A CRITICAL OVERVIEW OF THE EAST ASIAN DEVELOPMENT: THE CASES OF MIRACULOUS EAST ASIAN ECONOMIES AND CHINA

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ABSTRACT

A CRITICAL OVERVIEW OF THE EAST ASIAN DEVELOPMENT: THE CASES OF MIRACULOUS EAST ASIAN ECONOMIES AND CHINA

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East Asia has been one of the most important regions in the global economic system. In this thesis, the East Asian miracle and the success of China's transition are studied by overviewing the literature. The East Asian economies had experienced sustainable rapid growth from the 1960s to the end of 1990s, until the Asian crisis in 1997. China started her transition from the central planning system at the end of the 1970s. Since the transition began, China has grown at rates even higher than developed countries and she is one of the countries which survived the Asian crisis nearly without damage. Comparing these two experiences in East Asia would give an idea on the features of development in this region. The conclusion is that China shares the features of developmental state which is attributed to the miraculous East Asian economies.

Keywords: East Asia, China, economic growth, development

ÖZ

DOĞU ASYA KALKINMASININ ELEŞTİREL İNCELEMESİ: MUCİZEVİ DOĞU ASYA EKONOMİLERİ VE ÇİN

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Doğu Asya küresel ekonomik sistemdeki en önemli bölgelerden biridir. Bu tezde, Doğu Asya mucizesi ve Çin'in geçiş döneminin başarısı literatür taraması biçiminde ele alınmıştır. Doğu Asya ekonomileri, 1960'lardan 1990'ların sonuna kadar, Asya krizine kadar, istikrarlı bir hızlı büyüme süreci yaşadılar. Çin merkezi planlama sisteminden geçiş dönemini 1970'lerin sonunda başlattı. Geçiş başladığından beri, Çin gelişmiş ülkelerden bile daha hızlı büyümektedir ve Asya krizinden neredeyse hiç zarar görmeyen ülkelerden biridir. Doğu Asya'daki bu iki tecrübeyi karşılaştırmak bölgedeki kalkınmanın özellikleri hakkında fikir verecektir. Sonuç, Çin'in Doğu Asya ülkeleri ile ilişkilendirilmiş olan kalkınmacı devlet özelliklerini paylaştığıdır.

Anahtar Kelimeler: Doğu Asya, Çin, ekonomik büyüme, kalkınma

To My Family and Friends

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TABLE OF CONTENTS

LIST OF TABLES

TABLES

LIST OF FIGURES

FIGURES

CHAPTER 1

INTRODUCTION

As a consequence of its economic development, East Asia has been an important region for the international political and economic order since 1960s. The rapid growth led by Japan and followed by the Four Tigers and the newly industrializing economies of Southeast Asia had continued until the emergence of the Asian crisis at the end of the 1990s.[1] The crisis put the East Asian economies in financial difficulties followed by sharp growth declines.

These economies recovered their growth rates in a year; however the interesting point is that there was a country in the region which survived the crisis nearly without damage. This country is China, which was in the middle of her transition from a central planning system to a market-based system when the crisis emerged as in the words of the dominant literature on China. Since the transition began in the late 1970s, China has experienced rapid growth which is higher than not only other transition economies and developing countries, but also developed countries.

The economic success of East Asia, especially in integrating the world economy, has made economies in the region important for the developed countries since they have to follow any change in the balances of global economic system in order to preserve their positions. On the other side, the other developing countries were also interested in the development of the region in order to search for the possibility of their own development by implementing the East Asian model. These interests have given rise to a wide literature on the East Asian miracle and crisis and China's transition with different approaches and interpretations.[2]

[1] Japan is not included in this thesis in order to avoid widening the boundaries of the study.

[2] China is a large country that is more appropriate to describe her as an Asian country; however it is possible to describe her as an East Asian country within the thesis since the most important part of her economic development has taken place in China's eastern coastal areas.

As being in the same region and at the similar stages of development and having common cultural and traditional properties, the miraculous East Asian economies and China are thought to have the same development model. It is evident that making a full comparison of China's and other East Asian countries' development needs a more comprehensive and detailed study than this thesis. On the other hand, it is possible to overview the literature by means of the differences in general features of these economies and their similarities. As it will be seen in Chapter 2, developmental state has been among the most important theories about the East Asian miracle. It is meaningful to search for the features of developmental state in China in order to compare her with the other East Asian economies or have an idea whether China's development fits to the East Asian development model. There are different interpretations of developmental state in the literature, hence it would be useful to give an explanation for this thesis. Developmental state is used in the thesis as a state that intervenes the different areas of the economy effectively in order achieve economic development.

Although it is not its main purpose, this thesis deals with the role of the state in industrialization and economic development by overviewing the current debates on this issue regarding East Asia., especially concerning the developing countries. As it will be indicated in Chapter 2, different theories have different approaches to the role of the state in the economy which is also indicated for the case of East Asia in the thesis. In general, this discussion is about the minimal state which does not go beyond the limits of securing property rights and providing public goods versus the modes of state intervention in the economy exemplified by the developmental states. As mentioned above, this discussion has been wide and is not only related to the East Asian development. In the thesis, different approaches to the role of the states in the region are considered to view the conditions and consequences of the East Asian development from different perspectives in order to complement the comparative study of the East Asian development process with that of China. Hence, the thesis does not aim to discuss whether the state should take a role or not in economic development. This is only to indicate the specific role played by the state in economic development in East Asia.

Chapter 2 is on the East Asian miracle and crisis. Different views on the factors that gave rise to the success and failure of the economies in the region are overviewed. In what aspects the East Asian model is approved and in what aspects it is criticized are explored in this chapter. In Chapter 3, the economic aspect of China's transition is overviewed. After presenting briefly the conditions of the Chinese economy before the transition, the problems of the economy and the reforms that have contributed to both dealing with these problems and achieving a rapid and sustainable growth are explored. There are also different views on China's success. One of these views explains this success by the nature of China's reforms while the other view states that China has been converging to the capitalist economies, especially to the East Asian economies.

Chapter 4 overviews the issues that relate China and her neighbors. This overview includes comparing China and the other East Asian economies briefly as mentioned above. This comparison is useful to have a general idea on the East Asian development. Overviewing the performance of China during and after the Asian crisis contributes to this comparison. It is a discussion whether China has followed the East Asian model or not; however it is evident that China's economic growth and integration to the world economy have had some impacts on other economies of the world, especially on her neighbors. Finally, the literature is overviewed in order to search for the impact of China on the region. This is useful to indicate the competition between these economies and have a sight on the effects of this competition on the future of the region and its development. The impact of China on the other economies in the region is unclear according to most of the authors. It is mentioned that the external position of the East Asian economies does not depend only on China, but mainly their macroeconomic stability and some other factors are important.

After three chapters, the thesis reaches a conclusion. As mentioned before, a comparison of China's and other East Asian countries' development is a complex task. On the other hand, the main similarities and differences of development models of these economies are obvious. The differences mainly stem from their different starting points. As being in a transition which is not completed, China still has a more direct control over the economy when compared to the other East Asian economies. The fact that China's integration to the world economy has not included financial integration yet is the best example of this difference. The different starting points also gave rise to different industry structures and different kinds of government-business relationship.

On the other side, the main common feature of China and the other East Asian countries is that state intervention has played a significant role in the development. This most important feature of the East Asian development model was also preferred by China when she adopted *gradualist strategy* rather than *shock therapy strategy* despite the criticisms. The thesis explores the policy areas that the Chinese and the other East Asian governments have intervened. By moving from this point, the thesis concludes that China is closer to a developmental state rather than a market-oriented economy after the reforms that have been implemented since the end of the 1970s.

CHAPTER 2

THE EAST ASIAN EXPERIENCE

Development of the Third World countries has been an important issue of the international political and economic order by both its economic and social aspects. Development and industrialization has turned out to be used equivalently and the world has focused on the industrialization strategies of the developing countries as they indicated economic success. East Asia has a special place in the issue of development with a rapid growth of three decades followed by a severe crisis and a broad literature in this success and failure story. This chapter aims to draw a picture of the East Asian capitalism in the miracle period and the conditions that brought the end of this period by overviewing the literature. The chapter has two parts. The first part presents a brief overview of the East Asian miracle. The second part that purposes to explore the causes and consequences of the Asian crisis has seven sections which explain the process that brought the crisis, macroeconomic problems of the region prior to the crisis, cronyism, the financial liberalization process in the region, the role of the creditor panic in the crisis and finally the role of the IMF during and after the crisis.

2.1. The East Asian Miracle

The East Asian miracle is one of the biggest stories of twentieth century in Wade's words. This story is about the rapid growth of the newly industrializing countries in the region for nearly three decades that has attracted the attention of both developed and developing countries. In addition to the rapid growth, the World Bank emphasizes in *The East Asian Miracle, Economic Growth and Public Policy* (1993) that macroeconomic stability was also the part of the East Asian miracle.

When the rapid growth in the region and its causes is considered, there are some countries that are remarkable with their performances. The World Bank identifies these High Performing Asian Economies (HPAEs) as Hong Kong, Korea, Singapore, Taiwan (Four Tigers), Indonesia, Malaysia, Thailand (Newly industrializing economies of Southeast Asia) and finally Japan which has been a model for the others. The World Bank (1993) states that Hong Kong, Japan, Korea, Singapore and Taiwan are the real East Asian success stories and the other three, Indonesia, Malaysia and Thailand indicate accelerating growth.

Table 2.1: GDP Growth (Percentage)

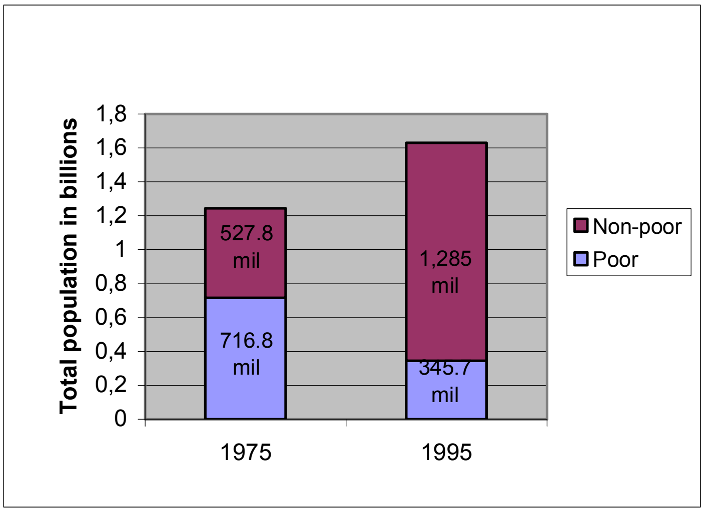
	1980-90	1990-95
Indonesia	6.1	7.6
Philipines	1	2.3
Thailand	7.6	8.4
Malaysia	5.2	8.7
Korea	9.4	7.2
Hong Kong	6.9	5.6
Singapore	6.4	8.7

Source: World Bank (1997a), p.234-235

These eight economies grew more rapidly and more consistently than any other group of economies in the world from 1960 to 1990 (World Bank, 1993: 28). In this period, the annual per capita income growth in these countries averaged 5.5 percent in these countries. The figures in the World Bank (1993) indicate that the growth rates of these eight economies were catching up the industrial economies while the situation of other developing countries was the opposite.

As well as the rapid growth and the macroeconomic stability, the economic growth of the East Asian countries was accompanied by the improvement in social indicators. The World Bank (1993) points out that these economies have been successful in reducing poverty and also increase in life expectancy was higher than in any other region. Six out of ten East Asians lived in absolute poverty in 1975 while this ratio fell to two in ten in 1995 (1998: 2). Consequently, the East Asian countries did not only achieve rapid growth but also the inequality in these economies declined.

How did the East Asian economies achieve rapid growth? The answer of this question has been searched by developed countries since it was significant for their position in the international political and economic order and by developing countries in order to search for the appropriateness of the East Asian development strategies to the development of their own countries.



Source: World Bank (1998), p.3

Figure 2.1: Poverty in East Asia

Table 2.2: Life Expectancy at birth (years)

	1983	1995
Indonesia	54	64
Philipines	64	66
Thailand	63	69
Malaysia	67	71
Korea	67	..
Hong Kong	76	79
Singapore	73	76

Source: World Bank (1985), p.174-175 and World Bank (1997a), p.214-215

2.1.1. Characteristics of the East Asian Growth

The most remarkable aspect of the East Asian development strategy was that the governments intervened effectively by different policy instruments. The government intervention in these countries has been one of the features of the East Asian political economy that gave rise to different views and approaches about their success. A brief overview of these approaches should be necessary in order to compare approaches to the region's development before and after the Asian crisis. The World Bank (1993) identifies three views on the East Asian success and the causes of this success that are the neoclassical view, the revisionist view and the market-friendly view. In this brief description of the East Asian miracle, mainly the market-friendly view of the World Bank will be overviewed and the other views will also be presented briefly.

Before overviewing these three views, there are two features of the East Asian economies that should be mentioned. Firstly, the productivity growth has been treated as the major cause of the East Asian rapid growth. The World Bank (1993) defines the productivity growth as the increase in output that is not caused by the measured increases in total factor productivity of inputs and states that better technology, better organization, specialization and innovations are among the sources of productivity growth. One third of the rapid growth of the East Asian economies is due to the productivity growth and two thirds is due to the physical and human capital accumulation according to World Bank (1993). On the other hand, there have been discussions that are on the opposite of these explanations that the East Asian growth is driven by input growth.

Table 2.3: Exports of East Asian Economies

	Total (million$)		Manufactures (% of total)	
	1980	1995	1980	1995
Indonesia	21,900	45,417	2	53
Philipines	5,740	17502	37	76
Thailand	6,510	56,459	28	73
Malaysia	13,000	74,037	19	65
Korea	17,500	12,058	90	93
Hong Kong	19,800	173,754	92	95
Singapore	19,400	118,268	50	80

Source: World Bank (1997a), p.242-243

Secondly, one of the important features of the East Asian development model was the export-oriented growth strategy and openness of these countries. All the HPAEs except Hong Kong began with import substitution industrialization and passed to export-push strategy (World Bank, 1993: 325). These countries were successful in implementing this strategy that their export performance was high. The World Bank (1993) states that the evidence that the share of the East Asian exports in world trade have risen steadily indicate the significance of exports in the rapid growth of the East Asian countries. It is stated that the HPAEs as a group increased their share in world exports from 8 percent in 1965 to 13 percent in 1980 and 18 percent in 1990 (World Bank, 1993: 37).

2.1.2. Three Views on the East Asian Growth

As an alternative approach to the neoclassical view and the revisionist view, the World Bank proposes the market-friendly view that has accepted the role of the government in the East Asian success in the manner that the interventions were based on getting fundamentals right. The World Bank (1991) states that government interventions are likely to promote growth when they are market-friendly and explains what market-friendly interventions mean. Firstly, the governments should especially prefer to invest in areas that private firms do not invest. In other words, the governments should provide public goods instead of investing in physical production. Secondly, the governments should revise their intervention policies by checking the domestic and international markets. Thirdly, the government interventions should be simple and transparent. In addition to the features of market-friendly interventions, the World Bank(1991) identifies the elements of a market-friendly approach as human development, providing a good climate for enterprises, integration with the global economy and stable macroeconomic foundation.

As having the features mentioned above, market-friendly government interventions do not cause market distortions. The World Bank (1991) points out that most of the countries with severely distorted prices did poorly in output growth and productivity and explains why the East Asian economies were successful despite the government interventions.

1- These governments disciplined their interventions with international and domestic competition which means that interventions were competent, pragmatic and flexible.
2- They did not distort relative prices unduly.
3- Their interventions were more moderate than the interventions of other developing countries. (p.5)

In other words, the government interventions in the East Asian economies served for the good functioning of the markets. The shift from import-substitution development strategy to export oriented growth strategy is seen as one of the evidence of such market-friendly approaches. The East Asian governments refuted *dirigisme* as they refuted *laissez-faire* (The World Bank, 1991: 5).

As a conclusion, the role of the government in East Asia has been a significant part of the discussions on the rapid growth of the region. The World Bank (1993) searches for the relationship between the public policies and the rapid growth and states that the HPAEs, by combinations of policies, maintained macroeconomic stability and accomplished three functions of growth that are accumulation, efficient allocation and rapid technological catch-up. Manageable budget deficits, moderate to low inflation rates, the success of maintaining stable exchange rates, the good management of external debt and dealing with the macroeconomic shocks in the world were the evidence of macroeconomic performance of the East Asian countries. One of the most significant points that the World Bank emphasizes is the practical flexibility of economic objectives rather than insisting on a single policy instrument.

In addition to the government intervention, some of the features of the East Asian countries that contributed to their rapid growth were emphasized by the World Bank (1993) as they had been lacking in other developing countries. The high level of private domestic investment that has been sustained by high levels of domestic financial savings was the core of the physical capital accumulation. Both saving and investment increased markedly in the HPAEs between 1960 and 1990 which is a performance that is higher than any other developing country (World Bank, 1993: 41).[3]

In addition to the high saving and investment rates, agricultural productivity in the region improved although the relative importance of this sector was declining due to the fact that this is normally expected for industrializing countries. Land reforms in Korea and Taiwan, good infrastructure in Japan and heavy investments in rural areas

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[3] On the other hand, the World Bank (1993) emphasizes the fact that saving is the outcome of growth, the reverse of this relation is not correct.

in Indonesia contributed to the productivity growth in agriculture (World Bank, 1993: 32).

Table 2.4: Annual Growth Rates of Sectors in the East Asian Economies (Percentage)

	Agriculture		Industry		Services	
	1980-90	1990-95	1980-90	1990-95	1980-90	1990-95
Indonesia	3.4	2.9	6.9	10.1	7	7.4
Philipines	1	1.6	-0.9	2.2	2.8	2.7
Thailand	4	3.1	9.9	10.8	7.3	7.8
Malaysia	3.8	2.6	7.2	11	4.2	8.6
Korea	2.8	1.3	13.1	7.3	8.2	7.9
Singapore	-6.2	0.5	5.4	9.2	7.2	8.4

Source: World Bank (1997a), p.234-235

There were also distinctive features of the region related to the human capital accumulation. The demographic transition from high to low birth and death rates began earlier than other developing countries in East Asia as the World Bank (1993) states, which also means that the rate of population growth declined. This decline in population growth rate had been higher and faster than the rest of the developing world.

The rapid decline of the population growth rate meant that the number of children at school age decreased that has improved the quality of education. Some of the East Asian countries were advantageous at the beginning since they had better-educated labor force. The World Bank (1993) also emphasizes that there had been a considerable development in closing the gender gap in education since 1965. Hence the improvement of the quality of both education and training in the region turned out to be a factor of rapid growth through human capital accumulation.

Although it is stated that the role of the institutions and cultural aspects of the East Asian countries in the development and economic success is not enough to provide a full explanation of the miracle, the World Bank (1993) mentions this factor which has also been analyzed by many academicians. It is stated that the general model of the Japanese success undoubtedly impressed East Asian policy makers. The relationship between the government and the business that is identified as a cooperation by the Bank was one of the main features of the East Asian industrialization. According to this relationship, the government granted credits and subsidies to the firms if the performance criteria were met which is called directed credit mechanism.

Obviously, the basic performance rule was exporting. Another feature of the export push strategy was that they mainly concentrated on the export of manufactures. The credits and the subsidies of the government were also allocated on a sectoral base according to this selective principle. As it can be understood from the explanations above, the implementation methods of the export-push strategy and its success in the region was approved before the Asian crisis; however the approaches to the policies of these economies have changed since the crisis which will be discussed in the next section.

The World Bank (1993) emphasizes that the cooperation of the government and the business enabled the government to win the support of the business elites and eased to check for performance criteria. It is also stated that the bureaucracy in these countries formulated effective policies and implemented these policies fairly. In addition, the ‘principle of shared growth’ had played a role in winning the support of the society of the East Asian governments. This interpretation of these features of the East Asian political economy is also problematic when compared to the views after the Asian crisis.

The World Bank (1993) mentions that accumulation is not enough for rapid growth, efficient resource allocation is also needed. The Bank states that the HPAEs achieved efficient allocation in three areas that are labor market, capital market and international trade. The efficient resource allocation of the East Asian economies was the evidence that the government intervention served for the good functioning of the markets and the free market principles were not violated. In this sense, the interventions of the East Asian governments were successful in achieving the fundamentals according to the World Bank (1993); however Bank’s view is that the selective interventions did not bring any advantageous consequence to the East Asian industries. The World Bank (1993) state that total factor productivity growth is observed in non-promoted sectors such as textiles. This claim and the whole report of the World Bank is criticized by Lall (1994) as follows.

