supported the economic reforms toward a market economy. This support for the reforms helped to maintain the necessary political stability and strengthen the power of the Communist Party leadership under Deng Xiaoping. This acceptance and legitimization of the Communist Party leadership in governing China is also part of the Chinese culture, and is based on the teachings of Confucius, which promote hard work, honesty and trustworthiness in human relations. Chinese culture also has an emphasis on family and social order, with a high value attached to the common good as opposed to individual rights, and a respect for the hierarchically superior scholar-bureaucrats that managed the powerful centralized government of Imperial China for almost two thousand years. These scholar-bureaucrats were selected according to a rigorous examination system, started in the Sui and Tang dynasties (581to 907), and perfected during the Song dynasty (960 to 1126). They were based on Confucian teachings, in which anyone could participate, regardless of social background. This tradition of selecting civil servants based on meritocracy is to some extent replicated in the selection of the members of the Communist Party that governs today's modern China, and this explains the easy acceptance by the Chinese people of those selected as the ruling bureaucracy (dates from Chinese chronology: Jin, 2003, p.255).

China’s growth drives

Bergsten et al. (2006, p. 19), under the auspice of the Center for Strategic and International Studies and the Institute for International Economics, has identified five drives as key to China’s stunning transformation over the past three decades: “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.” They identify that none of these key drives are at risk if the Chinese government does not deviate from its present economic policy and maintains its gradual refinement of its unique and effective social-capitalist model. Nevertheless, they identify that to sustain its economic growth, China will have to manage and overcome two important hurdles: to continue with the reform of its state-owned enterprises, and to improve its financial system for more efficient capital allocation. These hurdles will be evaluated below.

China’s state-owned enterprises

China has already made tangible progress in reforming its state-owned enterprises (created in the 1950’s when Mao Zedong abolished private ownership). Today there are approximately 150 well known state-owned enterprises that report directly to the central government, such as the China National Offshore Oil Corporation (CNOOC) and the State Grid Corporation of China (SGCC). Woetzel (2008) has explained that besides these well known state-owned enterprises, there are thousands more that fall into a grey area; there are the subsidiaries of these 150 that are controlled by the central government, and enterprises owned by provincial and municipal governments, as well as those who are partially privatized, with the state as a majority or influential shareholder (this last group includes companies such as the computer manufacturer Lenovo and the appliance giant Haier). Similarly, the majority shareholder for the automaker Chery is the municipal government of Wuhu.

Since the 1980s, the Chinese government and the Communist Party have followed a policy of separating government functions from business operations. This policy has been applied efficiently using the Chinese approach of gradualism: first to the consumer industry, then to high-tech and heavy manufacturing, and more recently to banking. As a result, government favoritism toward state-owned enterprises is fading. Woetzel (2008) has argued that global leaders (in both public and private sectors), must recognize the importance of taking a nuanced view of China's state-owned enterprises. On closer inspection, many are quite different from the state-owned stereotype of inefficiency, and companies with majority state-ownership (such as Haier) often prove to be operating at a world–class level.

China's financial system

The Chinese financial system arguably requires a more efficient approach to the allocation of capital. Farrell et al. (2006, p. 9-10) have stated that the principal task of a good financial system is to attract savings and channel these to productive investments. In their McKinsey Global Institute Report, they have noted that China's financial system is very efficient in attracting savings from the population, but has considerable room for improvement in its capital allocation, and in its overall efficiency. They have claimed that their suggested reforms could raise the GDP by 13 percent, and would help spread China's new wealth more evenly throughout the country. They have also explained that the caution of China's regulators in shifting funding toward more productive private companies is a result of their fear that this could accelerate layoffs in the less productive state-owned enterprises, and so lead to more social unrest. They have argued against this approach, and suggested that such a shift will stimulate job creation in the stronger areas of China's economy, and that the increased tax revenues from stronger private companies could fund social programs that would help relieve social tension.

This study by Farrell et al. (2006) has also outlined out that, as a consequence of the caution of the Chinese regulators, the state-owned (or partially state-owned) enterprises have absorbed the lion share of the available funding from the financial system. Private companies, having not received sufficient funding from the underdeveloped financial system, and thus have frequently resorted to the large informal lending market for their financial needs: besides being illegal, this market charges very high interest. Due to the 2008 financial crisis, the Chinese regulators have accelerated the necessary reforms, and already in 2009 China has arguably become the largest market in the world for initial public offerings (IPOs), as a source of funding for its private companies.