> Is this then the final word on industrial policy? Should the debate be wound up and neoliberal prescriptions endorsed? Not on the basis of the "miracle" study. The evidence presented, while revealing, is not complete. The definitions of market failure and industrial policy used are biased and partial. The theoretical framework of reviewing the effects of industrial policy is inadequate. Some logical implications of the arguments are not followed through. The policy conclusions on industrial policy are unwarranted and misleading. It fails to tackle, or even acknowledge, some of the critical arguments of the OED (Operations Evaluation Development) report. Despite its many contributions, therefore, the study is pusillanimous and disappointing.[4]

Amsden (1994) criticizes the World Bank's approach to the East Asian success from many aspects however her most important criticism is that *The East Asian Miracle, Economic Growth and Public Policy* is political and ideological. The claim of the Bank that the market-friendly policies were successful in East Asia so that they should be applied to other developing countries is also ideological. Amsden (1994) states that the World Bank (1993) ignores the effect of the institutions of the region and instead, "like Narcissus, all the Bank was capable of doing in its Report was seeing the image of its own "market-friendly" policies in East Asia's fortunes."[5] She points out that there are experts outside the World Bank who have studied East Asia for many years and they were excluded from the report and adds that all information to the reader is filtered. The Bank has the power of acting in this manner since it is a monopoly in its research when it is not in lending (Amsden, 1994: 633). Despite the criticisms, Yanagihara (1994) states that the report was a contribution to the literature by focusing on the role of public policy in the economic development process which has been debated widely.

As discussed above, the East Asian miracle stemmed from the market-conforming policies of the governments according to the World Bank and this approach is also shared by the neoclassical view. On the other hand, the neoclassicals extend this view considerably. According to the World Bank (1993), the neoclassical perspective

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[4] Lall S., *The East Asian Miracle: Does the Bell Toll for Industrial Strategy?*, World Development Vol.22, 1994, p.646

[5] Amsden A.H., *Why Isn't the Whole World Experimenting with the East Asian Model to Develop?: Review of The East Asian Miracle*, World Development, 22, 1994, p.628

has claimed that the East Asian success was due to the fact that these economies were performing in line with the neoclassical principles.

> neo-classical economic principles are alive and well, and working particularly effectively in the East Asian countries. Once public goods are provided for and the most obvious distortions corrected, markets seem to do the job of allocating resources reasonably well, and certainly better than centralized decision-making. That is evident in East Asia, and in most other parts of the developing and industrial world, and is after all the main tenet of neo-classical economics.[6]

As the quotation above indicates, the state intervention was absent in the East Asian economies according to the neoclassical view. This view also claims that the factor markets in the region were competitive and there were no price distortions. The success of the East Asian exports came from trading at international prices and following the comparative advantage principle. This view has ignored the role of the government intervention in the East Asian economies interestingly. The only contribution of the government was providing a stable macroeconomic environment and the principle of self-adjusting markets was not violated according to the neoclassical view.

"Getting prices right" is one of the most important principles of the neoclassical view which means that there are no government interventions in markets so that there are no market distortions and the prices are determined by market mechanism. In general, "getting the basics right" is essential for development objectives and this principle played a role in the development of East Asian countries according to the neoclassical view (World Bank, 1993: 9). On the contrary, the revisionists argue that the opposite of "getting prices right" is true for the development process of the region which will be discussed below.

> Neoliberals are inclined to think that "getting the prices right" is both a necessary and a nearly sufficient condition for maximizing the rate of long term growth ("getting" in the sense of letting prices find their right levels, and "right" in the sense of the relative prices established in freely operating domestic and international markets)…[7]

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[6] Wade R., *East Asia's Economic Success-Conflicting Perspectives, Partial Insights, Shaky Evidence*, World Politics, 1992, p.273 quoted from Riedel

[7] Ibid, p.271

Neoliberal is a subset of neoclassicals as Wade (1992) states. According to the neoliberals, governments provide "public goods" since it is difficult to arrange them by private contracts and should not intervene any more. Although it is clear that most governments has intervened more than providing public goods, the East Asian governments did not go beyond the limits which brought them success according to the neoliberals (Wade, 1992: 272).

> The conclusion is that "unshackling exports" (that most of the East Asian countries had themselves at first shackled) has been *the key to success*. However, it is also clear that successful performance needs several [other] policy strands. Political stability and the rule of law are essential. Economic policies apparently distorted prices less than was the case in most other developing countries; macroeconomic management was relatively successful, all economic sectors, particularly agriculture, were developed, and public investment in social and physical infrastructural facilities was productive. Where these economic conditions did not prevail, as in the Philippines, the economy faltered. Governments thus provided the environment for growth; but private enterprise, despite risk and uncertainty, made the investments necessary and through exposure to international competition became efficient and profitable.[8]

It has been observed that government intervention has been a significant part of developing countries' political economy and whether these interventions are efficient or inefficient is a discussion of different views. The neoclassical view term the role of government interventions in developing countries as *dirigisme*. Lal (1997) states that the *dirigiste* policies have been preferred because the economic theory has no offerings for development; however the neoclassical economics could manage this because it is able to analyze dynamic processes in developing countries since the fundamental method of neoclassical economics is to compare alternative equilibrium states of the economy.

> Moreover, there now exists a quite large number of what may be termed analytical economic histories (the only type of truly dynamic analysis available), of which the various studies of trade and industrialization are most noteable in allowing us to form judgements about the policies likely to foster development. Yet there are people who will not find this suffiecient in their search for the Holy Grail of the 'necessary and sufficient conditions for development'. It should be obvious that economics cannot hope to provide such conditions. What the experience of developing countries show is that, other things equal, the most important advice that economists can currently offer is that of Stewart and Streeten's so-called Price Mechanist: 'Getting the prices right'.[9]

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[8] Wade R., *East Asia's Economic Success-Conflicting Perspectives, Partial Insights, Shaky Evidence*, World Politics, 1992, p.272 quoted from Hughes

[9] Lal D., *The Poverty of 'Development Economics'*, The Institute of Economic Affairs, 1997, p.107

The revisionist view states that the role of the government intervention is crucial in the East Asian miracle and severely criticizes the neoclassical view. This view identifies the East Asian states as 'developmental states'. Wade (1990) defines the developmental state as the centralized state interacting with the private sector by holding the control in order to secure development objectives. On the other hand, the World Bank (1993) defines the developmental state as "the model in which powerful technocratic bureaucracies that are shielded from political pressure devise and implement well-honed interventions." The Bank states that the developmental state theory is not suitable for the East Asian case since this theory ignores the role of the cooperation between the state and the business although Wade's definition includes the cooperation.

Amsden (1989) identifies the East Asian countries as in the group of *late-industrializers* that their development was based on learning rather than innovation. Amsden (1990) states that the problem of *late-industrializers* was not increasing aggregate demand but becoming internationally competitive. Amsden (1989) also identifies two key institutions for understanding the *late-industrializers*. The first one is the reciprocity between big business and the state and the second one is the diversified business group that operates in a wider, less related range of industries. She also mentions that the success of East Asia lay in the ability of the state to discipline the labour and control the business (1990). In this sense, Amsden emphasizes the significance of subsidy system in these countries as the symbol of late-industrialization. The subsidy system is one of the examples of the government intervention in fundamentals or 'getting prices wrong' in Amsden's words. In addition, the East Asian governments successfully intervened to change comparative advantage instead of following it (Amsden, 1989, Wade, 1990, Singh, 1992).

Amsden (1989) concludes that the market-conforming paradigm is the antithesis of what actually happened in *late-industrializers*, hence in the East Asian economies. "The late industrialization is a new paradigm in terms of the operation of the market mechanism and the role of the state and late-industrialization is not merely an extension of advanced-country capitalism that the failure to perceive this fact has created a crisis in Western intellectual understanding." (1990: 31)

There is another revisionist interpretation of the East Asian miracle. Wade (1990) proposes the *governed market theory* as an alternative to theories based on the success of free market principles in the region and indicates the differences between the *governed market theory* and the other theories. The main difference is that the *governed market theory* relates the East Asian success to the capital accumulation whereas the other theories relate to the efficient resource allocation that is based on more freely-functioning and more internationally integrated markets. The governments in the region deliberately got some prices "wrong" in order to control the markets by changing the signals and also used non-price mechanisms to alter the behavior of market agents according to Wade (1990).

Wade (1992) criticizes the neoclassicals that they viewed economic development as a very simple process. Neoclassical view explains the good performance of newly industrializing countries by outward-looking and market-oriented policies, rapid improvements in human resource and institutional development. At this point, Wade (1992) mentions that the neoclassical view ignores the effects of technology. In line with this view, the World Bank (1993) oversimplifies the costs of learning and upgrading industrial technologies although this process is significant for the development of newly industrializing economies according to Lall (1994). The foreign firms are not willing to invest in design, development and innovation as local firms are according to Lall (1994). In addition, the needs of industrial activities to skills and information differ and because of this selective intervention is needed to promote these activities as Lall (1994) mentions.

There are also approaches in the literature that present the significance of the role of the government intervention in the East Asian success by emphasizing the institutional and cultural aspects of East Asia. Jenkins (1991) emphasizes the significance of relative autonomy of the states in East Asia and relates the effectiveness of the government intervention stemming from relative autonomy to the success of these economies, especially by comparing to the experiences of Latin American countries. Perkins (1994) emphasizes the differences among the East Asian countries as well their differences from other developing countries such as the presence of heavy interventions in Korea versus a system which is very close to *laissez-faire* in Hong Kong. Perkins (1994) states that the problem with the approach of the World Bank to East Asia is that the Bank tries to form generalizations that apply to all countries of the region although their differences are mentioned. Kwon (1994) emphasizes the cultural impact on the East Asian development by a historical perspective.

> What most Western economists fail to notice is the fact that the East Asian form of economic development had already made its debut long before the Keynesian revolution and neoclassical counter revolution. The prototype of the East Asian model goes all the way back to Meiji Japan (1868-1912). Unlike British capitalism which prospered under the ideology of individualism and the theory of the invisible hand, Japan took a distinctive path to economic development (Morrisima, 1982). From the very beginning, economic development was an integral part of nation building where strong government was the main driving force of industrialization and modernization. In this sense one cannot completely separate the post-WW II period of industrial policies from to Meiji period. In the aftermath of Tokugawa isolation, the national goal was to build Japan into a strong economy with a strong army to catch up with the West. A similar motivation lay behind the development push in Korea and Taiwan and other East Asian countries…[10]

Any explanation about the East Asian rapid growth constitutes a part of the general perspective on Asian capitalism as the Asian crisis in the late 1990s does. The problem of the literature about East Asia was not the existence of different approaches but the contradictions within some of the approaches before and after the Asian crisis. Referring again to Wade's approach to the East Asian miracle as one of the biggest stories of the twentieth century, the Asian crisis turned out to be another one. What happened to successful economies of East Asia in the late 1990s? Radelet and Sachs (1998b) prove that the miracle was not only a mirage. Hence, what were the causes of the Asian crisis?

2.2. Asian Crisis

Radelet and Sachs (1998a) state that the Asian crisis hit the most rapidly growing economies in the world and prompted the largest bail outs in history. According to Wade and Veneroso (1998), the devaluation of the Thai baht in July 1997 was followed by currency crisis or financial instability in Indonesia, Malaysia, the Philippines, Taiwan, Hong Kong, Korea, Estonia, Russia, Brazil, Australia and New

[10] Kwon J., *The East Asia Challenge to Neoclassical Orthodoxy*, World Development Vol.22, 1994, p.641

Zealand. It is remarkable that the Asian crisis affected countries that are even geographically far away from the region which is an indicator of the significance of the crisis in the international political and economic order.

The damages of the Asian crisis on the newly industrializing countries of East Asia were more considerable than its effects on the other parts of the world. Huge amount of capital outflow, bankruptcy of major firms, increases in interest rates, inflation and unemployment rates were the immediately observed consequences of the crisis in the crisis economies.

The East Asian countries also experienced political instabilities in the following years of the crisis. The economic crisis led to the collapse of several governments within the region such as the opposition coming to power in South Korea, the replacement of the coalition government in Thailand by a more reformist coalition and the shift from an authoritarian rule to an incipient form of democracy in Indonesia because of social unrest (Jayasuriya and Rosser, 2001: 381).

The question that has been asked for many times since the Asian crisis is what happened to East Asian countries that had experienced a miracle period for three decades so that such a serious crisis occurred. It has been obviously difficult to answer this question. Because of this fact, the literature about the causes and consequences of the Asian crisis is broad and there are different approaches about the crisis as there were about the rapid growth of the East Asian economies. The interesting point about these approaches is that they include contradictions in some of the significant features of the East Asian miracle and crisis as mentioned in the previous section. In this section, one of the objectives is to present these contradictions as well as overviewing the crisis.

Within the criticisms of the East Asian economies, ‘crony capitalism’ is a term that has been widely discussed since the Asian crisis. According to this approach, cronyism and corruption in the East Asian economies were among the major causes of the crisis. In this sense, the relationship between the East Asian governments and business has been severely criticized although this relationship was seen as one of the factors of the East Asian success during the miracle period. Crony capitalism approach is one of the contradictions that are mentioned above and will be discussed in one of the following sections.

It is obvious that there had been deficiencies in the Asian economies since the early 1990s up to the crisis. These deficiencies had been mainly financial; however there were also other macroeconomic problems such as the appreciation of exchange rates and the slowdown of export growth. These deficiencies were seen to be the main cause of the crisis at first sight. On the other hand, there is an approach in the literature that East Asia did not have such serious macroeconomic problems that should have caused a severe crisis so that it is more appropriate to claim that the Asian crisis was unanticipated.[11] According to Radelet and Sachs (1998a), even the financial problems were not this much serious although they turned out to be the major cause of the crisis.

The main weakness of the East Asian financial system was the financial liberalization that began in 1980s and accelerated in 1990s. The problem with the liberalization process in the financial sector was that the regulation and supervision of the governments were lacking which was a situation that was on the contrary to the development strategies of these countries. This fact had made the East Asian financial sectors riskier; however the creditors ignored the riskiness of their transactions in these countries since they expected to be bailed out by the governments or the IMF in case of any liquidity problem which is a situation termed as moral hazard problem. The discussions about the modal hazard problem will be presented later. When the crisis emerged, all the creditors were in panic to run from the East Asian banks and other financial institutions and this panic played an important role in deepening the crisis. It is not misleading to state that the main conditions which prepared the Asian crisis has been summarized in this paragraph.

[11] This adjective is used for the crisis in different papers by Radalet and Sachs. It was thought that a crisis without evident signals before its emergence is possible; however the description of the crisis by this adjective is criticized by the thesis jury by mentioning that there is not a distinction as anticipated and unanticipated crises in the literature. It is stated that crises are unanticipated by nature that appropriate measures are taken when there is an expectation of a crisis.

2.2.1. How Did the Crisis Happen?

As mentioned above, there have been some macroeconomic and microeconomic problems of the East Asian countries since the early 1990s. The main weakness of these economies was the rapid expansion of the short-term external debt. The short-term capital inflows that were used to finance current account deficits caused the appreciation of the real exchange rates which in turn put pressure on export growth that began to slow down in the mid-1990s. In addition to the short-term maturity structure of capital inflows, there was a problem with the purpose of bank lending. Bank lending was used for non-tradeables such as real estate, property and equity funds which caused overinvestment in these sectors and tradeables were undermined.

Table 2.5: Short-term Debt and Reserves (millions of US dollars)

	June 1994			June 1997		
	Short-term Debt	Reserves	Short-term Debt/Reserves	Short-term Debt	Reserves	Short-term Debt/Reserves
Korea	35,204	21,685	1.623	70,182	34,070	2.060
Indonesia	18,822	10,915	1.724	34,661	20,336	1.704
Malaysia	8,203	32,608	0.252	16,268	26,588	0.612
Philippines	2,646	6,527	0.405	8,293	9,781	0.848
Thailand	27,151	27,375	0.992	45,567	31,361	1.453
Taiwan	17,023	90,143	0.189	21,966	90,025	0.244

Source: Radelet and Sachs (1998a), Table 14

The rapid expansion of capital inflows meant that domestic bank lending increased considerably and the World Bank (1998) points out the monetary expansion that M2 expanded at an annual rate of nearly 20 percent in 1996 and 1997 in Thailand, Korea, Indonesia, Malaysia and the Philippines. Wade and Veneroso (1998) state that Western and Japanese banks lent heavily to Asian companies by ignoring their own limits on debt-equity ratios. These creditors thought that the fast growth rates of the East Asian economies would continue and exchange rates would remain stable so that they would have continued receiving high returns. The adoption of financial liberalization by the East Asian governments also contributed to this process of lending.

It is important to mention that the weaknesses of the East Asian economies stemmed from the private sector. Governments preserved macroeconomic stability even in the 1990s. They maintained budget surpluses and inflation rates below 10 percent and the ratio of public foreign debt to GDP declined. It seems that the only thing that these governments missed was the necessities of a healthy financial liberalization process. The macroeconomic conditions of the East Asian countries will be presented in the following section.

In the way of the crisis, the problems began initially in Korea and Thailand in the early 1997. Hanbo Steel, Sammi Steel and Kia Motors that were leading chaebols in Korea went bankrupt by following each other. These bankruptcies put pressure on Korean merchant banks because the foreign borrowing of these chaebols was mediated by these banks (Radelet and Sachs, 1998a: 18). In Thailand, property markets were falling and Somprasong Land could not pay its foreign debt on due date. The financial companies that lent heavily to property companies were in difficulty and the Bank of Thailand attempted to aid these companies however its foreign exchange reserves declined sharply (Radelet and Sachs, 1998a: 18). The World Bank (1998) describes the first phases of the crisis as follows.

> Equity investors were the first to withdraw. The stock market peaked for the year in February, and fell by more than 30 percent by year's end. As the yield curve tilted against Thai borrowers, short-term borrowing became increasingly common. Perceptions began to take hold in the market that asset prices were getting too high and the exchange rate was misalligned. In early 1997, total private capital flows started to taper off. In the first half of 1997, bond issues and syndicated loans fell by 30 percent relative to the same period in the previous year. Confidence took a further hit when Somrasong Land defaulted on a Eurobond issue.[12]

The slowdown of the export growth, in addition to the financial problems caused the expectation of devaluation in Thailand. In June 1997, the government ended its support to one of the major finance companies. This decision alarmed the creditors and gave rise to capital outflows. The devaluation of the Thai baht on July 1997 accelerated the capital outflows not only in Thailand but in the whole region. In August 1997, the IMF presented the support package and its conditions to Thailand

[12] World Bank, *East Asia: Road to Recovery*, Washington D.C., 1998, p.9-10

which increased the creditor panic and withdrawals further. Wade (1998) states that the IMF's involvement was like *screaming fire in the theatre* as Sachs called.

Although Thailand was the country having financial problems at the beginning, creditors thought that Thailand's situation signalled that the other countries of the region may also have had such problems. As the World Bank (1998) states, capital outflows from the region turned to be net flow of negative 12 billion dollars. In the table above, net private capital flows in Thailand, Korea, Indonesia, Malaysia and the Philippines are indicated. With this contagion effect the severity of the crisis increased. The devaluation of the New Taiwan dollar, the Hong Kong dollar and the Korean won followed Thai baht devaluation. In December, Korea signed an agreement with the IMF and later the IMF closed most of the banks in Indonesia as a part of the rescue program. The IMF programs during and after the crisis has been criticized severely that will be discussed briefly at the end of this chapter.

Table 2.6: Net Private Capital Flows in East Asia (billion US dollars)

	1996	1997
Private flows (net)	97.1	-11.9
Non-debt flows	18.7	2.1
Foreign direct investment	6.3	6.4
Portfolio equity investment	12.4	-4.3
Debt flows	78.4	-14
Banks	55.7	-26.9
Non-banks	22.7	12.9

Source: World Bank (1998), p.10

The creditors that were Japanese, US and European banks rushed to call in their loans. Major rating agencies downgraded Asian financial institutions which also increased the panic and accelerated withdrawals. These withdrawals caused the sharp rise of interest rates. This environment put pressure on banks that non-performing loans increased and foreign exchange reserves of these banks declined rapidly. Consequently, banks became unable to make new loans. Private firms that were profitable before the crisis could not continue their profits since they could not find credit to run their business or they were not able to use credit because of high interest rates. This was the beginning of the story that this currency and financial crisis spread to the real sector.

The World Bank (1998) states that the capital outflows caused a considerable deterioration in current account balances of the crisis economies and new surpluses were achieved by restricting imports rather than increasing exports. Thailand, Korea, Indonesia and Malaysia experienced a sharp economic contraction in 1998 and other countries in the region fell into recession. Unemployment rose and this caused social protests in some countries as the World Bank (1998) states.

Table 2.7: Annual Growth Rate of GDP

	1996	1997	1998	1999	2000	2001	2002
Indonesia	7.8	4.7	-13.1	0.8	4.8	4.2	4.5
Malaysia	10	7.3	-7.4	5.8	8.5	4.9	6
Philippines	5.8	5.2	-0.6	3.3	3.9	3.1	4.2
Thailand	5.9	-1.4	-10.8	4.2	4.2	3.5	4.5
Korea	6.8	5	-6.7	10.9	8.8	3.9	5.5
Hong Kong	4.5	5	-5.3	3.1	10.5	4	5.5
Singapore	7.5	8.5	0.1	5.9	9.9	5	6

Source: Nixson and Walters (2002), p.99

There are different discussions in the literature about the consequences of the events prior to the crisis in Thailand and other East Asian countries. As Radelet and Sachs (1998b) state, the scenario should have changed if the Thai government floated exchange rates in response to the fall in property prices in the early 1997. Korea was also at fault in maintaining exchange rate peg system. Radelet and Sachs (1998b) also point out that the governments of other countries did not consider the liquidity problems as much as they had to, for instance the state enterprises in Indonesia withdrew their deposits from the banking system which was a considerable amount that increased liquidity problems further. The postponement of large investment projects in Indonesia and Malaysia confused investors. Hence, government policies were also blamed for the process that gave rise to the crisis.

2.2.2. Macroeconomic Problems

The different interpretations of the macroeconomic conditions of the East Asian countries before the crisis are among the contradictions in the literature as mentioned above. During the rapid growth of the newly industrializing economies of East Asia, macroeconomic stability was seen as one of the most significant achievements of the governments since macroeconomic stability is a pre-requisite for well-functioning of markets and development of countries. Macroeconomic performance of the East Asian countries was especially approved by the market-friendly view of the World Bank as presented at the beginning of this chapter. On the other hand, poor macroeconomic conditions and mismanagement of policy makers of these countries turned out to be the cause of the crisis after 1997. There were obviously some problems in these economies, especially in the 1990s; however it is worth to question whether these problems were the direct cause of the Asian crisis.

As mentioned in the previous section, the main problem of the East Asian economies was related to the financial sector that short-term external private debt increased sharply. Financial liberalization policies that began in the 1980s and accelerated in the 1990s had an important role in this increase. As a consequence, the financial problems in the region were at the core of the Asian crisis and gave rise to other problems. Here, the other macroeconomic problems of the region will be explored and the financial liberalization and the problems of this process will be presented as a separate section.

Exchange rate peg was another factor that attracted short-term capital inflows since the creditors thought that exchange rate stability would continue. To defend the pegging system, the governments in the region kept the prices of tradeables relatively fixed and as a consequence, investment on non-tradeables such as construction, real estate and finance boomed which meant that investment quality diminished (Radelet and Sachs, 1999: 4). In Thailand, the increase in property and equity prices put pressure on financial institutions that had lent to these sectors which had a role in the emergence of the crisis as mentioned previously. On the other hand, there were exceptions. Property prices did not change in Indonesia and in Korea investment was concentrated in manufacturing sectors instead of non-tradeables (Radelet and Sachs, 1999: 4).

The overinvestment in non-tradeables and the rise of their prices caused the gradual appreciation of the real exchange rate.[13] Radelet and Sachs (1999) estimate 20 percent overvaluation in Thailand, Indonesia, Malaysia and the Philippines and about 10 percent in Korea. They state that appreciations in a short period signal a balance of payments crisis however they also mention that the appreciations in Latin America were larger. Between 1983 and 1993, just before the Mexican Crisis of 1994, Mexico's exchange rate appreciated in real terms by 40 percent. Hence, the exchange rate appreciations in East Asia were not very high to expect a balance of payment crisis.

It has been stated by many authors that the pegged exchange rates caused a number of other problems in East Asian economies. The immediate consequence was that the appreciation of the real exchange rates caused the slowdown of the export growth which was a significant factor of rapid growth. The depreciation of the yen against the US dollar throughout 1996 also caused the loss of competitiveness of pegged currencies against yen as the World Bank (1998) mentions. During the crisis, the East Asian governments had to use their foreign exchange reserves in order to defend the currency peg and they had to give up the pegging system when they ran out of the reserves. This shift in exchange rate policy had a significant role in financial panic.

As a consequence of the pressure caused by the exchange rate appreciations, export growth began to slow down in mid-1990s and dropped sharply from an average of 24.8 percent in 1995 to 7.2 percent in 1996 and fell further in the early 1997 in Thailand, Korea, Malaysia, Indonesia and the Philippines (Radelet and Sachs, 1998a: 15) There were different causes of the export declines in these countries (1999). In Korea, the slowdown of export earnings was due to the fall of world prices of semiconductors that Korea had overinvested. The situation in Malaysia was also caused by unfavorable world prices. On the other hand, export volumes dropped

[13] Real exchange rate is measured as the ratio of the prices of tradeables to non-tradeables according to Radalet and Sachs (1999).

sharply in Thailand that it was the most hit country by the slowdown of exports according to the World Bank (1998). Radelet and Sachs (1999) point out the causes of the decline in the export performance of the East Asian countries as follows:

1- The real exchange rate appreciations decreased the competitiveness of the firms in the region.
2- Overproduction in some sectors led to the fall in export prices.
3- China and Mexico emerged as competitors, especially in some sectors such as textiles.

As mentioned above, it is obvious that the East Asian countries experienced some macroeconomic difficulties in the 1990s. The purpose of pointing out these difficulties should be searching for their role in the Asian crisis. After the crisis, the immediate thesis of some political scientists and economists was that the crisis was stemmed from the poor macroeconomic stance of these countries that was caused by excessive government intervention. Although there were macroeconomic and microeconomic problems in the region that the mostly underlined ones are presented above, these economies with the following features that are pointed out by Radelet and Sachs (1998a) were generally in line with the macroeconomic principles as also indicated by tables:

1-Budget surpluses

Table 2.8: Government Budget (Percentage of GDP)

	Indonesia	Malaysia	Philippines	Thailand	Korea
1990	0.4	-3	-3,5	4,5	-0,7
1991	0.4	-2	-2,1	4,7	-1,6
1992	-0.4	-0,8	-1,2	2,8	-0,5
1993	0.6	0,2	-1,5	2,1	0,6
1994	0.9	2,3	1,1	1,9	0,3
1995	2,2	0,9	0,5	2,9	0,3
1996	1,2	0,7	0,3	2,3	-0,1

Source:Radelet and Sachs (1998a), Table 8

2- Inflation rates below 10 percent

Table 2.9: Average Annual Inflation (Percentage of GDP)

	1985-95
Indonesia	8.8
Malaysia	3.3
Philippines	9.8
Thailand	5
Korea	6.7
Hong Kong	8.7
Singapore	3.9

Source: World Bank (1997a), p.216-217

3-Prudent levels of sovereign debt

4-High domestic saving and investment rates

Table 2.10: Saving and Investment

	Gross domestic investment (% of GDP)		Gross domestic saving (% of GDP)	
	1980	1995	1980	1995
Indonesia	24	38	37	36
Philipines	29	23	24	15
Thailand	29	43	23	36
Malaysia	30	41	33	37
Korea	32	37	25	36
Hong Kong	35	35	34	33
Singapore	46	33	38	..

Source: World Bank (1997a), p.238-239

5- Growing foreign exchange reserves despite the large current account deficits because of the high capital inflows (see p.19 for foreign exchange reserves)

Table 2.11: Current Account Balance (Percentage of GDP)

	1985-89	1990-96
Korea	4,3	-1,7
Indonesia	-2,5	-2,5
Malaysia	2,4	-5,6
Philippines	-0,5	-3,3
Thailand	-2	-6,8

Source:Radelet and Sachs (1998a), Table 9

6- Good world market conditions that were favorable especially when compared to the Latin American case such as low world interest rates, stable prices of key commodities and good trade relations with the US

After overviewing these features of the East Asian economies, it is hard to suggest that the Asian crisis was caused by the macroeconomic weaknesses that rose especially in the few years before the crisis. The macroeconomic problems of the East Asian countries other than the ones related to the financial sector were not serious enough to cause the severe Asian crisis; it was possible to correct them by some regulations of the governments and the other macroeconomic indicators were not signaling a risk as presented above. It may be stated that these economies were generally in good macroeconomic conditions. The creditors should have not continued lending to the region if they thought the reverse although they expected to be bailed out. On the contrary, the creditors thought that the rapid growth of the economies in the region would have continued so that they would have continued yielding high returns.

2.2.3. Crony Capitalism

As it was described in the East Asian Miracle part, the relationship between the governments and business was one of the main features of the region's development. This relationship did not mean that firms enjoyed favored conditions without any responsibilities. The government controlled and supervised firms and performance criteria for directed credit eased these controls. The discipline of the government on business was very strong that the Korean firms could not even criticize the government openly according to Amsden (1990). One of the main features of the industrial policy was that the government decided which sectors and firms should have been promoted that is called *picking the winners*.

According to Wade (1998), direct lending of the East Asian governments to particular sectors was part of a system that he termed as the *bank-based system*. In addition to directed credit, there were close relations between the bankers and corporate managers in this system. In the *bank-based system*, transactions were based on personal relations rather than market principles. The strict controls on the movement of financial capital in and out of the countries were also another significant part of this system. These features of the East Asian economies indicated that the governments intervened effectively and intervention had an important role in the rapid growth. Li (2000) characterizes the East Asian political economy with the features that are mentioned above as *relation-based governance*.

During the miracle period of the East Asian economies the *relation-based* characteristics of these countries was approved as being an important factor of rapid growth by many authors and the World Bank as it was presented in the first section. On the other hand, the government-business relations and the *bank-based system* has been criticized severely since the Asian crisis and the East Asian experience has been identified as "crony capitalism". The term cronyism that has been claimed to be dangerous for development is related to the concepts of family and personal relations, bribery and corruption, patron-client relations and collusion according to Kang (2002). Hence, cronyism means the presence of non-market relations which is not desirable.

As it is undesirable for the health of the market, it has been claimed that crony capitalism had a significant role in the Asian crisis. Many political scientists and economists has claimed that the Asian crisis was caused by the excessive intervention of the governments that gave rise to rent-seeking activities. They conclude that the weaknesses of the East Asian economies stemmed from the investment decisions which were made on political criteria rather than economic criteria (Jayasuriya and Rosser, 2001: 384). The conclusion of Hughes (1999) summarizes the crony capitalism perspective.

> Once *dirigiste* policies entrenched crony capitalists in East Asian economies, liberal reforms become increasingly difficult to initiate and carry through. Efficient corporate governance, transparency in government-business relations, and competition policy cannot be achieved until the *dirigiste* policies, and the institutional structures to which they have given rise, are changed. This will entail strengthening commercial law and accounting standards, dismantling protectionist policies and offsets to protection through export incentives, radically reforming fiscal and financial polices and above all, ending industry policies that 'pick winners'. The Boards of Investment will have to go.

> At present there is no evidence that a start is being made to reform these key policies that support crony capitalism.[14]

Lal (1997) states that Third World countries expected to achieve industrialization by planning and sometimes used mathematical programming models in order to prepare plans. On the other hand, these models cannot be useful to determine which industries will be 'losers' and which will be 'winners' in the future according to Lal (1997) since planning involves market distortions and the measures taken against these distortions.

> This exercise in applied welfare economics- which is all that 'rational' planning amounts to- may reveal that *none* of the feasible instruments of policy allows a *net* improvement in welfare compared with the market outcome. From the experience of a large number of developing countries in the post-war period, it would be a fair professional judgment that most government interventions attempting to supplant the price mechanism (by direct controls) have done more harm than good- even compared, possibly, with *laissez-faire*. Most of the more serious distortions in the current workings of the price mechanism in Third World countries are due not to the inherent imperfections of the market mechanism but to irrational government interventions, of which foreign trade controls, industrial licensing, and various forms of price control are the most important. In seeking to improve upon the outcomes of an imperfect market economy, the *dirigisme* to which numerous development economists have lent intellectual support has led to so-called 'policy-induced' distortions which are more serious than any of the supposed distortions of the imperfect market economy it was designed to cure.[15]

Crony capitalism is also one of the issues about the Asian crisis that there is a contradiction in the interpretations before and after the crisis. There were criticisms of the relation-based systems in East Asia during the rapid growth of these economies; however these were ignored because everyone was interested in the miracle story. When the crisis emerged, crony capitalism turned out to be one of the causes. During the miracle period, these economies were defined as liberal market economies that were acting in line with the Washington Consensus and after the crisis these economies were blamed for breaking the rules by excessive and inefficient government intervention. In the table below, Furman and Stiglitz (1998) indicate positive and negative perspectives about the East Asian political economy. They mention that ideology had a role in these different interpretations; however they were also caused by the differences among countries.

[14] Hughes H., *Crony Capitalism*, Policy, 1999, p8

[15] Lal D., *The Poverty of 'Development Economics'*, The Institute of Economic Affairs, 1997, p.77

Table 2.12: Positive and Negative Perspectives on the East Asian Economies

Positive Perspective	Negative Perspective
Business-government coordination improved performance through superior handling of information.	Business-government relations gave rise to collusion and political cronyism.
Openness to international markets was the basis of their success.	East Asia's economies are closed in important ways; addressing this is essential to solve the crisis.
Macroeconomic stability, including low inflation and fiscal prudence.	Poor macroeconomic policy led to the crisis; institutional changes are needed for the future, including the establishment of an independent central bank in Korea with a mandate to focus on price stability.
Promoting competition, especially in exports.	Complaints about lack of competition and the existence of large conglomarates.
Strong financial markets mobilized large quantities of savings and allocated them efficiently to investment.	Weak financial markets caused the crisis.

Source: Furman and Stiglitz (1998), p.12

In contrast to the views about the damages of crony capitalism, Kang (2002) states that cronyism can lead to better information, monitoring, sanctioning and strengthen property rights where legal, political and economic institutions are weak which is a general feature of developing countries. In this sense, monitoring becomes easier by the close relationships of the agents and the uncertainty of the long-term transactions diminishes. This is a normal stage of development process according to Kang (2002). In line with this view, Radelet and Sachs (1999) state that corruption is not the distinct character of the crisis countries that separate them from the non-crisis emerging markets. On the other hand, Kang (2002) mentions the differences among countries and concludes that cronyism lowered transaction costs in Korea whereas the situation was the opposite in Indonesia and the Philippines.

If it is possible to claim that industrial policies of the East Asian economies that were based on government-business relations were directly responsible for the crisis, then it is impossible to explain the role of these policies in the success stories of these countries before the crisis. Chang, Park and Yoo (1998) state that the Korean corporations were encouraged and even forced into unprofitable business after the abolition of the industrial policy by the Kim Young Sam government which came to power in 1993. The Kim government changed the traditional government-business relation by the abolition of five-year planning and the weakening of sectoral policies. They state that the problems of the Korean industrial policy began with this change, not before.

The relationship between the government and business was the core of the East Asian development model. The consequence of this perspective is that the system that is termed as crony capitalism by some authors became necessary for developmental objectives of the East Asian countries. This is why Wade and Veneroso (1998) and many other authors prefer to define these countries as developmental states instead of systems of crony capitalism.

2.2.4. Financial Liberalization

It may be stated that there is an agreement in the literature about the major problem of the East Asian economies which originated from the weaknesses of the financial sector. As Radelet and Sachs (1999) state, many of the problems had their origins in financial liberalization policies introduced in each of the crisis economies in the late 1980s and the early 1990s that led to a very rapid expansion of financial sector and foreign borrowing. For instance, the financial liberalization process accelerated in Korea under the Kim government and consequently the Korean foreign debt increased nearly from \$ 44 billion in 1993 to \$ 120 billion in September 1997 according to Chang, Park, and Yoo (1998). They also mention that the Korean liberalization was more related to short-term foreign borrowing than to long-term foreign borrowing. As mentioned before, the short-term maturity structure was the general feature of the foreign borrowing in the region.

Wade and Veneroso (1998) state that the East Asian governments undertook radical financial deregulation and they were encouraged by the IMF, the OECD and Western governments, banks and firms. In the era of financial globalization financial liberalization may be seen advantageous for the emerging financial markets of East Asia. On the other hand, financial liberalization had been performed without appropriate regulation and supervision of the governments which is a fact that increased the riskiness of any financial transaction in the region.

The financial liberalization process in East Asia indicated significant effects on the financial and banking sectors of the region. Wade and Veneroso (1998) mention that the governments removed or loosened controls on companies' foreign borrowings, abandoned coordination of borrowings and investments and failed to strengthen bank supervision. Radelet and Sachs (1999) state that new private banks were opened since entry requirements to the sector were loosened. The banks had more freedom in their lending decisions and raising funds offshore. New institutions such as the Bangkok International Banking Facility also encouraged offshore borrowing. Also, the development of stock and equity markets offered new chances of financial investment in the region. These outcomes of the financial liberalization meant that the financial sectors of the region were expanding without strengthening the financial system. The East Asian governments violated one of the stability conditions of the Asian high debt model by acting in this way and this fact played a significant role in the emergence of the crisis according to Wade and Veneroso (1998).[16]

Mishkin (1999) states that the credit extensions in the crisis economies grew at higher rates than their GDP growth which gave rise to excessive risk taking. The capital account was liberalized for foreign investors in the East Asian countries: however domestic investors could not always invest abroad and diversify their risks (World Bank, 1998: 9). According to Mishkin (1999), there were two reasons for the excessive risk-taking. Firstly, the managers of the banks were not experienced in risk management and secondly the governments had little incentive to monitor and supervise the banks. He also mentions that the financial systems with these features were unable to prevent the moral hazard problem.

Radelet and Sachs (1999) state that there are two different moral hazard arguments for East Asia. According to the first argument, the creditors recognized the

[16] According to Wade (1998), high debt model of the region means that large Asian firms had a large amount of debt relative to equity when compared to Western and Latin American firms. High debt/equity enabled these firms to invest more than they could through retained earnings or equity finance and the high corporate investment contributed to the rapid growth of East Asia.

deficiencies of the East Asian economies and expected the collapse of these economies; however they thought that they would be bailed out in case of a crisis just as happened in Mexico. As mentioned before, the creditors were not conscious about the problems of these economies, hence it is indicated that this argument was not realistic. The creditors of East Asia believed that “it can’t happen here” instead of “the IMF will bail us out too” (Radelet and Sachs, 1999: 5). The second moral hazard argument is that creditors thought that they would be repaid if the projects of companies with close relations to the government fail (1999: 6). This case was true for East Asia that many firms and banks were granted government support which was also known by the creditors.

Krugman (1998) states that there were no explicit guarantees to the creditors from the East Asian governments; however the impression given by press and the owners of the financial institutions in the region was the opposite. Krugman (1998) mentions that some of these beliefs were validated in practice. For instance, finance companies in Thailand had guaranteed liabilities and bank debt was nationalized in Korea although it was defined as private debt. As a consequence, the lack of regulation on banks and firms combined with the government guarantees caused the banks and the firms to take very risky decisions (Radelet and Sachs, 1999). On the other hand, the creditors expected the borrower firms to be profitable and pay their debt back instead of bailing out as mentioned above, despite the guarantees of the East Asian governments that gave rise to the moral hazard problem to some extent.

The financial liberalization also deteriorated the banking sectors of the East Asian economies. Radelet and Sachs (1999) state that the banks were not able to allocate the huge amount of capital inflows efficiently. Most banks were undercapitalized and non-performing loans were rising gradually. It is obvious that the weak regulation and supervision of banks was a fact that increased the problems of the banking sectors in the region and as the capital inflows increased reforming the regulation and supervision systems of banks became more difficult. As Radelet and Sachs (1998b) mention, there was also the fact that any regulatory attempt on banks and their lending was problematic since they were closely connected to private corporations. For instance, almost every corporation in Indonesia owned their banks. In addition, state-owned banks were allowed to break many regulations without penalty (Radelet and Sachs, 1998b: 13). Krugman (1998) states that the Asian crisis was mainly about bad banking and its consequences.

The conclusion is that financial liberalization is not suitable to all countries at all times. Wade (1998) indicates the situations that financial liberalization is dangerous. All the situations that are given below were present in East Asia and Wade (1998) states that these economies became more and more vulnerable to the crisis by undermining the previous system that was based on the relation of industry and banking system.

- The banks have little experience in international financial markets and non-bank corporations borrow abroad.
- There is a bank-based financial system and a high debt-to-equity corporate sector.
- The exchange rate is pegged.
- The supervision of the banks and non-banks is lacking.