Risks to China's future growth

The real risks to China's future growth are identified as being the remaining poverty, an unbalanced and unsustainable growth model, and the bureaucratic approaches and corruption of government officials. These three major risks to China's future are examined below.

China's remaining poverty

Since Den Xiaoping began the economic reforms in 1978, more than 600 million Chinese have been lifted out of poverty. The living conditions of the people have been dramatically improved over these years, with income levels growing steadily. 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. This is a more than six-fold increase (for both), even after adjustment for inflation (United Nations, 2008, p. 9).

The share of food 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 on 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 and health. The occurrence 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, and cultural facilities) have been greatly expanded (United Nations, 2008, p. 9).

China's widening income gap

Unfortunately, not all of the population is 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 to 1 in 1978 to 1.9 to 1 in 1985, then rose to 3.3 to 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 terms of paying for services such as healthcare and higher education. These figures suggest that income inequalities have led to disparities in access to key public services in China (United Nations, 2008, p. 13-14). Nevertheless, the Chinese income inequality is still low compared with Latin America (and this inequality has created strong political instabilities in Venezuela, Ecuador and Bolivia, and is threatening other countries).

The rise of inequality is the result of the market forces that have generated China's strong growth. The economist Arthur Levis (1954) has suggested that "development must be inegalitarian because it does not start in every part of the economy at the same time." The reason for this, according to his model (1954, p. 140-141), is the dualism of the labor market. In this model, one group (the modern, industrial, capitalist, formal, or urban approaches) can capture the full benefits of the economic development; and the other (the subsistence, informal, traditional, agricultural, or rural approaches) will benefit less from this development. This polarity has occurred 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 professors. 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.

Reversing this widening income gap would help to prevent the political unrest of the underprivileged, especially from the rural areas. Nevertheless, achieving this is difficult, and remains one of major challenges for the Chinese Government in the coming years. In recent years, there has been increasing unrest among those excluded from the current economic boom, reflected in the frequent police encounters with protestors in Chinese villages and among minorities. The Wall Street Journal stated that the rioting by Uighurs in July 2009, in Xinjiang's capital Urumqi, put the international spotlight back on China's handling of its ethnic minority regions (Restall, 2009, July10). However, it would be a mistake to interpret this as a sign that China's control over its ethnic minorities is loosening. Rather, these incidents show the broader context of rising tensions within Chinese society.

Nevertheless, this unrest remains markedly different from that in Latin America, where anger is directed against free market economies and foreign investments. In China people appear to be fully convinced of Deng Xiaoping's assertion that "to be rich is glorious!", and the Chinese protesters desire education, and their share of the country's growing wealth generated by the free market economy.

China's solution to the income gap is growth

The financial crisis of 2008 represented a challenge to the ability of the Chinese economic growth solution to maintain political stability. This crisis has also created the additional risk of unrest in the cities, as consequence of the rising urban unemployment: particularly amongst the large contingent of students that are leaving the universities and are not finding adequate jobs. This year alone, more than six million new graduates are entering the employment market (The Economist, April 8th 2009, p. 40).

China's unsustainable future 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, according to the preliminary numbers from The National Bureau of Statistics of China (The People's Bank of China, 2007, p. 18), net export contributed 21.5 percent to GDP growth, domestic consumption contributed 39.7 percent, and gross capital formation contributed 38.8 percent (see Figure 1) . These figures indicate that the Chinese Government must change emphasis on the growth drivers of the GDP if they want to continue growing at a similar pace to the previous thirty years.

The huge increase in US current account imbalance, with the consequent emergence of huge surpluses in emerging economies (led above all by China) remains a problem. The US arguably cannot continue with an uncapped rise in government debt or profligate private borrowing, and its only alternative is to earn it way out with a big rise in net exports. This means that China must strongly expand demand for imports, relative to supplying exports (Wolf, 2009). Economists believe that such shifts in the growth drivers are both feasible and likely as domestic income rises.