The World Bank (1998) also points out the financial liberalization process as the main cause of the crisis and states that the uncontrolled capital inflows which were intermediated through unregulated domestic financial systems caused a domestic credit boom opening a way to the crisis. "This was a series of bets that paid off in the form of more rapid growth."[17] On the other hand, the Bank mentions that domestic policy mistakes were only a part of the explanation of the Asian crisis and its causes. In this sense, the volatility of investor expectations caused by a lack of information and credit rating agencies' fault of not alarming the investors because of overlending in the region are pointed out. These explanations of the World Bank are problematic since the World Bank (1993) draws a very different picture. The financial liberalization process in the region began in the late 1980s and in the early 1990s. Hence, it is expected that the World Bank should warn the East Asian countries and their investors by the report devoted to the region in 1993 and other annual reports before a severe crisis occurred.

[17] World Bank, *East Asia: Road to Recovery*, Washington D.C., 1998, p.16

The process of financial liberalization in East Asia has been criticized by many other authors. Jomo (2001) states that the financial liberalization in the East Asian economies cannot be considered as a part of the development strategies that gave rise to the rapid growth, industrialization and structural changes before this process began. Wade and Veneroso (1998) state that the financial structure of East and Southeast Asian economies differ from what the IMF usually deals with, hence financial liberalization will have higher costs and smaller benefits in Asia than elsewhere. Wade (1998) mentions that the norms of the Anglo-American system that is based on capital market are very different from those of a bank-based Asian system in response to the IMF, US and UK Treasuries that insisted on further capital account liberalization with regulation and supervision after the crisis. As a conclusion, the process of financial liberalization in emerging markets should be under the control of the governments and based on some rules, otherwise money may move very quickly.

2.2.5. Capital Inflows

Mishkin (1999) states that lending booms generally follow the adoption of financial liberalization that has been observed in other economies and adds that this is also the exact story of East Asia where capital inflows amounted to between 50 and 100 billion dollars annually from 1993 to 1996. The central banks in Europe and Japan contributed to the huge growth of capital inflows to the emerging markets and the main feature of the capital inflows to any region of the world was their short-term maturity structure according to Wade (1998). Wade (1998) states that 80 percent of net global foreign exchange transactions had a maturity date of seven days or less. The capital flows to East Asian economies also shared this feature. According to the World Bank (1998), nearly 60 percent of all short-term capital flows to developing countries went to East Asia. Chang, Park and Yoo (1998) mention that Korea's debt was not at unsustainable level although it was large and fast-growing; however the problem was that the share of short-term debt rose from 43.7 percent in 1993 to 58.3 percent at the end of 1996. Another problem was that the East Asian countries used the inflows for financing their current account deficits. On the other side, the creditors were interested in the higher yields of the financial markets in the region.

According to Radelet and Sachs (1999), capital inflows to the region increased from an average of 1.4 percent of GDP between 1986 and 1990 to 6.7 percent of GDP between 1990 and 1996. In Thailand, the foreign liabilities of banks and financial institutions rose from 5 percent of GDP in 1990 to 28 per cent of GDP in 1995 (Radelet and Sachs, 1999: 3). Malaysia was the only country that foreign direct investment inflows were higher than borrowing. Net government borrowing was less than half a percent of GDP in each country, except in the Philippines with 1.3 percent of GDP (1998a: 8). Hence, most debt was private debt in East Asia

There were some differences in this huge amount of private lending among the East Asian countries according to Radelet and Sachs (1998a). In Korea and Thailand, mostly banks borrowed from foreign creditors and non-bank corporations did in Indonesia. Lending to non-bank private corporations possessed more risk for lenders since the debt of these corporations was not guaranteed by the government.

The conditions of the world markets played a role in the increase of capital flows to East Asia as well as the financial liberalization in the region. Radelet and Sachs (1998a) point out that that capital account liberalization in industrialized countries allowed capital to flow across borders quickly and easily, especially to emerging markets. Also, the East Asian financial markets became more attractive than Latin American markets for foreign creditors after the Mexican Crisis.

It is obvious that some of the features of the economies in the region played a role in attracting foreign investors more than the friendly financial environment in the world. Radelet and Sachs (1998a) identify the features that contributed to capital flows as follows. First, sustained economic growth of these economies gave confidence to investors. Second, financial deregulation without adequate supervision eased risk taking by banks and reduced the procedures of lending. Third, the exchange rate pegging system that had been implemented since the early 1990s in Thailand, Malaysia, Korea, the Philippines and Indonesia allowed exchange rates to be predictable which reduced exchange rate risks of foreign investors. Finally, governments implemented tax breaks in order to attract foreign investors.

Although their contributions on growth are significant, Radelet and Sachs (1998a) state that the capital flows can make macroeconomic management more complex when they are large, volatile and not used efficiently. They present two channels of macroeconomic pressures that are caused by capital inflows. The first one is that capital inflows lead to a real appreciation of the exchange rate and to an expansion of non-tradeables sectors at the expense of tradeables sectors. The other macroeconomic pressure is the fact that the financial systems and institutions of these countries are not strong enough to cope with high levels of international capital flows and these kinds of pressures contribute to the increase of financial risk over time (Radelet and Sachs, 1998a: 10). As discussed in the previous sections, the East Asian economies felt both of these pressures.

In addition, Mishkin (1999) state that the lending boom caused by financial liberalization causes the increase of non-performing loans and the deterioration of banks' balance sheets. He mentions that the deterioration in bank balance sheets is a fundamental factor that causes financial crises. He also points out that capital inflows are not the cause of financial crises but they are the symptom of asymmetric information problem which causes lending boom, speculative attack or moral hazard. Hence, bank regulation and supervision have to be the most vital policies in order to avoid financial crises instead of capital controls according to Mishkin (1999). This interpretation is correct on the one side that the East Asian economies should have given importance to their banking systems. On the other side, regulation and supervision of banks would have indicated that some degrees of capital controls are needed in order to avoid the crisis. In other words, a combination of these policies would have been a better strategy for these countries.

As a conclusion, Radelet and Sachs (1998b) state that the Asian crisis has its roots in attempts of financial reforms in East Asia in the early 1990s that aimed upgrading financial institutions so that the crisis was not the inevitable result of "Asian capitalist model". The weaknesses of the partial financial reforms that exposed the Asian economies more directly to the instabilities of the international financial market seem to be the major cause of the crisis.

2.2.6. Creditor Panic

As presented in the previous section, it is seen that the emphasis is on the problems of the financial sector among the weaknesses of the East Asian economies since these problems increased the vulnerability of the region to the crisis. The East Asian economies were not experiencing serious problems that should have brought them to a severe crisis; however creditor panic played a significant role in increasing the severity of the crisis. These kinds of crises are termed as ‘self-fulfilling crises’ in the literature.

Radelet and Sachs (1998b) define self-fulfilling crisis as the situation that individual creditors act rationally but the market outcomes produce panic and capital flow reversals. At this point, the distinction between illiquidity and insolvency is critical (Radelet and Sachs, 1998b: 5). Insolvency means that the borrower is unable to pay the outstanding debts even in the future. On the other hand, an illiquid borrower is unable to pay the current debt obligations. Radelet and Sachs (1998b) mention that an illiquid borrower should finance the current debt by new loans however there is an unwillingness or inability of the capital market to provide new loans to a borrower with liquidity problems. An individual creditor is unwilling to make a loan to an illiquid borrower if the other creditors do not lend so that a collective action of the creditors emerge. Hence, there is a possibility that none of the creditors do not lend to an illiquid borrower since they expect that the other creditors will not (Radelet and Sachs, 1998b: 5).

If the depositors think that there is a problem in a bank or the whole financial and banking sectors of an economy, they immediately withdraw their deposits since they do not want to be among the last depositors of the bank waiting for the withdrawal and loose their deposits or part of them. The motivation of depositors is not the bad situation of a bank but mainly the fear that the other depositors would run from the bank (Radelet and Sachs, 1998b: 6). The panicked behaviour of depositors deepens the liquidity problems of the borrower countries. In the Asian crisis, the creditor panic had an important role that the financial problems of Thailand gave rise to the panic and capital outflows and the panic caused the contagion of the crisis to the other economies in the region. The policy mistakes of the governments and the international organizations that were mentioned before also had a role in increasing the creditor panic.

Radelet and Sachs (1999) present indirect and direct evidences of the role of creditor panic in the Asian crisis. The East Asian economies were strong enough to sustain debt servicing on a reliable basis and they could have carried out without a financial collapse if they had made some adjustments in exchange rates in the mid-1997 (1998b: 24-25). The conclusion of this interpretation is mentioned before for many times that the crisis cannot be explained by the weakness of fundamentals. This is an indirect evidence of the role of the creditor panic (1999).

Self-fulfilling crises occur when economies have short-term foreign liabilities that are higher than short-term foreign assets (Radelet and Sachs, 1999). As mentioned before, the increase in the short-term foreign debt was the main weakness of the East Asian economies. Radelet and Sachs (1999) state that the crisis hit only countries with high levels of short-term foreign debt and this is one of the direct evidences of the financial panic hypothesis. The crisis economies had different economic structures and fundamentals and the only common characteristics of these countries were their geographical locations and high levels of short-term debt. This is the other direct evidence according to Radelet and Sachs (1999). The final evidence is that the negative impacts of the crisis diminished after one year although there were no considerable changes in the fundamentals, which can be interpreted by the reversal of the financial panic after the repayment and rescheduling of debts.

2.2.7. The Rescue Programs

When intervening the crisis economies, the first target of the IMF was the re-establishment of the financial market confidence by especially stabilizing the exchange rate. The IMF stressed that its purpose was not bailing out the foreign creditors but supporting the stabilization of the crisis economies since the Fund did not want to create a contagion effect that all the creditors in the region and in other emerging markets expect to be bailed out (Radelet and Sachs, 1998b: 29).

> One month after Thailand floated the baht, it announced on August 5th a policy reform package that had been formulated in cooperation with the IMF. The 34-month, $17.2 billion standby arrangement was approved by the Fund Board on August 20th.The IMF contributed $4 billion, the World Bank and Asian Development Bank $2.7 billion, and individual governments the balance of $10.5 billion (including $3.5 billion from neighboring Southeast Asian countries). Japan contributed $4 billion; the United States did not contribute to the package. Indonesia followed suit by signing a 36-month, $40 billion package on October 31st. The IMF contributed $10 billion, and the World Bank and the ADB added $8 billion, and other governments the balance (including $5 billion and $3 billion in "second line of defense" from Japan and the U.S., respectively). Somehow, the official figure of $40 billion includes $5 billion of "assistance" from Indonesia's own reserves'! Korea signed its $57 billion of "assistance" from $21 billion from the IMF, $14 billion from the World Bank and the ADB, and $22 from a group of industrial countries of the five afflicted economies came under the tutelage of the IMF.[18]

As a first step, the IMF programs targeted to control the currency depreciation, fiscal balance, inflation and output decline. Rebuilding foreign exchange reserves, restructuring and reforming the banking sector were also among the goals of the programs in order to re-establish the financial confidence. Obviously, preventing the default on foreign debt obligations was an important part of these programs (Radelet and Sachs, 1998a: 24). In order to achieve these goals, the IMF's demands from the crisis economies were fiscal contraction, closure of banks and financial institutions, high interest rates, restricting domestic credit and certainly the full payment of foreign debt obligations.

Among these requirements, fiscal contraction was one of the issues that have been discussed widely. The IMF stated that fiscal contraction was needed to support the monetary contraction, to defend the exchange rate, and to provide funds to the financial system. In line with this approach, the Bank demanded a fiscal surplus of 1 percent of GDP (Radelet and Sachs, 1998a: 30). The problem was that the East Asian countries were in budget surpluses and their fiscal situation was not among the causes of the Asian crisis as mentioned before. In addition, exchange rate movements are not closely related to the realization of budget surpluses and a fiscal contraction will lead to a more depreciated exchange rate in an economy with prudent fiscal policies as in the East Asian economies (1998b: 32). Radelet and Sachs (1998a) mention that it should have been better to target a small deficit for each crisis country which was a fact that was also recognized by the IMF later and the target was revised

[18] Radelet and Sachs, *The Onset of the East Asian Financial Crisis,* Harvard Institute of International Development, 1998a, p.23-24

as small deficits in Korea, Indonesia and Thailand (deficit of 1 percent of GDP in Korea and Indonesia).

Bank closure was the other act of the IMF in the region that has been debated and criticized severely. Radelet and Sachs (1998a) state that 58 out of 91 finance companies were immediately suspended in Thailand where 56 of these were liquidated and 14 out of 30 merchant banks were suspended in Korea. In Indonesia, 16 commercial banks were closed which turned out to be the mostly criticized bank closures of the IMF. In the following months, the Indonesian Central Bank had to provide a considerable amount of credit to keep the banking system liquid which increased the money supply and put pressure on inflation targets.

In addition to the fact that bank closures damaged the other targets of the programs, they also deepened the financial panic. When a bank is closed, the depositors of the bank run from the bank as soon as they understand that they will not be bailed out which was also the case in the Asian crisis. In addition, creditors did not roll over loans which put pressure on exporters since they could not obtain credits (Radelet and Sachs, 1998b: 35). It would have been better to implement a longer term and a more comprehensive strategy for bank restructuring and recapitalization. It is obvious that the banks and the financial institutions of the region needed reforms or some of them had to be closed; however the problem was the *hurried approach* of the IMF that lacked deposit insurance and a comprehensive restructuring plan (1999: 10).

High interest rate was the other point of the IMF programs. The Fund required high interest rates in order to appreciate the exchange rate; however the relationship between interest rates and exchange rate was not the most important issue according to Furman and Stiglitz (1998). They state that higher interest rates strengthen the exchange rate today and in the future but cause a macroeconomic cost. Wade (1998) states that the other reasons of implementing a high interest rate strategy were encouraging domestic capital to stay at home and attracting foreign lending which in turn will appreciate the exchange rates. On the other hand, foreign capital does not return whatever the interest rate when a whole economy is sinking and experiencing instability. In addition, the increase in real interest rates raised the East Asian firms' fixed payment obligations and as high interest rates were accompanied by tax increases and cuts in government expenditures, capital outflows accelerated (Wade, 1998: 700).

Radelet and Sachs (1998a) state that the IMF also recognized the problems of the high interest rate strategy however claimed that the benefits of currency stabilization would outweigh the short-run costs of high interest rates. On the other hand, the short-run costs were not low that the high interest rates undermined the profitability of banks and private firms and caused economic contraction in addition to the problems mentioned above according to Radelet and Sachs (1998a). In addition to the economic contraction, the currency appreciation was not achieved. Hence, increasing interest rates was not a suitable strategy to deal with the Asian crisis. According to Furman and Stiglitz (1998), the outcomes of a high interest rate strategy depend on the history and the institutional structure of the economy.

Radelet and Sachs (1999) state that financial crises become more complicated when there are a large number of private sector debtors rather than a sovereign debtor as in the case of the Asian crisis. For instance, Indonesia was remarkable with the high private sector debt. The first IMF program of Indonesia did not even mention the private debt and this issue was included in the third program which also caused a criticism of the Fund (Radelet and Sachs, 1999: 11). Finally, the strategy of restricting the domestic credit has been criticized. This strategy meant that the central banks of the crisis economies will not provide credits, which means that the lender of last resort property of the central banks was eliminated (1998a: 28).

When the consequences of the IMF programs are overviewed, it is seen that they failed. They did not solve the problems of the crisis economies, most importantly targets for currency depreciation and stock market collapse and inflation according to Radelet and Sachs (1998a). The financial panic deepened after the implementation of the programs, the international credit of the East Asian countries decreased further and it was observed that the fall in output was higher than expected (Radelet and Sachs, 1998a: 25). These experiences of East Asia indicate that it is not a suitable strategy to make radical financial reforms in the middle of a liquidity crisis that reinforced the cronyism image in addition to deepening the macroeconomic problems (Wade, 1998: 701).

As Radelet and Sachs (1998a) state, the IMF attributed the failures to the unexpected contagion effects, political uncertainty and poor implementation of its measures by the governments in the region. This claim was true to some extent since the governments did not fully implement the reforms that were included in the programs and the elections in Korea caused political instability where contagion effects carried any instability to other countries in the region (Radelet and Sachs, 1998a: 25).

Because of the failure of the original programs, new agreements were signed with Thailand in November 25, Korea in December 24, 1997 and Indonesia in January 15, 1998 (Radelet and Sachs, 1998a: 25). Among these, the second program of Korea was more effective that the monetary and fiscal targets were revised and a restructuring plan for Korean bank loans to international banks was prepared. Although this plan included the increase of interest rates of debts and the guarantee of new bonds by the Korean government, the exchange rate began to appreciate and the panic was controlled (1999: 10).

The IMF programs also included non-financial structural changes such as reducing tariffs for liberalizing trade regime, opening sectors for foreign investment and reducing monopoly powers (Radelet and Sachs, 1998a: 25). These requirements indicate that the IMF identified the problem as a macroeconomic balance of payments problem rather than a microeconomic financial problem and the crisis as a crisis of excess consumption rather than excess investment (Wade, 1998: 700). As Wade and Veneroso (1998) state, the IMF program of Korea was like the standard programs with structural and institutional reforms although they were not needed in the middle of the crisis and the main purpose was operating the Korean financial system as a Western one. The consequence of this faulty approach was that the IMF programs failed to achieve re-establishing market confidence and setting economic growth in the East Asian countries according to Radelet and Sachs (1998b).

Even the World Bank (1998) mentions the point that several questions raised about the rescue programs although it is stated that there is a need for further research. The conclusion of this section should emphasize the significance of efficient organizations that take role in the issues of international political and economic order. There is a need for a more formal mechanism for the regulation of the emerging markets' private debt that is mainly based on private funds rather than IMF bailouts (Radelet and Sachs, 1999: 10). Lender of last resort, strict banking regulation and supervision, deposit insurance and bankruptcy laws are the institutions of industrialized countries to prevent financial crises; however they are not present or work efficiently in the international context, especially in developing countries (1999: 11). The IMF did not serve as a true lender of last resort during and after the Asian crisis (1998b: 36). There are few effective mechanisms to stop international panics in emerging markets; hence there is a need for developing the institutions for the well-functioning of international capital markets since the crises in emerging markets have the potential of damaging the other markets (1999). In addition to all its consequences, the Asian crisis is an evidence of this fact.

2.3. Conclusion

The East Asian miracle and the crisis have been one of the most widely studied issues of the literature on political economy. In this sense, the purpose of this chapter is not only overviewing the development strategies of the East Asian economies that brought them success and failure. By overviewing the literature on the region, one of the intentions turned out to explore the causes of the deep interest on East Asian experience and the contradictions that have stemmed from the differences in these interests.

The fact that the whole world was impressed by the performance of the newly industrializing economies in East Asia is attributed to the developing countries' willingness to implement the strategies of the East Asian countries in their economies and developed countries' need to sustain their position in the international economic and political order. From the theoretical perspective, the cause of the deep interest on the East Asian miracle may be the astonishment that has been induced by the economic success of the countries which were not implementing orthodox policies.

It is obvious that this success story would have damage the neoclassical theory. In this sense, the purpose of the neoclassicals has been to prevent this damage by trying to explain the high performance of the East Asian economies by neoclassical principles. As this chapter proves, the neoclassical interpretation and the market-friendly view of the World Bank are similar. The market-friendly view is an adjusted version of the neo-classical view to the East Asian reality so that this view has also been trying to preserve the superiority of the neoclassical theory. This is why the revisionists have criticized severely the neoclassical view and the market-friendly view and identified their approach to East Asia as political and ideological. On the other hand, it is evident that the concerns of the revisionists have also had political and ideological aspects. As a conclusion, even the theoretical interest on the East Asian development has included political and ideological components.

When the failure of the East Asian economies in the late 1990s is considered, the Asian crisis enabled the neoclassicals to take a breath and indicate the weaknesses of the East Asian development strategies. The neoclassicals has blamed the policies of the governments in the region, they especially pointed out the excessive intervention of these governments that caused poor macroeconomic stance, cronyism and market distortions especially in the financial markets. As another aspect of the neoclassical response to the crisis, Jayasuriya and Rosser (2001) state that the Asian crisis led to an ideological crisis in the West because the Washington Consensus which was seen as the best set of policies to be implemented in the developing countries has broken down and different views emerged within orthodoxy.

On the other hand, the revisionists have pointed out that the Asian crisis occurred because the system of their development model was changed and damaged. In this sense, they blamed the IMF and developed countries such as US, UK and Japan which were the creditors of the region as they contributed to the rapid and uncontrolled financial liberalization process. The consequence of following the financial globalization without any regulation and supervision was the huge short-term debt burden which meant that the East Asian countries shared the faith of other developing countries despite their distinctiveness during the period of rapid growth.

It seems that the World Bank blames any other factor in the region rather than itself for the Asian crisis and different views blame different factors: the governments of the region because of policy mistakes, the cultural impacts on Asian capitalism because of cronyism or international organizations and developed countries because of unsuitable policies on the region. The only distinguishing feature of the process that prepared the Asian crisis from the environment of the other severe crises was the good world economic conditions. On the other hand, the crisis affected the world economy as well as ending the miracle in East Asia. This fact turned out to be one of the causes of the interest on the East Asian experience. Some of the economies that are even geographically far away from the region found themselves in financial problems as a consequence of the Asian crisis. It should also be mentioned that there were also social consequences of the crisis although they are not emphasized in this thesis. Another interesting issue emerged that China which is a close neighbor of the crisis economies sustained the crisis nearly without damage. The next chapter concentrates on the success of this country and the similarities of her success with the East Asian miracle, if any.

CHAPTER 3

CHINA'S TRANSITION

3.1. Introduction

> The period from 1917 to the early 1950s witnessed a number of countries, containing one-third of the world's population, reject the market as a mechanism for the allocation of resources and the determination of production, and instead embrace the so called Soviet model of central planning. This model contained a number of key features: material balance planning for allocating resources; collectivist agriculture; price, wage, interest rate and exchange rate control; emphasis on heavy industry dominated by large state owned enterprises (SOEs) with little priority given to the production of consumer goods; foreign trade control through state trading monopolies; emphasis on economic autarky; and discrimination against the private sector. This model's dramatic collapse and rejection in Eastern Europe in the late 1980s and early 1990s, and the Soviet Union itself in 1991, created an unprecedented scale of transition from planned to market economies and reintegration into the global economy, affecting some 400 million people in 26 countries. For economists the major challenge during the last decade of this century has been to advise how best this immense task could be accomplished, particularly given that there were few real world examples to draw upon and certainly none on the scale required.[19]

China was one of the countries mentioned above that adopted the model of central planning by the establishment of the People's Republic of China in 1949 and entered a transition period to a market-oriented economy in the late 1970s. Obviously, these countries and their systems had a number of common characteristics which mainly stemmed from the Russian system; however Hobsbawm (1996) states that the Chinese socialism and the Russian socialism have to be distinguished since the national aspect of the former was remarkable. He also mentions that most of the Chinese people viewed China as the model and center of civilization. In this sense, China did not share the concerns of staying behind the West of Russia and other socialist countries (Hobsbawm, 1996: 529).

China's transition was seen to be natural because of the economic conditions of the pre-reform period. The most common explanation for the cause of the transition was

[19] Harvie C., *Economic Transition: What Can be Learned from China's Experience*, International Journal of Social Economics Vol.26 No.7/8/9, p.1091

that heavy industry, which was one of the basic components of the Soviet model, was not appropriate to the rural economies that were rich in labor but poor in capital like China. In addition to the decline of economic growth as a consequence of the problems brought by the central planning, Hobsbawm (1996) states that the improvements in basic social indicators such as life expectancy age did not continue which was a fact that weakened the trust on socialism. Under these conditions, Yao and Zhang (2003) state that the impact of the East Asian success on Chinese people and the Communist Party played a role in the transition decision as well as following the general trend of transition in the other socialist countries and China's success has been due to adopting the open-door policy that has been seen as the most significant component of the East Asian development strategy. This issue will be discussed in one of the following sections.

Table 3.1: Real GDP Growth Rate of China

1987	11,1	**1996**	9,6
1988	11,3	**1997**	8,8
1989	4,3	**1998**	7,8
1990	3,9	**1999**	7,1
1991	8	**2000**	8
1992	13,2	**2001**	7,5
1993	13,5	**2002**	8,3
1994	12,7	**2003**	9,5
1995	10,5	**2004**	9,5

Source: Liu and Ng (2006), p.2

Table 3.2: GDP per capita in China (US dollars)

1991	350
1992	410
1993	520
1994	470
1995	600
1996	700
1997	770
1998	820
1999	860
2000	950
2001	1,040
2002	1,130
2003	1,270
2004	1,486
2005	1,704

Source:http://www.dbresearch.com

Since the transition began, another success story of Asia has been taking place in China for nearly three decades. The annual growth rate of the Chinese economy has been an average rate of 9.5 percent between 1979 and 2001 and China's GDP moved from eleventh to seventh in the same period (Siackhachanh, 2002: 3). The economic growth rate of China was not only higher than low and middle income countries but it was also higher than the industrialized countries (Minami, 1994: 11). As another indicator of this success, average annual per capita GDP growth in China was 8 percent between 1978 and 1995 according to the official statistics which was faster than almost any country in recent history[20] (World Bank, 1997b: 1). About 350 million Chinese people were lifted out of poverty (Siackhachanh, 2002: 3) and life expectancy has increased from 64 in the 1970s to over 70 in the late 1990s (Qian, 2003: 1). In addition to these, China has taken important steps to catch up with the world technology with more than 100 science and technology parks and sixty nine engineering centers (World Bank, 1997b: 40). Most of the economists believe that the best part of China's growth has not come yet and its performance will be better as a consequence of the WTO membership according to Qian (2003).

It is evident that transition is a different process when compared to reforms in developed countries. In *From Plan to Market* (1996) that is devoted to the transition economies and their performances, the World Bank emphasizes that transition is more than typical reforms since the change is deeper and more systemic and the main purpose is to establish key market institutions.

> The ultimate goal of transition in countries shedding central planning is to build a thriving market economy capable of delivering long-term growth in living standards. What distinguishes transition from economic reforms in other countries is the systemic change involved: reforms must penetrate to the fundamental rules of the game, to the institutions that shape behavior and guide organizations. For transition to succeed, it must restructure the institutional basis of the social system—an enormous and enormously time-consuming agenda.[21]

In line with this view, the World Bank (1997b) states that China has experienced two transitions. The first transition has been from a command economy to a market-based economy and the second transition has been from a rural and agricultural society to an urban and industrial society. As well as the difficulties of the former, the transition of the society has also many risks as the World Bank (1997b) mentions. Many authors have stated that the world has been impressed by the economic success of this country although how China, which was a poor country at the beginning of the transition, achieved to grow rapidly and gain such a significant position in the international political and economic order is still a question that needs an answer.

[20] Siackhachanh (2002) states that per capita income increased from below 168 US dollars to just under USD 1000 in this period.

[21] World Bank, *From Plan to Market, Executive Summary*, Oxford University Press, 1996, p.2

> China is embarked on an extraordinary voyage of change. Its breathtaking speed and sweep promise new economic horizons and fresh hope for China's huge population. China has telescoped into one generation what other countries took centuries to achieve. In a country whose population exceeds those of Sub-Saharan Africa and Latin America combined, this has been the most remarkable development of our time.[22]

This question becomes more interesting when China is compared to other transition economies of the former Soviet Union and the Eastern Europe. Lin (2004a) states that the international economists expected the success of the reforms in the former Soviet Union and the Eastern Europe economies since they followed the strategy that is based on the neo-classical principles of price liberalization, rapid privatization and macroeconomic stabilization by avoiding fiscal deficits. This strategy is termed as "shock therapy" or "big bang" and is based on the Washington Consensus which includes strengthening fiscal discipline, enlarging the tax base, unifying exchange rate, increasing public investments to improve income distributions, liberalizing trade, removing FDI barriers, privatizing SOEs, removing restrictions on market entry and protecting property rights (Lin, 2004a: 12).

In contrast to the expectations, the countries that adopted the shock therapy strategy experienced a number of difficulties in their reforms as Lin (2004a) points out. Harvie (1999) states that this approach mainly targeted the replacement of the whole planning system by the market-oriented system as rapidly as possible; however output declines, rising unemployment and poverty, increasing income disparities, social cohesion and crime turned out to be among the economic and social costs of the rapid change in the former Soviet Union and Eastern Europe countries.

Unlike the countries mentioned above, China's transition which began with Deng Xiaoping in 1979 has been performed by the gradual and incremental approach. The main point is that the socialist character of the economy has been preserved and the centralized political control of the Communist Party have been maintained whereas political reform accompanied the economic reform in the transition economies that adopted the shock therapy approach (Harvie, 1999: 1093). Hence, China's short-

[22] World Bank, *China 2020, Development Challenges in the New Century*, Washington D.C., 1997, p.97

term goal at the beginning of the transition was only the economic reform which was directed by the state.

At the beginning of the transition China did not have a clear reform program. The Chinese leadership and the majority of the Chinese people did not have any idea on how the reform should be performed; however they recognized that the central planning system did not work according to Gang (1994). On the other hand, China did not prefer to take the radical measures of the other transition economies since the Cultural Revolution convinced the policy makers that the main problem was not the system itself and its structure but the "failure to concentrate on economic construction" (Gang, 1994: 1).

> Continued belief in the old system did not prevent China from moving in the direction of market-oriented reform. Since 1978 the majority of Chinese leaders have agreed on "introducing more market mechanisms" into the economy. The problem has been a lack of consensus on defining the "market" and its institutional requirements. As a result, the reform objectives have been readjusted many times, from "a planned economy with some market adjustment" and "the combination of planning and market" to the current "socialist market economy". Obviously, defining the new objective is still highly controversial and will be further debated and modified.[23]

When China and other transition economies are compared, China's success is the outcome of its ability to manage the timing, sequence and scope of liberalization as Yao and Zhang (2003) emphasize. In addition to the superiority of China's transition process among the experiences of other transition economies, the point that this ability was missing in the East Asian countries, especially in financial liberalization, may explain the difference between the performance of China and the weaknesses of these economies during the Asian crisis.

> This realization may shed some light on the question of "reform sequencing". The fundamental guideline for sequencing incremental reform is to introduce reform in sectors or areas of least resistance, not necessarily in the largest sector. In China, that sector was agriculture. China began its economic reform in agriculture (which happened also to be the largest sector) because that sector was the easiest place to carry out reform policies. In contrast, radical reform specifically attacks the "hard cores" of economic institutions from the very onset. Also in contrast to gradualism, which focuses first on economic reform, the radical reform targets political reform before economic reform. This difference is not surprising given that political reform is in essence the process

[23] Gang F., *China's "Dual-Track Transition" Toward the Market: Achievements and Problems*, The 1990 Institute August, 1994, p.1 These reform objectives were the reinterpretation of Marxist economic theory by the Chinese government according to Minami (1994).

> through which pro-reform groups take actions to overcome resistance from those whose interests lie with the old system. When pro-reform groups are not strong enough to overcome that resistance, either no economic reform takes place at all (as happened in the Soviet Union and some Eastern European countries prior to 1989) or economic reform goes first through the dual-track transition.[24]

In line with the gradual and incremental approach, new institutions were developed in China without breaking down the old system immediately so that the reactions of the resistance groups whose interests are damaged by the reforms have been reduced temporarily until the conditions improve as Gang (1994) states. As a consequence of following this strategy, China has not experienced social chaos and economic disorder as the other transition economies did.[25]

As a consequence of the gradualist nature of the Chinese reforms, dual-track approach which is defined as the adoption of some aspects of market economy while simultaneously operating under planning economy, characterized the reforms at the beginning of the transition. This system was initially introduced in prices in 1984; however it had been used in other policy areas such as urban reform, foreign trade reform, foreign exchange reform, fiscal reform, labor reform, housing reform, social security reform, ownership reform and domestic currency issuance (Gang, 1994, Sachs and Woo, 1996). The efforts to establish a non-state sector while trying to reform the SOEs has been one of the best examples of this approach. As Lin (2004a) states, the dual-track approach has an important role in China's growth, economic and social stability and Gang (1994) emphasizes its role in politics.

> Transition from a planned economy to a market economy through the dual-track system reflects the most fundamental characteristic of Chinese economic system reform developing the elements (or sectors) of a new system side by side with the old unreformed system, and then, if things go well, reforming the old system in line with the positive developments emerging from the new components of the economy. This reform strategy may not be justified by "eliminating efficiency loss" or "minimizing the implementation costs" of the reform, but may be rationalized by reducing the costs of political conflict the reform may generate in the real world.[26]

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[24] Gang F., *China's "Dual-Track Transition" Toward the Market: Achievements and Problems*, The 1990 Institute August, 1994, p.3

[25] World Bank (1996) points out that transition causes a social change that is generally positive; however may have negative impacts such as the increase in crime because of the economic uncertainity during transition process.

[26] Gang F., *China's "Dual-Track Transition" Toward the Market: Achievements and Problems*, The 1990 Institute August, 1994, p.2

According to some economists, the failure of China was inevitable despite its favorable initial conditions because the dual-track approach was adopted instead of shock therapy strategy as Lin (2004a) points out. On the other hand, Qian (2003) states that dual-track approach was a way to improve efficiency while protecting existing rents and making best use of the existing institutions at the same time which was a political choice to avoid creating losers. The Chinese economy experienced some problems in the 1990s as predicted by these economists; however China's annual GDP and trade growth turned out to be 9.3 percent and 15 percent respectively in the period 1990–2002 (Lin, 2004a: 3). In addition to the growth rate, Lin (2004a) mentions that the living standards improved quickly in China, especially in urban areas.

Despite its benefits, it is obvious that the dual-track mechanism could not be maintained forever. As Qian (2003) states, China has taken steps to single-track mechanism since the early 1990s and identifies two main reasons of this effort. First, the planned track lost its significance as the market track grew fast. Second, the government was ready to compensate potential losers when the planned track was abolished.

Although gradualism has been criticized much, this strategy played a role in China's economic stability in critical periods. Yao and Zhang (2003) state that the gradual approach to openness, especially in stock and foreign exchange markets, was the factor that saved China from the Asian crisis since these measures protected the Chinese economy from speculative attacks and other risks of short-term capital flight. The conditions of China during the Asian crisis will be discussed in Chapter 4.

3.2. Initial Conditions

At the beginning of the transition, China was a poor agrarian economy that 71 percent of the labor force was employed in agriculture, poverty rates were high and average per capita income was very low (Harvie, 1999: 1104).[27] There was a

[27] Hogan (2000) states that 80 percent of China's population survived on less than one dollar a day in 1978.

difficulty in purchasing essential imports since foreign exchange reserves were very low and the technology gap between China and other countries widened considerably (World Bank, 1997b: 12).

Before the transition, the production and resource allocation decisions were taken by the central government as the central planning system implied. Zhu (2003) describes the functioning of the resource allocation system as follows. The central government transferred the resources from agriculture to industry by taxation and keeping agricultural prices low.[28] Then, the government collected revenue from industry that consisted of the state-owned enterprises (SOEs). Finally, the system redistributed the state's revenue back to the sectors according to the central plan. State's revenue was ensured by the prohibition of any entry to the industry sector. Lin (2004a) states that another reason of nationalizing the industrial firms under central planning was to control their investments so that they were directed to heavy industries. Although the enterprises were owned by the state, the problems of asymmetric information and incentive incompatibility existed as Lin (2004a) emphasizes.

Although the requirements of agricultural development were as much as industrial development's, resources were mainly used in industry and the government adopted an agricultural development strategy that the main purpose was to guarantee resources to industry.[29] The most important principle of this strategy was collective farming that income was distributed according to the members' contribution to production which was very difficult to observe (Lin, Cai and Li, 1996: 5).

Agriculture did not have any priorities although this sector was the main foreign exchange earner of the economy in the pre-reform period (Lin, Cai and Li, 1996: 4). More than 60 percent of China's foreign exchange earnings came from agriculture when the processed agricultural products were included. Hence, the ability to import

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[28] There was an assumption that low input prices would guarantee profits of state enterprises to be enough for payments of their loans or reinvestments according to Lin, Cai and Li (1996).

[29] Between 1953 and 1985, agriculture received less than 10 percent of state investments whereas industry received 45 percent although 75 percent of the Chinese population worked in agriculture (Lin, Cai and Li, 1996: 5).

capital for industrialization depended on the performance of agriculture so that there was a need to solve the problems of this sector in order to achieve industrialization as Lin, Cai and Li (1996) emphasize.

In addition to the features that are mentioned above, the pre-reform China was characterized by a closed economy to foreign trade and investment. The government monopolized the operation of foreign trade in order to protect the domestic economy from the competition of international market forces (Zhu, 2003: 3). In this sense, prices and quantities of imports and exports were determined by the central plan. Lardy (2003) states that the exchange rate and the relative prices did not play an important role in China's foreign trade since the planning process was carried out in physical terms and presents the consequences of the pre-reform trade system as follows.

- A significant share of China's exports consisted of goods that were against comparative advantage.
- Exporters had no incentive to increase their sales which caused the inability to finance imports.
- China's trade volume grew slowly.[30]

China has established heavy industry; however the economy was inefficient because of low allocative efficiency caused by acting against comparative advantage and low technical efficiency caused by the lack of incentives by managers and workers. These inefficiencies caused total factor productivity increase to be low in the Chinese economy that was only 0.5 percent between 1952 and 1981 according to the most favorable assumptions of the World Bank (Lin, Cai and Li, 1996: 7).

The inefficiencies under central planning were caused by a number of distortions in the Chinese economy in interest rates, foreign exchange rates, prices of raw materials, wage rates, commodity prices, resource allocation and managerial autonomy in SOEs (Lin, 2004a: 10). As Lin (2004a) states, the government

[30] China's share in world trade dropped from 1.5 percent in 1953 to 0.6 percent in 1977 (Lardy, 2003: 5).

depressed the interest rates in order to provide cheap loans to state enterprises, overvalued the domestic currency in order to lower the costs of imports and depressed the prices of all kinds of inputs in order to enable the enterprises to accumulate surplus. As the wages were kept low like the prices of other inputs, the government had to provide living necessities to the workers at low prices. These distortions caused shortage of capital, foreign exchange, raw materials and living necessities (Lin, 2004a: 10).

China had a long way to achieve the transition. On the other hand, the World Bank (1996) mentions that China had advantageous conditions when compared to other transition economies and the Chinese policy-makers have not faced many of the difficulties of other transitions. Despite the market distortions caused by the planned economy, Harvie (1999) mentions that China had an advantageous position at the beginning of the transition with its economic growth, low inflation, low budget deficits, high savings, low external debt and cheap, literate and adaptive labor force.[31]

Another view is that the undesirable conditions of the pre-reform period that stemmed from the market distortions made China ready for reforms. The World Bank (1997b) indicates that poor countries tend to grow faster than rich ones. Qian (2003) also states that transition economies have more potential of efficiency improvement when compared to developed countries as soon as they prevent distortions. The fact that planning was not adopted in China as much as the other socialist countries did was another favorable condition for the transition according to the World Bank (1997b). Accompanied by the fact that the central bureaucracy was weakened during the Cultural Revolution, the strong administrative capacity of China was a significant factor at the beginning of the reforms, especially at the local level so that local governments were ready to take responsibilities (World Bank, 1997b: 13).

[31] For instance, the share of technicians and engineers in the industrial labor force was higher than newly industrializing economies of Southeast Asia (World Bank, 1997b: 13).

Having cultural and historical connections to Hong Kong and Taiwan has been also an advantageous feature of China, especially in attracting foreign direct investment from these countries (Harvie, 1999, World Bank, 1997). The Chinese minorities in several Southeastern Asian countries brought not only money to China but also knowledge and technology. In addition to these, there was political stability in China that the Communist Party leadership experienced unity and stability of its longest period and even the disputes within the Party were solved "without the dogmatism and violence of the Cultural Revolution" (Goodman, 1994: 91). Harvie (1999) mentions that this position gave China the chance of implementing gradual and incremental reforms without a stabilization program. Hence, there is an agreement in the literature that China had nothing to lose by reforms.

3.3. Rapid Growth

3.3.1. Two Perspectives

Since China's rapid economic growth and its successful integration to the world economy have attracted the attention of policy makers of other economies and academicians, there have been different attempts to explain China's achievements. According to Sachs and Woo (1997), there are two schools that interpret the Chinese experience from different perspectives although their explanations about the basic issues have been parallel.

One of these perspectives is the "experimentalist school" which states that the evolutionary, experimental and incremental nature of the reforms has a significant role in China's success, because it would have faced social conflict, instability and poorer economic policies if reforms were implemented rapidly. The other perspective on China's performance has been presented by the "convergence school" which states that the Chinese institutions have been gradually converging to the institutions of non-socialist economies, especially to the system of East Asian economies. They point out that the initial conditions of China were appropriate for the labor-intensive, export-led growth strategy of the East Asian economies (Sachs and Woo, 1997: 3).[32] According to this school, China will be more successful as the convergence becomes faster.

Sachs and Woo (1997) point out that the experimentalist school and the convergence school have some common points. They both agree on the achievements of China in macroeconomic stability, establishing market institutions, integration to the world economy, reduction of the discrimination against private sector and the state's role in providing public goods. The difference of these two schools have mainly stemmed from their explanations about the reform process and its future.