Consumer spending in China today is around 40 percent of GDP, as opposed to 70 percent in the US. Even while maintaining a high savings rate, Chinese people on average can substantially increase their consumption (Malkiel and Taylor, 2008, p. 86). This consumption growth will be pushed by the younger generation (known collectively as the 'young emperor generation', and also called the 'me generation'). This generation includes those born after the market reform started in 1978, and after the 'one child' policy was introduced in 1979. Typically, they have grown up indulged by their parents, who doted on them as a single child, and this was assisted enthusiastically by the grandparents. They are characterized as self-centered, frequently self-indulgent, and the most avid and savvy consumers. This generation is therefore driving demand in China, buying everything from expensive watches to imported cars (Degen, 2009, June 17, p. 1 and 6).

There also is the possibility for China to continue growing the economy for awhile longer, with room for substantial investment in infrastructure. In particular, there are still large investments required for the development of the western region of the country. The vast investments in infrastructure made in the last thirty years are credited with allowing China to grow at a much faster pace than India.

Corruption in China

The corruption of officials, who profit personally from public office, exists throughout the world to differing degrees, and Transparency International (TI, 2009) is a nonprofit organization that surveys the world's countries to determine their perceived level of corruption. Based on these surveys, they rank 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 very low levels of perceived corruption). 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, 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) has argued that:

> 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.

Farhoomand and Woo (2006, p. 6-15) explain that corruption is an extremely complex social behavior. They identify six key forms of corruption in China: government or insider control of corporate mechanisms (which encourages power manipulation within and outside the organizations), non alignment of the personal interest of managers with that of the shareholders of companies, the under-developed legal system (which leads to ambiguity to as to the definitions of commercial bribery, and thereby increasing opportunities for corruption), government officials (who, 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), abuse of the ‘guanxi’ network, and a lack of basic social values.

The role of corruption in facilitating reforms

Johnston (2001, p.7) has argued that these forms of corruption may have unexpectedly helped to overcome some of the conflicts between state power (as represented by its bureaucrats), and the forces promoting the economic reforms (as represented by the rapidly emerging entrepreneurs). Government bureaucrats, motivated by corrupt purposes, may have modified and adapted government policies that would have otherwise hindered the economic reforms, as these provided them with attractive opportunities for collusion with the entrepreneurs. This, in turn, may have promoted China’s extraordinary growth.

While corruption may have helped lubricate the economic reforms, it has potentially explosive consequences for China’s economic and political future in the long term, as Johnston (2001, p. 8) and Minxin (2007, p. 1) have both argued. Illicit practices, such as bribery, kickbacks, theft, and misspending of public money, have cost at least three percent of GDP. This corruption may also undermine the legitimacy of the ruling Chinese Communist Party, widening inequalities in income 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 Chinese government’s response to corruption

The Chinese Communist Party continues to address corruption exercised by party members and government officials. The Supreme People's Procuratorate (SPP) recently revealed that more than 9,000 officials were found guilty of corruption in the first six months of 2009

(China Daily, 2009, July 17). Those found guilty are severely punished: for example, Li Peiying, the former chief of the Capital Airports Holding Company (CAH), was convicted of taking bribes and participating in embezzlement, and was subsequently executed in Jinan, capital of east China's Shandong province (China Daily, 2009, August 7). Similarly, Chen Tonghai, the former chairman of China's second-largest oil company Sinopec Corp., was convicted of corruption (for taking close to $28 million in bribes), making him one of the most prominent officials from a Chinese state company to be punished for graft. He was given a suspended death sentence (Oster, 2009). The Chinese government is clearly aware 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.

Unfortunately, corruption is a common problem to all countries, and especially in emerging economies. The solution is a systematic and focused effort to promote transparency in the political process and government bureaucracies. This requires changes that are not easy to promote because of the many conflicting interests, particularly from the politicians benefiting from the situation. In 2007, China established the National Bureau of Corruption Prevention (NBCP), who report directly to the State Council, in order to promote transparency in all levels of government to prevent corruption (People's Daily Online, 2007). This bureau aims to monitor the flow of suspicious assets and suspicious corruption activities, by establishing an information-sharing system among prosecuting organs, courts, police authorities, and banks.