The main argument of the experimentalist school is that gradualism has been the key of China's success as mentioned above. They also state that this strategy is appropriate to other transition economies. The successes of China in agriculture, township and village enterprises (TVEs) and state-owned enterprises (SOEs), which will be discussed in the following sections, have been the consequences of the experimentalist approach and they are examples of China's economic institutions that are different from the institutions in other economies. Hence, China has been moving to a unique economic model by this strategy according to the experimentalist school (Sachs and Woo, 1997: 2).

In contrast, the convergence school states that China's achievements have not stemmed from gradualism, but despite gradualism (Sachs and Woo, 1997: 2). Gradualism stemmed from the interests of the Chinese leadership which hesitated to take radical measures not only because of economic change but also because of political risks; however it is obvious that gradualism causes the delay of some serious problems to the future according to the convergence school. In addition, they state that the gradualist strategy cannot be implemented in Eastern Europe and the former Soviet Union because the economic structures of these countries and China differ considerably. China's rapid growth despite gradualism may only be explained by the favorable economic structure of China at the beginning of the reforms which signals

[32] Sachs and Woo (1997) state that they have also been among the supporters of the convergence school perspective.

that China and its economic institutions have been converging to East Asian economies and institutions instead of moving to a unique system (Sachs and Woo, 1997: 3).

3.3.2. Economic Explanation

The interpretations of the experimentalist school and the convergence school on China's rapid growth are political economic approaches. As well as the methods and the long-term consequences of China's reforms, the economic factors that have played role in achieving rapid growth have to be mentioned. According to the World Bank (1997b), China's rapid growth has driven by four factors since 1978.

First, high saving rate was the most remarkable factor of China's growth since 1978 as it was the case in the East Asian economies. According to the official statistics, China's saving rate averaged 37 percent of GDP between 1978 and 1995 which is among the highest in the world (World Bank, 1997b: 4). In the same period, the share of government in national saving decreased from 38.5 percent to 1.7 percent whereas household savings increased from 11.6 percent to 56.3 percent (Chunlin, 2002: 6).[33] Chunlin (2002) points out that the rise in household savings meant that the pattern of income distribution has changed in the Chinese economy which is one of the significant outcomes of the reforms in the manner that the share of households in national income increased at the expense of state-owned enterprises. In addition, the stability of high saving rate has been another success of the Chinese economy as the World Bank (1997b) mentions.

The World Bank (1997b) presents three factors that gave rise to the increase of saving rate in China. First, households began to set new consumption plans as their incomes rose above the subsistence level and have increased their savings for attaining their plans. Second, the rising life expectancy years caused households to save more for their retirement. Third, institutional arrangements such as the implicit guarantee of deposits in the banking system have encouraged household savings (World Bank, 1997b: 6).

[33] Chunlin (2002) interprets the increase in household savings as the privatization of national saving.

The characteristics of the market and people's reactions to these characteristics based on traditional and cultural approaches have also been among the explanations of the high savings rate of China. Minami (1994) states that high savings rate was also the consequence of the fact that people did not have many alternatives to saving money. In other words, most consumption goods were lacking in the economy and the underdeveloped financial markets did not provide households different ways to keep money. In addition to these, Yao and Zhang (2003) mention that high savings rate has stemmed from the traditional and cultural characteristics of Chinese people like the East Asian people, rather than being a result of government policy. On the other side of the positive explanations about the high household savings rate, Stiglitz (2006) points out that one of the causes of excessive savings in China has been the weakness of the government social-insurance programs. Also, Minami (1994) emphasizes that the government should take steps to transform savings into productive investments, especially hidden savings that have been usually faced in rural areas and have not been transferred into the financial system.

Second, a considerable structural change has been observed in China since the transition began. As the first step of the structural change, the share of agriculture in the Chinese economy has declined since the transition began. The increasing poverty in rural areas and the rising demand for labor in industry and services has played a role in this change (World Bank, 1997b: 6). Employment in agriculture had declined from 71 percent to about 50 percent between 1978 and 1995 as an expected consequence of economic development and the emergence of the manufacturing sector (Harvie, 1999, World Bank, 1997). The contribution of this process to GDP growth had been about annually 1 percent between 1978 and 1995 as the World Bank (1997b) states and China achieved this structural change in a short period when compared to the experiences of other economies.

At the beginning of the transition, the productivity of agriculture increased as a consequence of reforms in this sector which increased rural savings. Rural savings were invested in rural industries so that agricultural reforms played a significant role in rural development. In addition to this, the surplus labor of commune system provided a steady supply of labor for rural industry and has favored the development of the non-state sector (World Bank,1997: 10). Township and village enterprises that have emerged as a consequence of rural development, have contributed to China's transition and growth considerably.

There has been also a change in the ownership structure of enterprises that played an important role in achieving the industrial growth. As it was stated before, the industrial production was performed by state-owned enterprises under central planning. Since the transition began, collectively-owned township and village enterprises and in the second half of the 1990s private enterprises that are supplemented by joint ventures and foreign-funded enterprises have had a significant share in industrial growth (World Bank, 1997b: 6-7). There are more private enterprises in China than the number given by the official statistics because many private firms have an incentive to underreport their production and employment or operate under the banner of township and village enterprises in order to avoid the restrictions imposed on private enterprises according to the World Bank (1997b).

Thirdly, the World Bank (1997b) mentions the nature of the reforms in China. When the reforms began in 1978, there was not an economic crisis or a serious political problem in China; however the Chinese leadership was seeking to increase the growth of the economy and improve the living standards. As mentioned before, there was not a certain reform program, instead new objectives were created as the old ones were achieved and the willingness to reform increased as the success came. The Chinese reforms have had pragmatic, incremental and experimentalist features since stability was more important than any objective and any dramatic change was avoided as the World Bank (1997b) mentions. The reforms were experimented in selected areas and if they provided successful consequences, they were implemented in other areas. If they did not work, they were abandoned so that their costs diminished. These features of the Chinese reforms have been observed in different reform areas such as agriculture, rural industry, opening the economy and state enterprises. The final factor that has contributed to the success of China according to the World Bank (1997b) is her initial conditions and they are discussed above.

3.4. Reforming the Economy

As a consequence of the reforms, China has managed to overcome most of the distortions of the central planning system and market forces began to have an important role in the economy as Harvie (1999) states. Although state intervention in the economy continued to be strong, it was reduced gradually which gave rise to the emergence of the non-state sector.[34] The production of the non-state sector constituted 60 percent of GNP in 1991 and 51.9 percent of total industrial output in 1992 (Gang, 1994: 4) and employment in the non-state sector reached 204.85 million in 1994 (Qian, 2003: 18). Being a product of market, non-state sector prevented the misallocation of resources and established the labor-intensive industries that were in line with the comparative advantage of the Chinese economy. Obviously, these changes in the Chinese economy that were seen as great improvements by a specific perspective do not mean that China did not experience any difficulties in this process.

3.4.1. Problems of China's Transition

Although China's successful experience of transition has impressed the world, there were ideological, economic and political problems of the reform process that the Communist Party leadership had to deal with at the beginning of the transition. The economic problems mainly stemmed from the partial and gradualist nature of reforms, specifically from the incompleteness of the reforms in the financial sector and state-owned enterprises (Harvie, 1999, Lin, Cai and Li, 1996).

Since the transition began, the weaknesses of the Chinese economy were caused by macroeconomic cycles and inflation turned out to be a problem as a consequence of these cycles. The weaknesses of the financial and banking sectors and the difficulties of restructuring SOEs were also among the macroeconomic problems of China during the transition. Problems of the political decentralization process have also played a role in the macroeconomic cycles. The imbalance between the central

[34] TVEs, the private enterprises, joint-venture enterprises, overseas Chinese enterprises and foreign enterprises constitute the non-state sector of China (Lin, Cai and Li, 1996: 23).

government and the local governments in economic decision-making in the late 1980s was among these problems. Harvie (1999) mentions that there was a lack of instruments for macroeconomic control and instead administrative instruments were used. Siackhachanh (2002) states that these macroeconomic problems of the Chinese economy mean that this pattern of high growth is not sustainable in the long-run. In addition to this, he points out that the economic growth has been maintained by massive input growth rather than productivity growth.

As another problem, income disparities increased between both rich and poor people and rural and urban areas, especially because of the uneven pattern of development caused by the special economic zones (SEZs) according to Harvie (1999). The World Bank (1997b) states that urban incomes are as much as four times rural incomes when the subsidies granted to urban residents are taken into consideration, which is a very high ratio in international standards. In addition to the preference of the coastal areas for the establishment of SEZs, the restrictions on labor mobility and the concentration of poor performing state enterprises in some rural areas have been among the causes of the increasing income disparities in China (Harvie, 1999: 1112). As a more general explanation, Qian and Weingast (1996) state that income disparity is a consequence of decentralization since it is expected that decentralization creates differences among regions.

Siackhachanh (2002) points out that the decrease in agricultural prices because of the surpluses in agriculture has played a role in the decline of rural income in the past years although the government adopted the policy of supporting the agricultural prices. In addition, rural residents have had to pay the charges and fees imposed by local governments, which have been risen rapidly and sometimes collected by officials for personal use. In addition to the problem of rising income disparities, the costs of food self-sufficiency have been rising in China according to the World Bank (1997b). The imports of agricultural products will increase as a consequence of WTO membership which is also a disadvantage for China's agricultural sector.

The World Bank (1996) states that some income disparity is expected at the beginning of transitions that would create incentives for efficiency and the role of the government to establish social safety nets that are suitable to market system is essential to diminish the damages of this problem.[35] If a system is established for transferring resources from rich provinces to poor provinces, richer ones would also benefit since the migration problem would be solved and new markets would be opened in the interior region (1997b). The Chinese government has put efforts to deal with the income disparity problem and its consequences. The announcement in 1993 of the aim of lifting the 50–60 million rural poor out of poverty by the year 2000 is an example of this effort as Harvie (1999) mentions. In response to the problem of income disparities between the regions, the government adopted some policies in order to improve rural income by reducing tax burden and supporting investment in some rural areas.

> …In particular, the government is planning to promote the economic development of 2,600 counties, which include about 30,000 to 50,000 townships, nationwide to create rural employment and attract foreign investment to the interior and rural regions. In addition, the authorities have earmarked CNY 530 bn (USD 63 bn) to build infrastructure for the western and central regions and CNY 230 bn (USD 28 bn) to expand agriculture irrigation systems and develop public utilities. To alleviate the local tax burden on farmers, the government will extend a pilot rural tax reform scheme implemented in Anhui to other provinces in order to prevent the protests by farmers and jobless rural workers from spreading…[36]

Finally, China has had to deal with the problem of increasing unemployment which has been one of the main causes of social unrest. As Siackhachanh (2002) points out, about 200 million workers are unemployed or underemployed in the rural areas according to the OECD estimates. The productivity gains in agriculture, growing labor force and the restrictions on labor movement have played a role in the rise of unemployment. It is also estimated that about 120 million workers have migrated illegally from rural areas to urban areas in order to search for jobs; however unemployment in urban areas has also been rising since the SOEs began to cut

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[35] World Bank (1996) states that social security meant a guaranteed job for working people and guaranteed land for people living in rural areas in pre-reform China. Most of the large rural families lived on pension support and poverty relief; however today's smaller families and labor mobility have changed the conditions.

[36] Siackhachanh N., *China 2020:Challenges Ahead*, Deutsche Bank Reseach, 2002, p.7-8

excess workers[37] (Siackhachanh, 2002: 7). Hence, generating new jobs turned out to be an important issue from the beginning of the reforms.

Siackhachanh (2002) states that the whole rural labor force was employed in agriculture in 1980 and they began to move to industry with higher wages, especially to TVEs, since the reforms began. About 13.6 million jobs were created in the early 1980s by TVEs; however TVEs have not expanded enough to absorb the surplus labor. About 8.1 million jobs were created annually by the TVEs in the 1990s and they are not able to create new jobs any more because of the credit tightening so that the problem of unemployment has not been solved (Siackhachanh, 2002: 6).

The Chinese government has adopted some measures against unemployment which had common objectives with the measures against the income disparity problem. These measures include increasing rural income and revising the restrictions on labor to allow movement between rural areas and small cities within the country (Siackhachanh, 2002: 7-8). In addition to these measures, it is also important to sustain the high growth of the economy at a rate enough to create new jobs. As a conclusion, China has had to achieve preserving the stability of the economic growth and reducing the unemployment while controlling the inflation and reforming the SOEs at the same time since the transition began (Harvie, 1999).

As mentioned above, Harvie (1999) states that the difficulties that have been faced during the reforms were caused by the problems of the gradual approach that mainly stemmed from the fact that many reforms have been incomplete. In addition to these, gradual approach may encourage corruption according to Harvie (1999), especially under the dual-track price system that there are both controlled prices and liberalized prices for identical products which will increase the likelihood of profit-seeking behaviour. Siackhachanh (2002) presents the other causes of corruption in China as the weakness of the legal system and its implementation and the dependency of the judical organs on political entities by funding.

[37] The migration of workers was illegal because the *hukou* system that was adopted in 1958 and became hereditary, restricts rural residents' movement from their birthplace (Siackhachanh, 2002: 6).

> Like many transition economies, China is confronted with corruption. According to official figures published in January 2002, the Communist Party of China (CPC) prosecuted 175,000 of its own members for corruption in 2001, which is 30% higher than in 2000. Not only cases involving lower-level CPC members, but also those related to senior officials are on the rise. Corruption is rife in all areas of business. According to a staff estimate of the International Finance Corporation in Beijing, about 80% of first-generation managers in securities business are serving time in jail for fraud.[38]

As another interpretation, Gang (1994) states that rent-seeking may have positive consequences under dual-track mechanism that the reduction of the planning system's control may extend the scope of the market and contribute to the emergence of the non-state sector. This interpratation is similar to the interpretation of crony capitalism by Kang (2002) that is presented in Chapter 2.[39] On the other hand, there are obviously better ways of extending the scope of the market such as strengthening the legal framework on transferring property rights.

> …Moreover, corruption may work against reform in several ways. It may block the evolution of the economy toward a one-track system by perpetuating the dual track. The positive effects of marketization may be offset by the higher transaction costs caused by corruption. Officials accruing to corrupt officials, the chance of political instability may actually be heightened. Finally, corruption undermines the building of an effective legal system. In sum, while corruption is not totally bad, it does adversely affect economic reform.[40]

In addition to the efficiency loss, corruption may also cause social instability as the jobless workers protest not only the failure of the government to provide social safety nets but also official corruption. It happened in the northern industrial rustbelt region of China where unemployment is higher than the rest of the country (Siackhachanh, 2002: 9). Hence, the Chinese government has had to take measures also against corruption.[41]

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[38] Siackhachanh N., *China 2020:Challenges Ahead*, Deutsche Bank Research, 2002, p.9

[39] It should be noted that, there has been no relationship between the government and the private sector in China as in the East Asian economies; however the corruption took place in the state sector where the top managers were appointed by the Communist Party.

[40] Gang F., *China's "Dual-Track Transition" Toward the Market: Achievements and Problems*, The 1990 Institute August, 1994, p.4

[41] In addition to corruption, World Bank (1996) emphasizes the importance of measures against private organized crime that have risen in transition economies because of uncertainities in property rights and other legal procedures.

It is announced that the functions of revenue management and expenditure management will be separated in all public institutions in order to prevent corruption and the other functions of these institutions will be simplified and made transparent. Also, a plan has been developed by the Supreme People's Court for independent funding of the judiciary (Siackhachanh, 2002: 10). Although there have been considerable efforts, it will take some time for China to establish the legal and regulatory framework that will manage to prevent corruption as Siackhachanh (2002) mentions. In addition to the measures against corruption, the World Bank (1996) states that strengthening the whole legal system by means of designing good laws and implementing them effectively is one of the most important institutional reforms in transition economies.

In order to achieve the transition and also in response to the problems of the transition mentioned above that were faced during the transition, China has implemented economic reforms in different policy areas which were complemented by the gradual political reforms. Obviously, the most impressing changes in China occurred as consequences of the decentralization and open-door policy. After the adoption of these policies, the other reforms followed each other. Township and village enterprises were established and gained a significant role in the Chinese economy by the help of the increasing local power as a consequence of decentralization. The open-door policy created the necessity to reform the financial and banking sectors which were accompanied by fiscal reforms. Reforming state enterprises has constituted an important part of China's reform agenda; however has turned out to be a difficult task for China among a number of reforms that has been implemented since the beginning of the transition. It is possible to see this difficulty as the presence of an undesirable part of the central planning system as most of the authors do. On the other hand, a more reasonable way to criticize SOEs is to mention their burden on the economy such as increasing non-performing loans. The efforts of China in reforming SOEs will be presented at the end of this chapter.

3.4.2. Opening the Economy

Open-door policy has been one of the most frequently used terms regarding the global economy. As a definition this term refers to the equal trading rights among countries.[42] There is an agreement in the literature that adoption of the open-door policy since 1978 has played a significant role in China's success which is a common feature of China's reform strategy with the development strategies of the East Asian economies. First steps that had taken according to this policy were that the foreign trade plans were abolished, the reliance on a few foreign trade corporations which were owned and controlled by the Ministry of Foreign Trade was abandoned and local foreign trade corporations with the power of controlling trade operations were established within a few years (Zhu, 2003, World Bank, 1997). The World Bank (1997b) states that procurement targets for 3000 export products were set in the central plan until 1979; however this target was reduced to 100 by 1985 and there are no targets today. Hence, the first stage of opening the Chinese economy was the decentralization of foreign trade. The next stage was easing the protectionist policies. Although non-tariff barriers remained, the tariffs on imports have been lowered and according to Lardy (2003) indirect taxes that reduced the profitability of exporting were rebated in 1984.[43] In addition, foreign investors were encouraged to establish joint-ventures in China (Qian and Weingast, 1996: 15).

According to the literature on this issue, the open-door policy brought its consequences to the Chinese economy immediately. World Bank (1997b) states that the value of the Chinese exports and imports as a share of GDP tripled between 1978 and 1995 and the trade volume increased from 36 billion dollars to 300 billion dollars in this period. In other words, the openness of China which is measured by the percentage of total trade to GDP, increased from 17 percent in 1978 to about 40 percent in the mid-1990s (Galbraith and Lu, 2000: 10). Also, the point that the commodity composition of China's foreign trade has changed since the transition

[42] This definition is found in http://www.geocites.com and faced in some articles.

[43] Lardy (2003) mentions that "duty drawback system" which was formalized in the second half of 1980s purposed to reduce the costs of imported raw materials and intermediate goods that are used for the production of exports so that the export processing takes place at world prices without restrictions.

began is strongly stressed. As Lardy (2003) states, China's export growth became increasingly concentrated in labor-intensive manufactured products in which China has a comparative advantage.[44]

As the most important policy change, open-door policy required taking steps for liberalizing the trade and according to the literature there have been considerable efforts in China to lower trade restrictions and protectionist policies as mentioned above. Where tariffs, quotas and licensing had been the instruments of China under central planning to protect the domestic industry from imports, lowering tariff rates, easing non-tariff barriers and expanding foreign trading rights have turned out to be among the reforms for trade liberalization (Harvie, 1999: 1109). As the World Bank (1997b) states, China announced that it would lower tariffs on a number of goods at the November 1995 meeting of The Asian-Pacific Economic Corporation (APEC) and further cuts were announced at the next year's meeting of APEC. In addition to these, the World Bank (1997b) mentions that the tariffs have been lowered further after the WTO membership. On the other hand, further reforms are needed to establish a liberal and open trade regime in China (Harvie, 1999, World Bank, 1997).

The World Bank (1997b) states that China has experienced some problems during the trade liberalization process and took some measures in the Ninth Five Year Plan and Fifteen-Year Perspective Plan. Although its benefits were obviously seen, it was recognized that further trade liberalization would bring some difficulties to domestic industry, especially to industries that are dominated by the state ownership. The adjustments to deal with these difficulties may temporarily increase unemployment and weaken the banking system according to the World Bank (1997b). Hence, the reforms on liberalizing the trade should have been accompanied by other reforms in the economy. Achieving trade liberalization is important for China because the benefits of trade liberalization in the long-run outweigh its costs in the short-run although it is a process that includes a number of risks according to the World Bank (1997b).

[44] Labor-intensive manufactures of textiles, apparel, footwear and toys have been the fastest growing exports of China. Their exports rose from US dollars 4.3 billion to US dollars 53.5 billion between 1980 and 1998. Also, half of the foreign direct investment has been received by the manufacturing sector where the restrictions on foreign investment have been few (Lardy, 2003: 8-9).

According to Galbraith and Lu (2000), the open-door policy consists of two types of policy change that are opening the geographic regions to foreign investment and opening of specific institutions nationwide. They state that geographic opening began in 1979 in China with giving privileges to some provinces and came to the 1990s with the establishment of SEZs which are explained below. On the other side, Galbraith and Lu (2000) state that the institutional opening has been slower than geographical opening; however the following changes have occurred:

> With respect to trade: China has implemented a progressive decentralization of its foreign trading system, a system of export tax refunds, and it has applied the corporate system to foreign trading companies. Later, an export promotion policy was launched, including further decentralization, introducing the market system into foreign trade, and reform of the foreign exchange system. The Chinese currency became convertible under current account, non-tariff barriers have been cut (reducing import quotas and shorten control list), and tariffs reduced. Most recently, of course, China has been negotiating its entry into the WTO, and further major reductions of tariffs and trade barriers are in prospect.[45]

In addition to the growth of exports, Chinese reforms in the way of increasing the openness of the economy and the effect of Deng's trip to the South in 1992 which purposed to accelerate the growth of the economy and emphasized the importance of open-door policy has given rise to the rapid growth of foreign direct investment (FDI). An important share of FDI flows to China has come from the Chinese diaspora in Hong Kong, Singapore and Taiwan (World Bank, 1997b: 90).

Table 3.3: FDI Inflows (Millions of US dollars)

	1990-2000	2002	2003	2004	2005
China	30 104	52 743	53 505	60 630	72 406
United States	109 513	74 457	53 146	122 377	99 443
East Asia	48 777	67 350	72 174	105 074	118 192
Developing Economies	134 670	163 583	175 138	275 032	334 285
World	495 391	617 732	557 869	710 755	916 277

1990-2000 data indicate the annual averages.

Source: UNCTAD, *World Investment Report 2006*, www.unctad.org

45 Galbraith J.K., Lu J., Sustainable Development and Open-Door Policy in China, UTIP Working Paper Number 16, 2000, p.9-10

FDI has had an important role in China's stable economic growth.[46] According to the World Bank (1997b), 40 percent of FDI to developing countries flows to China. When the fact that China attracted almost no FDI before 1979 is considered, net inflows of 38 billion dollars by 1995 is an achievement that deserves admiration.[47] In Table 2.3 which is taken from UNCTAD, *World Investment Report 2006* FDI inflows to China are given. In addition FDI inflows to the United States, East Asia, developing countries and in the world are included so that there is a chance to make a comparison. It is remarkable that FDI inflows of China outweigh inflows to the United States in 2003. In addition to FDI inflows, cross border sales of bonds and equities have increased sharply and reached 30 percent of total inflows in the second half of the 1990s although FDI is still the biggest component of private capital flows (World Bank, 1997b: 92). The World Bank (1997b) states that China would face some difficulties in sustaining the FDI flows, because of this reason achieving macroeconomic stability gains significance as it is the case observed in other emerging markets.

Qian (2003) points out a misperception about China as it is generally stated that FDI and exports, hence foreigners and foreign markets, have been the driving force of the Chinese economic growth. He points out the fact that foreign trade and investment do not contribute to the large countries as much as they do to small countries, hence states that the role of exports and FDI in China's success have been overstated. Qian (2003) also states that the Chinese economic growth was not caused by only coastal areas but inland areas which neither received much FDI nor have a remarkable exporting activity also have taken place in this process. He concludes that internal changes which contributed the process of opening the economy have given rise to exports and FDI rather than the reverse. In other words, the success of opening the economy depends on how the economy has transformed.

The World Bank (1997b) states that the reforms in exchange rate system have contributed greatly to the process of opening the Chinese economy by the help of

[46] Yao and Zhang (2003) state that FDI, exports and GDP growth form a circular relationship that FDI inflows and exports stimulate GDP growth which attracts more FDI and enhance export push strategy.

[47] In 1983, the total amount of FDI inflows to China was only US dollars 0.64 billion but reached to US dollars 4.37 billion by 1991. (Yao and Zhang, 2003)

government's realistic exchange rate policy. Yao and Zhang (2003) point out that China would not have been able to promote trade and attract foreign capital without moving to the world exchange rate. The national currency of China, the Renminbi (RMB), was unconvertible and overvalued persistently until the reforms began which hindered international trade and foreign investment. RMB has been gradually devalued after 1979 which made the Chinese market attractive for foreign investors. From 1978 to 1995, RMB has been devalued by almost 400 percent (Yao and Zhang, 2003: 82).

The dual exchange rate mechanism was adopted in the late 1980s that the government established a few official swap markets as an official channel to allow investors to change foreign currencies into RMB at a higher rate than the official exchange rate (Yao and Zhang, 2003: 81). In 1985, a "foreign exchange adjustment center" was established in Shenzen where enterprises could trade foreign exchanges at negotiated prices and other centers that were similar to this one were established in other provinces in the following years (Lin, Cai and Li, 1996: 12). As the foreign exchange reserves increased, dual exchange rate mechanism was abolished in 1994 and the exchange rate was unified.

Current account convertibility was established in 1996 and restrictions on payments for current transactions, even the non-trade ones, were removed (Harvie, 1999: 1109). The World Bank (1997b) states that the exporters were allowed to keep a portion of their foreign exchange earnings and imports were liberalized as the government supported the development of foreign exchange markets. The right to hold foreign exchange was given to individuals. These liberalizations in the foreign exchange market meant that the central bank was not the monopoly of foreign exchange transactions any more as the World Bank (1997b) mentions. More importantly, the reforms in the exchange rate system provided China a strong external position which has been reflected in a sharp increase in the international reserves (Harvie, 1999: 1109).

The establishment of the special economic zones (SEZs) for the purpose of attracting foreign investment was also among the most significant reforms since they have played an important role in the development of the Chinese trade and the increase of foreign direct investment. The World Bank (1997b) points out that SEZs became attractive to foreign investors since they offered fiscal, infrastructural and financial incentives. Sachs and Woo (1997) state that SEZs were given the autonomy to experiment with new institutions, especially which are related to the international economy and SOEs within SEZs were exempted from the central plan and many other regulations. Qian and Weingast (1996) state that SEZs were allowed to become market economies dominated by private ownership whereas the other regions of the country were still dominated by central planning and public ownership. As a consequence of their advantages, FDI to China has been concentrated in SEZs that nine coastal provinces and three municipalities have received more than 85 percent of the total inflows since the reforms began (World Bank, 1997b: 90).

The rise of FDI inflows is another common feature of China and the East Asian economies. On the other hand, Yao and Zhang (2003) mention that the history of FDI is much shorter in China when compared to the East Asian economies and unlike these economies the inflows to China have been concentrated in SEZs that are in eastern coastal provinces which is an important cause of increasing income disparities between the regions. For instance, 88 percent of total FDI flew to the eastern region where Guangdong alone received 27 percent of the total in 1995.

At the beginning, four SEZs were established at the coastal areas and another one was added in 1980.[48] Sachs and Woo (1997) state that the restriction of the economy's opening to particular geographical regions was one of the outcomes of China's gradual approach. They point out that other regions demanded the same privileges as they observed the development of SEZs. More than 9,000 SEZs had been established by 1993 as their success was seen (World Bank, 1997b: 11).

There were specific reasons that the coastal areas were chosen for the establishment of SEZs at the beginning. Yao and Zhang (2003) point out these resons as their more

[48] Qian and Weingast (1996) state that Guangdong and Fujian were the initial examples of regional experimentation that they were given some privileges in 1979 such as preserving 30 percent of foreign exchange earnings from increase in exports. Later, the first four SEZs were established in Shenzen, Zhuhai, Shantou in Guangdong, Xiamen in Fujian.

productive basis of agriculture and industry, more efficient transportation system, better environmental and human resources and most importantly closeness to the China's largest investors, especially to Hong Kong. On the other hand, Goodman (1994) states that Deng proposed Guangdong and Fujian provinces for the establishment of SEZs not only because of their closeness to Hong Kong and Taiwan but because they have "historically acted as China's gateways to the rest of the world". Goodman (1994) also mentions that there was an intention to capture any negative impacts of foreign technology in these areas by setting SEZs in restricted regions.

Another issue is that there is obviously a need to control external borrowing while opening the economy, especially short-term debt must be remained manageable although China has the advantage of a large amount of foreign exchange reserves. It should be remembered that the short-term external debt has been the source of many financial crises as it was in the Asian crisis. China's external debt reached about 130 billion dollars by the end of 1996 since the economy has been able to borrow more as its creditworthiness increased (World Bank, 1997b: 91). In order to avoid the risks, the World Bank (1997b) suggests China some measures on external borrowing. According to these suggestions, state enterprises should be subject to new criteria when borrowing abroad and also they should use international accounting and auditing systems.

The issue of financial integration has also been very important for the emerging markets. The World Bank (1997b) mentions that financial integration would bring a number of benefits to China that competition from foreign banks could promote the efficiency of domestic banks and portfolio inflows could increase liquidity in capital markets and contribute to the improvement of the market. On the other hand, China also has to overcome a number of difficulties that would rise by the financial integration process. As an example of problems that may be experienced at the beginning, the World Bank (1997b) mentions that domestic banks could experience problems with the new instruments that they have to use because they are not familiar to these instruments. More importantly, the increasing competition may cause lending to less creditworthy clients by domestic banks according to the World

Bank (1997b). If strict measures are not taken in order to strengthen the financial sector, more serious problems would be experienced. The risks of a weak financial sector are known by the experiences of other emerging markets and the wide literature on these experiences.

Although the literature on this issue emphasizes that it is not completed, China's success on opening the economy by gradual reforms should not be undervalued. As mentioned above, China's share in world markets nearly tripled in less than two decades and China became the largest recipient of FDI among the developing countries. According to Yao and Zhang (2003), China became the world's ninth largest trading economy in 1999 where it was 23rd in 1978 and achieved the highest growth rates of GDP and exports among the APEC countries in the period 1990-1995. From 1994 to 2005, China's exports increased from US dollars 120 billion to US dollars 762 billion (Liu and Ng, 2006: 5). The common point in literature is that it is obvious that the entry to WTO in 2001 has contributed and accelerated the process of integration to the international trade of China.

According to Lin (2004b), the WTO accession is consistent with China's goal of establishing a socialist market economy. It will help China to solve the problems of the economy. China will establish institutions for forming a correct relative price according to the WTO principles. The SOE problem will be solved by preventing the discrimination policies of the government and big SOEs will have the opportunity of being reformed. Transparency principle of WTO will require stable and predictable economic management and policies. In addition to these, local protectionism will be prevented (Lin, 2004b: 22-3).

According to Lin (2004b), the most significant influence of WTO accession is the transformation of the government's role and China has made some reforms on the functions of government since 2003 in order to meet WTO requirements. In industrial policy, the government can no longer rely on direct controls and administrative measures, only indirect measures can be used. The industrial structure will change greatly by WTO accession that the labour-intensive industry will grow rapidly in line with China's comparative advantage. On the side of the trade policy, it is evident that tariff reductions are required. The government should make trade policy transparent and assure that policies are uniformly implemented. The dominance of SOEs in the rights of importing and exporting has been changing. In addition, there will be disputes within WTO framework for mechanisms to deal with anti-dumping accusations (Lin, 2004b: 26-7)

WTO accession will bring improvements to the taxation system. More importantly, accession requires from China to amend or abolish the existing laws and regulations inherited from the central planning system which are inconsistent with WTO framework according to Lin (2004b). The description of Lin (2004b) is another example of the literature which is certain that the main purpose of China has been adopting the market-oriented economy fully and this process has been accelerated. Unfortunately, any other view opposing this description of China after WTO accession could not be found within the literature.

In line with this view, Lardy (2003) states that WTO accession indicated its initial consequences that the average tariff rate of 56 percent in 1982 was reduced to 15 percent by 2001. The share of imports with licensing requirements fell from 46 percent in the late 1980s to fewer than 4 percent of all commodities. Import substitution lists were abolished and the number of trading companies increased considerably (p.6).

In addition to these indicators, the open-door policy has enabled China to gain access to a variety of intermediate products, capital equipment, foreign technology and knowledge through FDI according to World Bank (1997b). Lardy (2003) states that China's integration to the world economy dramatically increased competition in domestic market and this competition has had an important role in the transformation of the economy, especially the state sector. As a conclusion, China replaced the inward-looking strategy by the export-oriented strategy and the principle of self-reliance by the advantage of foreign technologies and international business practices (Yao and Zhang, 2003: 72).

The opening of the Chinese economy has not only given rise to domestic competition, but also has made China enter the international competition. From the perspective of the international economic order, it is hard to claim that the other economies of the world have welcomed China. They have seen China's growth as a damaging factor to their economies, especially to their exports and FDI inflows. The impact of China on the East Asian economies will be discussed in Chapter 4. The World Bank (1997b) states that China's integration to the world economy which is predicted to continue will not be a threat instead will provide a mutual benefit to China and the world. According to Lin (2004a), the economic development of China contributed to the world economy as well as increasing the welfare of Chinese people.

It is worth to ask why China preferred to open her economy. It is obvious that she has insisted and put efforts on this goal so that she became this much successful. Predicting the neoclassical answer to this question is not difficult since the success of the strategy as they call open-door policy is their main evidence of China's willingness to establish a market-oriented economy. First, it is a question whether an open economy is enough to talk about a market-oriented economy. In the next sections, it will be seen that China has preserved important features of the central planning system. Second, if open-door policy means treating equally in international trade, China as an implementer of this policy should have been doing this. Although there is not a search on this issue within this thesis, it seems to be not possible in this complex environment of international political and economic order.

3.4.3. Decentralization

Transition to a market-oriented economy requires the elimination of the monopoly of the central government in the economy that is achieved by economic and political decentralization. The Chinese decentralization has purposed to create a market where there was a strong political resistance to economic reform and Qian and Weingast (1996) mention that the Chinese style decentralization has succeeded to overcome political opposition. Decentralization of economic policy-making has been the key of China's achievement by "enhancing the durability of economic policies, allowing economic reforms to live beyond the particular political leaders who initiated them" (Qian and Weingast, 1996: 10). For instance, the reforms on opening the economy that are mentioned above succeeded by the help of the environment provided by the measures taken for the political and economic decentralization. These are the dominant views in the literature on China's decentralization and its impact on the transition. On the other side, it should be remembered that decentralization did not mean that the central government has given up dealing with the economy. The central government has maintained its role in the economy by deciding who should have the right of economic policy-making.

> The critical component of China's market-oriented reform, which began in 1979, is decentralization. Three components set this decentralization apart from previous ones. First, it also encompassed considerable transfer of authority from the government to households and enterprises; second, it encompasses marketization; and third, it included opening China to the outside...[49]

In addition to the reforms in the way of opening the Chinese economy, there have been reforms in agriculture and industry that have also been the outcomes of the political and economic decentralization. According to the World Bank (1997b), the introduction of agricultural reforms was the first step of the growth process that has transformed China. The "household responsibility system" was the most important part of China's agricultural reform which assigned collectively owned land to households for up to fifteen years according to the World Bank (1997b). The peasants undertook the responsibility to produce a given output which the state guaranteed to purchase by contract under this system as Goodman (1994) states. This system was banned at the beginning by the central government because it was found to be responsible for transferring profits and production decisions from communes to households; however it has been encouraged by local governments and the central government signaled an approval to this system in 1981 (World Bank, 1997b: 9).

In addition to the introduction of the household responsibility system, the system of unified procurement prices in agriculture was abolished and agricultural prices were raised as Zhu (2003) states. Farmers were allowed to sell their products that were

[49] Qian Y., Weingast B.R., *China's Transition to Markets: Market-Preserving Federalism, Chinese Style*, Journal of Policy Reform, 1996, p.14

above the quota at market prices, grain quotas were lowered, grain imports were increased, restrictions on private trade between provinces were eased and special programs for increasing cotton production were introduced (World Bank, 1997b: 9). According to Qian (2003), state's procurement of grains remained fixed which were 47.8 million tons and 50.5 million tons in 1978 and 1988 respectively where total production in the economy increased from 304,8 million tons to 394.1 million tons. These reforms meant that the transfer of resources from the agricultural sector to the industrial sector at low prices by the state became harder as Zhu (2003) points out.

On the side of the industrial sector, the control of the plan on the industry and industrial products diminished considerably. SOEs were allowed to sell their output that exceeds the planned quantity at negotiated prices (Zhu, 2003: 4). The number of key industrial products under direct control of the State Planning Commission had decreased from 120 to 60 since 1986 and the share of industrial products with output targets decreased from 40 percent to 20 percent (Minami, 1994: 20). In addition, the number of goods and materials distributed by the state decreased from 256 to 20 and commodities controlled by the plan decreased from 188 to 25 (Minami, 1994: 20).

There are also pessimistic approaches to China's agricultural reforms. Sachs and Woo (1997) state that reforms in agriculture are another reflection of China's gradual reforms that the end of commune system provided productivity gains on the one side and the lack of private ownership of land prevented reforms on the other side. They also point out that the improvements in agriculture slowed down after 1985 and mention three factors of this stagnation. First, the farmers have been uncertain about the future of land since the private ownership of land has not been well-defined. Second, the rise of agricultural procurement prices lagged behind input prices. Finally, investments in agricultural infrastructure have been decreased.[50] As a conclusion, China could not continue the productivity gains of agriculture that were observed at the beginning of the transition because of the partial nature of reforms according to Sachs and Woo (1997).

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[50] Sachs and Woo (1997) state that the level of investment in agricultural infrastructure in 1994 was only 58 percent of the 1979 level.

On the other hand, Harvie (1999) mentions that China's initial focus on agriculture at the beginning of the transition is an important lesson that should be derived from its experience of transition. This means that it was a good strategy for China to start the transition process from the sector that it had a comparative advantage. The Chinese government has put efforts on strengthening agriculture because its importance in the economy has continued although the labor force has moved to industry and also it was understood that agricultural growth would improve rural areas, especially poor counties.

By the help of the reforms in the agricultural sector, China achieved improvements in productivity through resource reallocation so that output and rural income increased and rural savings and funds provided investment for the establishment of township and village enterprises (Harvie, 1999: 1106). The reforms in the industrial sector have followed these achievements by the mid-1980s. In the 1980s, the structure of capital accumulation had changed in the Chinese economy that agriculture and light industry did not fund heavy industry and the state's dominance in capital circulation did not continue any more according to Minami (1994). Qian (2003) points out that there has been another misperception about China which is viewing the agricultural reforms at the beginning of the transition as the only success of China. In response to this view, Qian (2003) mentions that China is not a poor agricultural country any more and indicated its success outside the agricultural sector.

Table 3.4: The Shares and Growth Rates of Sectors of the Chinese Economy

	Percentage of GDP				Average annual growth rate (%)			
	1984	1994	2003	2004	1984-94	1994-04	2003	2004
Agriculture	32	20.2	14.6	15.2	4	3.3	2.5	6.3
Industry	43.3	47.8	52.2	52.9	12.3	10	12.7	11.1
Manufacturing	35.5	34.4	36.7	37.3	11.7	10.1	14.9	13.2
Services	24.7	31.9	33.2	31.9	9.8	8.2	7.3	8.3

Source: http://www.worldbank.org

As it is mentioned before, China has an advantage of huge, qualified and cheap labor force. Glyn (2006) states that total employment in China is estimated to be around 750 million which is about one and a half times of all rich economies and nearly ten times the total employment of Japan and Korea. He mentions that this fact has been one of the factors that have played a role in low wages of the Chinese labor.[51] In the pre-reform period, workers were assigned to industrial enterprises, received national wages and benefited from favorable retirement conditions that were under the guarantee of the socialist system. One of the important consequences of the reforms in the Chinese industrial sector is that the labor market has been gradually formed. The autonomy of township and village enterprises in rural areas and private enterprises in urban areas to hire their workers and determine their wages played a role in this process.

The reforms in the Chinese economy that are mentioned above are all consequences of political and economic decentralization. This process gave rise to the development of economic actors other than the central government. Zhu (2003) states that local governments has benefited mostly from decentralization. Central government introduced the centre-local revenue sharing system in 1980 that local governments had a large fixed share and they were made responsible for their own budgeting which was a significant step to increase the autonomy of local governments. Local governments were also allowed to keep the entire extra-budgetary revenues.[52] In addition to these, local governments gradually gained some rights over material allocation, investment, bank loans and foreign trade in the following years as a consequence of decentralization (Zhu, 2003: 5). These developments induced the increase of local power and contributed to the emergence of the township and village enterprises (TVEs) which have been controlled by local governments.[53] These collective enterprises have constituted a significant part in the development of local governments and the growth of the Chinese economy.

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[51] Glyn (2006) mentions that wages in manufacturing sector of China are still 3 percent of the US level.

[52] Qian andWeingast (1996) define extra-budgetary funds as the funds that include certain categories of revenues retained by the ministries of the central government and local governments. They also mention that extra-budgetary revenues give incentives to local governments because they are easier to hide from the central government and can be used more flexibly.