China's impact on the world

It is in China's global interests to show the world that it is restoring its past greatness and sophistication, and that the 'Century of Humiliation', 'Three Bitter Years', and the 'Cultural Revolution' are things of the past. Successful sponsoring of the 2008 Olympics in Beijing and the preparations for sponsoring the 2010 World Expo in Shanghai have been useful in this regard, and indicate that China possesses a government that can carry out whatever it deems necessary to realize its goals.

China's far-sighted approach

Zakaria (2009, p. 95) has outlined some reasons for the ability of China's government to take a far-sighted approach in developing its economy. He has argued that China simply doesn't have to respond to the public in carrying out their strategy, and so avoids making foolish and short-sighted popular political to appease voters. He has cited the US government as an example of this short-sighted practice: in order for the US government to obtain approval from congress for the much needed incentive program to restart its economy after the 2009 recession, it had to accept a lot of unnecessary (and potentially foolish) concessions to satisfy the selfish personal interest of Congressmen and Senators, before it was possible to obtain their support for a program that would benefit all Americans.

China's lead over the US in generating electricity from renewable sources is an example of its ability to respond quickly. Bradsher (2009), in his article in the New York Times, has pointed out that as the US is taking its first steps toward mandating that power companies generate more electricity from renewable sources, whereas China has implemented a similar requirement almost two years ago, and is investing billions of dollars to remake itself into a green energy superpower. This year China is on track to overtake the US as the world's largest maker for wind turbines, after doubling wind power capacity in each of the last four years.

China's new role in the world

China is fast moving to build strong relationships in Latin America, filling in the void left by the US, by offering large financing packages to countries that are struggling with slowing economies, plunging commodity prices, and lack of credit. These problems are largely due to the financial crisis, which is attributed US and its excessive neo-liberal economic policies.

Most of these developing countries have suffered in the past under the policies imposed by the International Monetary Fund (IMF) sponsored by US, and have had to privatize their state-owned enterprises, let bad banks fail, maintain government spending under control, and keep interest rates high so to let the market economy work. Noticeably, in response to its own crisis of 2008 the US did exactly the opposite on all four fronts, which has perhaps contributed to mistrust in Latin America for the US.

In the New York Times, Romero and Barrionuevo (2009) have recorded that during the first quarter of 2009, China has been negotiating deals to double a development fund in Venezuela to $12 billion, has lent Ecuador at least $1 billion to build a hydroelectric plant, has provided Argentina with access to more than $10 billion in Chinese currency, and has lent Brazil's national oil company $10 billion. They suggest that these deals largely focus on China's ability to protect its interests in natural resources (such as oil) for years to come. They also stress that China's trade with Latin America has grown quickly this decade, making it the region's second largest trading partner after the United States. But the size and scope of these loans point to a deeper engagement with Latin America, at a time when the influence of the US is eroding. Another significant development in global economics is the agreement to substitute the dollar with the Chinese Yuan in bilateral commerce between China and most Latin America countries. This is evidence of China's push to substitute the Yuan for the dollar as international reserve currency.

The fast growing developing economies of Brazil, Russia, India and China (baptized by Goldman Sachs with the acronym BRIC), are challenging the economic dominance of the US and the European Union (EU). On June 16, 2009, the leaders of the BRIC countries held their first summit in Yekaterinburg, and issued a declaration calling for the establishment of a multipolar world order. Particularly, these countries have requested a greater influence in the IMF and World Bank (WB), challenging the absolute US leadership and the imposition of its excessively liberal market economic model that generated the 2008 financial crisis. The IMF and WB (created during the Second World War) were traditionally dominated by US ideas and money, and have served to spread US influence and business interests over the developing world.

Implications for the US

The great challenge for the US is its large accumulated debt with China, and the need for additional borrowing to finance its massive economic stimulus plan. This problem began in the early 80s, when Americans began to consume more than they produced, and made up the difference by ever-increasing borrowing. At the same time the Chinese were saving almost half of their earnings instead of investing in their economy. With this ever-growing savings, the Chinese government financed consumption in the US to promote China's exports to American consumers.

The massive lending by China reduced interest rates in the US, and encouraged more and more borrowing and spending by the Americans. The excess of low cost financing encouraged Wall Street managers to create increasingly riskier financial innovations, in order to boost profits. The profits and risks of these financial innovations were carried by investors, who were happy to pay extraordinary bonuses for these profits to the Wall Street managers that created these financial innovations (at no risk for themselves). This encouraged Wall Street managers to create even more profitable and increasingly risky financial innovations. This financial merry-go-round for investors and Wall Street managers ended with the burst of the real state bubble that started the 2008 financial crisis.

Figure 2. Leman Brothers: an example of 'moral hazard'

Source: The Economist (2009, July 16) (Copied: http://www.economist.com/businessfinance/displaystory.cfm?story_id=14034875)

The Lehman Brothers bank is a good example of the 'moral hazard' that precipitates the financial crisis. This bank made losses in the two quarters before it collapsed, yet continued to accrue a compensation pot for its employees not far off the levels of 2007 (see Figure 2). Returns to shareholders over the entire cycle worsen when the failures of the bank are included. Lehman paid out $55 billion to employees in the decade up to the end of 2008. Shareholders earned cumulative profits of zero, including the loss of all of their capital when the firm failed (The Economist, 2009, July 16).

The enormous economic stimulus package recently launched by the US government to restart its flailing economy has to be financed by more borrowing from China. However, the extent to which the Chinese are willing to continue to provide finance the US is now uncertain (Wolf, 2009). In the short term, the Chinese government has no choice but to provide finance to the US so that the US can continue importing from China. These Chinese exports to the US are vital to sustain China's economic growth. Nevertheless, due to perceived lack of sustainability of China's economic growth model based on exports to the US, it is likely that the Chinese government will gradually divert most of their resources invested in US treasury bills to develop new markets in Latin America and Africa, and to stimulate growth in consumption in their own economy.

Analyzing US debt and China's accumulation of a vast pool of capital, Zakaria (2009, p. XX) has written in the preface to *The post-American world*:

> The best scenario would be for China and the United States to work together to slowly unwind their mutual suicide pact. China would benefit by having more money to reinvest in its domestic economy. The United States would benefit from being forced to make some hard decisions that will ultimately make it better off. Since at least the 1980s, America has recognized that it could spend with abandon, forever delaying the date of repayment. This has not been good for its foreign or domestic policy. It's made Washington arrogant lazy, and careless. But the free ride is coming to an end.

US risks inflation and devaluation of its currency

The gradual drying up of the supply of low cost financing, previously available to the US from China, is likely to increase interest rates in the US. Shaky auctions of treasury notes in July 2009 reignited concerns as to whether the US government can continue to attract buyers from China and elsewhere (to repay trillions in new debt) without raising interest rates (Rappaport & Areddy, 2009, July 31). If interest rates have to be raised to attract buyers for the US debt, these will certainly discourage the American consumer from borrowing and spending. Additionally, the government may be forced to print money to pay for its economic stimulus package, without being able to finance this.

The consequence of this for the US could be a prolonged recession, inflation and the devaluation of the American dollar. The US will, after resolving the financial crisis of 2008, continue to be one of the most powerful nations in the world, but it will have to learn to share the world leadership with other countries, particularly with Europe, China, and the other BRIC countries. The US, China and the World have to learn how to work more effectively together, to learn to respect different ideas, to avoid excesses (such as those from Wall Street) and extremism (such as North Korea), and to provide a decent living to all people everywhere. This approach is the only way to avoid political unrest, wars and new financial crises.

REFERENCES

Bergstein, C. F., Gill, B., Lardy, N. R., & Mitchell, D. (2007). *China: The balance sheet: What the world needs to know now about the emerging superpower*. New York: Perseus Publishing.

Bradsher, K. (2009, July 2). Green power takes root in the Chinese desert . *The New York Times*. Retrieved June/July 4, 2009, from http://www.nytimes.com/2009/07/03/business/ energy-environment/03renew.html

Canaves, S., & Areddy, J. T. (2009, July 31). Murder bares worker anger over china industrial reform. *The Wall Street Journal*. Retrieved July 31, 2009, from http://online.wsj.com/article/SB124899768509595465.html

China Daily. (2009, July 17). More than 9,000 officials guilty of corruption: SPP. *China Daily*. Retrieved August 8, 2009, from http://www.chinadaily.com.cn/language_tips/cdaudio/2009-07/17/content_8441172.htm

China Daily. (2009, August 7). Former China airport chief executed for corruption. *China Daily*. Retrieved August 8, 2009, from http://www.chinadaily.com.cn/bizchina/2009-08/07/content_8542189.htm

Chow, G. C. (2005, October). *Corruption and China's economic reform in the early 21st century* (CEPS Working Paper No. 116). Retrieved August 7, 2009, from http://scholar.google.com/scholar?q=Corruption+and+China%E2%80%99s+economic+reform+in+the+early+21st+century&hl=en&rls=com.microsoft:en-us&um=1&ie=UTF-8&oi=scholart

Chow, G. C. (2006). *China's economic transformation* (2nd ed.). New York: Wiley.

Degen, R. J. (2009, June 17). *Opportunity for luxury brands in China* (Working paper No. 31). Retrieved August 7, 2009, from http://www.globadvantage.ipleiria.pt/wp-content/uploads/2009/06/working_paper-31_globadvantage.pdf

Degen, R. J. (2009, July 5). *Understanding China's historical development: The profit and the risk that China's stock market provides investors* (Working paper No. 35). Retrieved August 7, 2009, from http://www.globadvantage.ipleiria.pt/wp-content/uploads/2009/07/working_paper-35_globadvantage.pdf

Degen, R. J. (2009, July 29). *China's challenge: The opportunities and risks that China's booming economy provides* (Working paper No. 36). Retrieved August 7, 2009, from http://www.globadvantage.ipleiria.pt/wp-content/uploads/2009/08/working_paper-36_globadvantage.pdf

DiPaola, P., & Li, J. (2008, August 27). From "made in China" to "invented in China". *Fortune China*. Retrieved August 7, 2009, from http://www.bain.com/bainweb/publications/publications_detail.asp?id=26571&menu_url=publications_results.asp

Farhooman, A. F., & Woo, C. H. (2006, June 22). *Business corruption in China* (Case Research Center, The University of Hong Kong). Retrieved August 7, 2009, from http://harvardbusiness.org/product/business-corruption-in-china/an/HKU581-PDF-ENG?Ntt=Business%2520corruption%2520in%2520China

Farrell, D., Lund, S., Rosenfeld, J., Morin, F., & Gupta, N. (2006, May). *Putting China's capital to work: The value of financial reform* (McKinsey Global Institute). Retrieved August 7, 2009, from http://www.mckinsey.com/mgi/reports/pdfs/china_capital/MGI_chinacapital_fullrepofu.pdf

Hexter, J., & Woetzel, J. (2007). *Operation China: From strategy to execution*. Boston: Harvard Business School Press. International Monetary Fund (IMF). (2009, April). *World economic outlook: Crisis and recovery April 2009*. Retrieved August 7, 2009, from http://www.imf.org/external/pubs/ft/weo/2009/01/pdf/text.pdf

Jin, Y. (Ed.). (2003). *The history and civilization of China*. Beijing: Central Party Literature Press.

Johnson, R. A. (2008, March 20). *Corruption: Dare we compare the United States & China?* (Paper presented at the annual meeting of the Western Political Science Association, Manchester Hyatt, San Diego, California). Retrieved August 7, 2009, from http://www.allacademic.com/meta/p_mla_apa_research_citation/2/3/8/3/2/p238323_index.html

Johnston, M. (2001). *Corruption in China: Old ways, new realities, and a troubled future* (Department of Political Science Colgate University, Hamilton, New York). Retrieved August 7, 2009, from http://people.colgate.edu/mjohnston/MJ%20papers%2001/currhist.pdf

Landes, D. S. (1998). *The wealth and poverty of nations: Why some are so rich and some so poor*. New York: Norton.

Landes, D. S. (2006, Spring). Why Europe and the West? Why not China? *Journal of Economic Perspectives, 20*(2), 3-22. Retrieved August 7, 2009, from http://www.atypon-link.com/AEAP/doi/pdf/10.1257/jep.20.2.3

Lewis, A. W. (1954, May 22). Economic development with unlimited supplies of labour. In *Manchester School of Economic and Social Studies* (pp. 139-191). Retrieved from http://www.popline.org/docs/0620/018429.html

Malkiel, B. G., Taylor, P. A., Mei, J., & Yang, R. (2008). *From Wall street to the Great Wall: How investors can profit from China's booming economy*. New York: Norton.

Menzies, G. (2002). *1421: The year China discovered the world*. London: Bantam Press.

Menzies, G. (2008). *1434: The year a magnificent Chinese fleet sailed to Italy and ignited the renaissance*. New York: William Morrow.

Minxin, P. (2007, October). *Corruption threatens China's future* (Carnegie Endowment for International Peace, Policy Brief No. 55). Retrieved August 7, 2009, from http://www.carnegieendowment.org/files/pb55_pei_china_corruption_final.pdf

Morisset, D., & Lee, L. (2008, November 11). *Welcome to the China luxury summit 2008*. Retrieved August 7, 2009, from http://chinaluxurysummit.com/

Oster, S. (2009, July 16). Sinopec ex-chief convicted of graft. *The Wall Street Journal*. Retrieved July 31, 2009, from http://online.wsj.com/article/SB124764264846943917.html

People's Daily Online. (2007, September 13). China establishes national bureau of corruption prevention. *People's Daily Online*. Retrieved August 8, 2009, from http://english.peopledaily.com.cn/90001/90776/90785/6261846.html

Rappaport, L., & Areddy, J. T. (2009, July 31). Bond worry: Will China keep buying? *The Wall Street Journal*. Retrieved August 8, 2009, from http://online.wsj.com/article/ SB124896282178793797.html

Restall, H. (2009, July 10). The Urumqi effect . *The Wall Street Journal*. Retrieved July 31, 2009, from http://online.wsj.com/article/SB124716357455819069.html

Romero, S., & Barrionuevo, A. (2009, April 15). Deals help China expand sway in Latin America. T*he New York Times*. Retrieved August 7, 2009, from http://www.nytimes.com/2009/04/16/world/16chinaloan.html

Schumpeter, J. A. (1942). *Capitalism, socialism and democracy*. New York: Harper & Brothers.

Shih, G. (2009, August 6). Retailers suffered listless sales in July . *The New York Times*. Retrieved August 7, 2009, from http://www.nytimes.com/2009/08/07/business/economy/07shop.html?em

Tejada, C. (2009, July 13). New corruption rules arrive at sensitive time. *The Wall Street Journal*. Retrieved July 31, 2009, from http://blogs.wsj.com/chinajournal/2009/07/13/ new-corruption-rules-arrive-at-sensitive-time/

The Economist. (2009, April 8). Where will all the students go? *The Economist*. Retrieved August 7, 2009, from http://www.economist.com/world/asia/displaystory.cfm?story_id=13446878

The Economist. (2009, July 16). Going overboard: Are investment banks run for employees or shareholders? *The Economist*. Retrieved August 8, 2009, from http://www.economist.com/businessfinance/displaystory.cfm?story_id=14034875

The People's Bank of China. (2008, July 18). *Annual Report 2007*. Retrieved August 7, 2009, from http://www.pbc.gov.cn/english/chubanwu/nianbao/2007.asp

Transparency International (TI). (2008). *2008 corruption perceptions index*. Retrieved August 8, 2009, from http://www.transparency.org/news_room/in_focus/2008/cpi2008/cpi_2008_table

United Nations (UN). (2008, September 25). *China's progress towards the millennium development goals 2008 report* (Published jointly by Ministry of Foreign Affairs of the People's Republic of China and the United Nations System in China). Retrieved from http://www.un.org.cn/public/resource/b0bb7b863d301be218a33ac8094b772a.pdf

Woetzel, J. R. (2008, July). Reassessing China's state-owned enterprises. *McKinsey Quarterly*. Retrieved August 7, 2009, from http://www.mckinseyquarterly.com/ Reassessing_Chinas_state-owned_enterprises_2149

Wolf, M. (2009, June 9). It is in Beijing's interests to lend Geithner a hand . *Financial Times*. Retrieved August 7, 2009, from http://www.ft.com/cms/s/0/ae533fa6-551f-11de-5d4-00144feabdc0.html

World Bank (WB). (2009, April). *World Development Indicators 2009* (The World Bank Data & Statistics). Retrieved August 7, 2009, from http://go.worldbank.org/U0FSM7AQ40

World Trade Organization (WTO). (2008). *International trade statistics*. Retrieved August 7, 2009, from http://www.wto.org/english/res_e/statis_e/its2008_e/its08_toc_e.htm

Zakaria, F. (2009). *The post-American world*. New York: Norton.