[53] Sachs and Woo (1997) state that the control of TVEs by local governments rather than purely private owners was also a consequence of China's gradual approach.

In addition to their contribution to the growth of the economy, local governments have also played a significant role in the political process of the transition as they became a new source of state capacity under the new conditions of economic openness and decentralization (Zhu, 2003: 8). One of the consequences of the Chinese decentralization was the reduction of state capacity since the pre-reform state capacity was based on the centralization of economic resources and complete control over foreign trade and investment. The reduction in resources that are controlled by the state, easing the controls over foreign trade and investment as a consequence of open-door policy and the increase in local power weakened the state capacity in China (Zhu, 2003: 5). In these conditions, local governments turned out to be one of the instruments of state capacity although the conflict between the central government and local governments that will be mentioned later caused some problems.

In addition to its consequences, the general features of the Chinese decentralization should be mentioned. Qian and Weingast (1996) term the Chinese style of decentralization as "market-preserving federalism" that they define as a vertical separation of political powers. Qian and Weingast (1996) state that the most important implication of the market-preserving federalism is the competition among local governments where none of the governments has been a monopoly in the economy. This competition has extended the factors of production as a consequence of the hospitable environment provided by the local governments in order to be more attractive.

As another consequence of market-preserving federalism, Qian and Weingast (1996) mention that decentralization provides a diversity of policy choices and experiments and their feedback which is important since the interests and expectations of people in different jurisdictions are different. Also, local governments face hard budget constraints as a consequence of decentralization which brought incentives of proper fiscal management. Most importantly, market-preserving federalism provides the political foundations for markets as the economic responsibility is given to local governments so that political interventions to the market diminish as Qian and Weingast (1996) emphasize.

3.4.4. Township and Village Enterprises

In order to understand the Chinese reform process, the role of township and village enterprises (TVEs) has to be investigated according to Qian (2003). As mentioned above, one of the most important consequences of the increasing local power in China has been the establishment of TVEs which have been recognized by their success and increasing share in the economy. [54] TVEs are non-state enterprises; however they are not private enterprises with clear private owners (Sachs and Woo, 1997: 33).[55] Qian (2003) mentions that TVEs played a role in efficiency improvement in an environment where property rights were not secure. With this features, TVEs are unique to China and their system should have been an example to other transition economies in terms of indicating the importance of entry to liberal markets, competition, enterprises operating under hard budget constraints and increasing the incentives of local governments (Harvie, 1999: 1114).

The role of TVEs in China's economic success has been considerable that 26.6 percent of China's total industrial output was produced by TVEs in 1991 and 44 percent in 1996. The main point is that TVEs challenged the monopoly of SOEs that the share of SOEs in total industrial output fell from nearly 80 percent in 1978 to 57 percent in 1988, which also meant that state's revenue from industry was reduced (Zhu, 2003: 5). In addition to their contribution to the industrial production, TVEs have created about 100 million new jobs since the beginning of the transition (Harvie, 1999: 1114). More than 24.2 percent of the rural labor force worked in TVEs by the end of 1992 (Gang, 1994: 3). In addition, the after-tax profits of TVEs were used for reinvestment and local public goods by central government. In 1985 and 1992 respectively, 46 percent and 59 percent of after-tax profits of TVEs were reinvested and 49 percent and 40 percent were used for local public expenditures (Qian, 2003: 22). In addition, Zhu (2003) states that the connection of TVEs to the

[54] The root of TVEs is the agricultural commune system that was established in 1958 (Qian, 2003: 25).

[55] Qian and Weingast (1996) state that they are owned by township and village communities and Sachs and Woo (1997) point out that there are different types of TVEs that have faced different levels of control by local governments.

international markets, especially in coastal areas, have had an important role in their success and China’s economic growth. The contributions of TVEs to exporting and attracting foreign direct investment have been remarkable.[56]

TVEs have also contributed to the development of the local governments as mentioned above. On the other side, their success was mainly due to the supports of the local governments. TVEs were promoted by the local governments since they contributed to both local government revenues and extra-budgetary revenues as Zhu (2003) mentions. In addition to this, the central government granted subsidies and easy access to inputs and loans to the exporting firms as in the case of East Asian economies, hence local governments had an incentive to promote exporting and attract FDI. In this sense, trade offices were established under local governments as mentioned before and local governments used different instruments in order to give incentives to the export-oriented TVEs (Zhu, 2003: 7). Local governments were also allowed to use some policies such as granting tax breaks in order to attract foreign investment. According to Zhu (2003), these features explain the fact that many investors feel that China is more open to foreign direct investment than countries like Japan or Korea which have strict controls on local authorities. Although they have had favorable conditions, TVEs have faced hard budget constraints which is one of the most important features that separate TVEs and SOEs (Qian and Weingast, 1996: 19).

By quoting from Oi (1992 and 1999), Zhu (2003) identifies the behavior of the Chinese local governments as ‘local state corporatism’ to describe their interventionist feature and mentions that this intervention was different from the mechanism of the central planning system. Local governments have not granted subsidies to all enterprises equally, instead specific enterprises have been promoted as a consequence of export-oriented growth strategy that this selective strategy is another similarity with the strategies of the East Asian economies.

The experimentalist school views TVEs as a successful institutional innovation while the convergence school views them only as a way to real private ownership

[56] For instance, their share in total exports was 36 percent in 1996 (Zhu, 2003: 7).

according to Sachs and Woo (1997). TVEs are suitable to undeveloped economic conditions of China according to the experimentalist school; however the convergence school mentions that there is an immediate need to the privatization of TVEs (Sachs and Woo, 1997: 33-34). [57] There are two main considerations for not privatizing TVEs according to the convergence school. First, private ownership had been prohibited in many areas until recently. Second, the collective ownership reflects the low mobility of labor in China. From moving this point, the convergence school states that market failures in the Chinese economy are created by the state in response to the claim of the experimentalists that market failures stemmed from undeveloped market conditions and TVEs are the institutions that fit these conditions well according to Sachs and Woo (1997).

Although the two schools have different explanations about TVEs, they both agree on the future of these collective enterprises that their role in the Chinese economy will decrease as Sachs and Woo (1997) mention. The collective ownership has given rise to some problems. This form of ownership causes political interventions in local governments; defeats risk diversification, limits the scale of operations of the enterprise and limits the market for managerial control (Sachs and Woo, 1997: 40-41). Hence, the privatization of TVEs was seen as a necessity for the Chinese economy on the one hand and it would have been the natural consequence of the transition to a market economy on the other hand.

It is obvious that TVEs experienced more favorable conditions than private enterprises. Qian (2003) states that private sector was underdeveloped because of the absence of legal protection and they were attacked by the state in the periods of political problems. On the other hand, TVEs had more secure property rights in an environment where these rights were not defined. This period came to an end and TVEs were privatized in the late 1990s according to Qian (2003). The fact that private firms became more important in the economy and the decline in the profitability of TVEs has played a role in this decision. In addition, local governments encouraged the privatization of TVEs since they were allowed to keep

[57] Sachs and Woo (1997) point out that small enterprises in East Asian countries are private.

privatization revenues (Qian, 2003: 41). Despite these factors that gave rise to their privatization, the contributions of TVEs to the reform cannot be ignored.[58]

3.4.5. Recentralization

The decline in state capacity that is mentioned above caused some problems in the Chinese economy in the late 1980s that stemmed from the fact that the state was in difficulty in dealing with the new economic conditions of the transition, for instance the state lacked the fiscal and monetary instruments that served the needs of the new economic system according to Zhu (2003). In addition to this, Zhu (2003) states that the strong local governments, which have been part of the state capacity as a consequence of the transition, caused some problems although their contribution to the growth of the economy has been significant. Competition among these local governments and lack of central control gave rise to macroeconomic problems. [59] The main problem was the sharp increase in investment and inflation in the late 1980s that put pressure on the Chinese economy and the transition process.[60] The increases in wages, the prices of agricultural commodities and money supply also played a role in the rise of inflation according to Minami (1994).

> Because the source of funds for enterprises' investment in equipment shifted from government expenditure to bank loans, bank loans to enterprises started to increase after 1984, especially after 1986, and they increased more rapidly than funds deposited by enterprises in banks. This rapid increase in the money supply caused inflation.[61]

Investment increased dramatically that average investment ratio in the period of 1984–1989 was 34 percent which was high in international standards (Zhu, 2003: 5).

[58] Qian (2003) states that the privatization of TVEs accelerated in 1998 since private sector was emphasized as "an important component" of the economy in the Chinese Constitution by an amendment.

[59] Some of the local governments, especially the ones specialized in manufacturing goods became protectionist that is termed as "dukedom economies" (Qian and Weingast, 1996: 2).

[60] Minami (1994) states that the prices increased by an average of 6.2 percent; however he states that the government was not objective in the process of collecting statistics which means that the inflation could be higher than the rates given by official statistics.

[61] Minami R., *The Economic Development of China, A Comparison with the Japanese Experience*, St. Martin's Pres, 1994, p.183

Lin, Cai and Li (1996) state that the right of credit approval given to local banks caused rapid expansion of credits in 1984 and the money supply increased 49.7 percent from 1983 to 1984. The increase in investment gave rise to inflation that the inflation rate reached 18.5 percent in 1988.[62] Although the real growth rate of the economy was 11.5 percent, there was a signal of an economic crisis in China in 1988 that turned out to be the cause of social unrest in the following year (Zhu, 2003: 5). In response to these economic problems, the student demonstrations in 1989 in Tiananmen Square put the leaders of the Party in difficulty according to Goodman (1994).[63] This problem was solved by power in a traditional manner as Zhu (2003) mentions; however Tiananmen incident affected the economy negatively that FDI and exports declined according to Minami (1994).

> In 1988, the government's attempt to liberalize price controls caused a high inflation expectation. The interest rate for savings was not adjusted. Therefore, panic buying and a mini-bank run occurred. Loans, however, were maintained at the previously set level. As a consequence, the money supply increased by 47 percent in 1988. The inflation rate in 1988 reached 18 percent. During the periods of high inflation, the economy overheated. A bottleneck in transportation, energy, and the supply of construction materials appeared. Because the government was reluctant to increase the interest rate as a way of checking the investment trust, it had to resort to centralized rationing credits and direct control of investment projects—a return to the planning system. The rationing and controls gave the state sectors a priority position. The pressure of inflation was reduced, but slower growth followed.[64]

Lin, Cai and Li (1996) state that the problems stemmed from the fact that the macroeconomic reforms lagged behind the reforms in the resource allocation system and microeconomic institutions. In addition, there was a need to create new instruments in order to balance the local power under the new economic conditions. In order to take measures against these problems, the central government tried to recentralize the financial sector and investments between 1989 and 1991; however this policy was resisted by the governor of Guangdong province and the governors of other strong provinces (Zhu, 2003: 8-9). This kind of response from the local

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[62] This is not a seriously high rate when compared to the inflation experiences of other countries. The World Bank (1996) states that the macroeconomic controls and the high household savings in the economy kept the inflation at moderate rates.

[63] Tiananmen Square is in the center of Beijing and has a historical and symbolic importance for China and the Communist Party.

[64] Lin J.Y., Cai F., Li Z., *The Lessons of China's Transition to a Market Economy*, The Cato Journal Vol.16 No.2, 1996, p.13

governments took its power from the fact that some of them accumulated large amount of resources that the central government could not confiscate easily. As a consequence of this attempt, the central government realized that recentralization had a high cost after a decade of economic decentralization (Zhu, 2003: 9).

This experience also indicated that decentralization provided an environment that is favorable to future reforms that will complete transition according to Qian and Weingast (1996). They also point out four factors that prevented recentralization. First, recentralization meant that financial responsibilities of the central government would increase such as establishing a social safety net. Second, some of the local governments accumulated a significant amount of wealth that the central government could not take away easily as mentioned above and it became difficult for the central government to monitor local governments. Third, the incentives of the government and the Communist Party have changed. Finally, the fall of socialism in the Eastern Europe and the former Soviet Union on the one side and the success of the East Asian economies on the other side had an impact on China.

The recentralization period was ended by Deng Xiaoping's trip to southern China in 1992 where he emphasized the importance of establishing a market economy and open-door policy (Zhu, 2003: 9). Deng's trip was not only the end of the recentralization but was also an accelerating factor for the transition of the economy. Deng adopted collective leadership that he created the conditions for others to act, rather than to undertake the whole responsibility. In this sense, the economic reform was left to other reformers and Deng was concentrated in the political reform and the foreign affairs of China; however Goodman (1994) states that Deng was regarded as the metaphor of the reform era and the achievements in the late 1980s and the early 1990s.

The positive impacts of Deng's approach on the Chinese economy were seen in the following years although the problem of imbalance between the central government and the local governments continued. Zhu (2003) mentions that the economy experienced double-digit growth rates from 1993 to 1995 due to the environment created by this trip; however the inflation rate also increased and reached 20 percent in 1994. Siackhachanh (2002) states that China has achieved to control inflation in the following decade as Table 3.5 also indicates.

Table 3.5: Annual Inflation Rate of China

1980	6	**1993**	14.7
1981	2.4	**1994**	24.1
1982	1.9	**1995**	17.1
1983	1.5	**1996**	8.3
1984	2.8	**1997**	2.8
1985	9.3	**1998**	-0.8
1986	6.5	**1999**	-1.4
1987	7.3	**2000**	0.4
1988	18.8	**2001**	0.7
1989	18	**2002**	-0.8
1990	3.1	**2003**	1.2
1991	3.4	**2004**	3.9
1992	6.4	**2005**	3

Source: http://www.econstats.com

More important than the growth rates, Deng had prepared the ideological groundwork for the adoption of a more comprehensive reform strategy for transition and his views were formally accepted at the Fourteenth National Congress of the Communist Party in 1992 according to Harvie (1999). At the Third Plenum of the Fourteenth Central Committee in 1993, "socialist market economy" was defined as the presence of market forces that have the primary role in resource allocation within the context of continued state dominance. Achieving socialist market economy became a national goal and was included in the Chinese Constitution in 1993 (Harvie, 1999: 1108). Although the orthodox Marxist theory rejects the existence of socialism and market economy at the same time, socialist market economy was supported by the explanation that "a planned economy and a market economy are two sides of the same coin under socialist conditions" according to Minami (1994).

It is obvious that there was a need to strengthen the institutions of the Chinese economy in order to achieve the national goal. As mentioned above, exchange rate system turns out to be a significant issue under the open-door policy. As the Asian crisis indicated, the good-functioning of the banking and financial sectors is essential for the emerging markets. Monetary management and fiscal stance are also important for the transition economies in order to achieve macroeconomic control. For China, reforming the SOEs has also been a significant part of the reform agenda. The establishment of a good-functioning legal system would also complement these institutions. The rest of this chapter is about China's macroeconomic reforms.

> If transition economies are to join the ranks of the established market economies, they will need not just good economic policies but strong, transparent and accountable institutions to support and implement them. Institutional reform is particularly pressing because the previous structures were adapted to the needs of a very different economic system. Inadequate institutions impose huge economic costs, and institutional development-of legal and financial systems and of government itself- takes many years if not decades. Institutional and social policy reforms tend to follow macroeconomic reforms and formal ownership changes and are now high on the reform agenda in all transition economies.[65]

3.4.6. Reforms in the Financial System

Openness promotes economic growth as it is always mentioned in the literature on developing countries; however it includes unforeseen risks especially in the financial and banking sectors so that timing, scale and sequencing of reforming these sectors are very important as Yao and Zhang (2003) mention. The World Bank (1996) emphasizes that financial reforms are important for efficient reallocation of resources in transition economies and they have to be thought as a complement to macroeconomic stabilization, enterprise reform and strengthening legal system. As Minami (1994) mentions, developing financial markets in order to decrease the dependency of financial institutions on People's Bank of China, the Central Bank, has to be seen as a priority. As the experiences of other emerging markets were good lessons for China, secure and market-oriented financial system has been one of the key objectives of reform program and the following legislative measures have been taken in line with this objective according to Harvie (1999):

- strengthening the autonomy of the Central Bank
- commercialising the state banks and providing them greater autonomy in lending decisions
- encouraging the development of new market-based financial institutions and deepening financial markets
- developing instruments for indirect monetary policy management (p.1108)

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[65] World Bank, *From Plan to Market- Executive Summary*, Oxford University Press, 1996, p.10

In addition to these, there was a need to change the interest rate policy of government. The interest rates were kept low in order to promote the capital-intensive industries before the reforms. They have been increased since 1979, however they have been still below the market-clearing rates during the reforms and it is not clear whether there will be any regulations on interest rates after the reform period as Lin, Cai and Li (1996) mention. The World Bank (1997b) states that it is important for the government to reduce the number of interest rates that are controlled officially while China succeeded to develop a money market which determines interest rates at the end of the 1990s according to Harvie (1999).

The transition economies have had two ways to reform their banking systems, to reform their own existing systems that are consisted of indebted state banks or to allow the entry of new banks and liquidate the old ones according toWorld Bank (1996). China adopted a dual-track approach also in the banking reform by concentrating on reforming the state-owned banks and also allowing the entry of new banks. As a consequence of this system, the Chinese banking system is constituted of the People's Bank of China that was established in 1984, four state-owned commercial banks (SOCBs) that were initially established as specialized banks, three policy banks and fourteen small commercial banks which were established recently (World Bank, 1997b: 32).[66]

Central Bank and specialized banks were separated in 1983 and the regional branches of these banks were required to link their total credit extension to the deposits collected in their region so that the banking system was also decentralized. If there was any problem in one of these branches, the regional branch of the Central Bank was responsible rather than the general office of the specialized bank. As a consequence, the influences of local governments on credit decisions of the regional branches of the Central Bank and specialized banks increased considerably (Qian and Weingast, 1996: 17).

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[66] Policy banks were established in 1993 in order to protect the banking system from the costs of government directed investments (World Bank, 1997b: 26).

Zhu Rongji who was put in charge of economic reform in 1991, took direct control of the Central Bank in 1993 (Zhu, 2003). There have been a number of reforms since 1993 such as tightening control over lending, recalling much irregular credit and enhancing central supervision over local branches of banks. New joint stock banks were established in order to create competition for the state-owned banks in 1995 and banking law was enacted in 1996 as Siackhachanh (2002) points out. Zhu Rongji achieved to create a conservative monetary system by the reforms in the banking system as Zhu (2003) mentions. Goodman (1994) states that the Central Banks' prohibition of the Ministry of Finance from borrowing bank fund to finance state debt was remarkable as a transformation of state socialism.

> Over the past twenty years, China's banking system has undergone a significant transformation from a mono-banking system to two-tiered system comprising a central bank and an increasingly large number of domestic and foreign commercial banks. The domestic banks include four state-owned commercial banks (which account for about 80% of total deposits and over 70% of total loans), 12 joint stock banks and city commercial banks. In addition, there are so called policy banks, which were established to provide priority sectors with soft credits, and a large number of urban and rural credit cooperatives that provide services similar to those of commercial banks.[67]

Also, reforms that purposed to increase the openness of the economy contributed to the banking sector reforms by a large amount of trade surplus and capital inflow that increased the foreign exchange reserves of the Central Bank (Zhu, 2003: 10). China's foreign exchange reserves of more than 120 billion dollars in 1997 was the second largest reserve amount in the world economies as Harvie (1999) points out. As another financial development, the Chinese stock market was opened in the early 1990s as Harvie (1999) states. According to Sachs and Woo (1997), dual-track mechanism was also adopted in the stock market at the beginning that A shares were offered to Chinese citizens and B shares were open to foreigners and could not be purchased by Chinese citizens and this system was abolished in 1996.

Siackhachanh (2002) states that the problems of the banking sector have mainly caused by direct lending policies to support SOEs, especially loss-making SOEs. In 2001, the People's Bank of China estimated 26 percent non-performing loans in outstanding loans that were made by the SOCBs. In addition, the capital ratios of

[67] Siackhachanh N., *China 2020:Challenges Ahead*, Deutsche Bank Research, 2002, p.5

SOCBs have not been high enough to deal with bad loans according to the standards of Bank for International Settlements and their profits have been low that have been between negative percentages and 0.33 percent in 1999 (Siackhachanh, 2002: 5). As a consequence of these weaknesses, Standard & Poors rated four SOCBs at levels below A that the highest rating was BB+ (Pei and Shirai, 2004: 2).

In 1999, the government established four asset management companies (AMCs) in order to transfer non-performing loans of SOCBs (Pei and Shirai, 2004: 2). Each AMC was capitalized at RMB 10 billion and about RMB 1.4 trillion of non-performing loans have been transferred from SOCBs to AMCs. It may be stated that AMCs have been successful; however non-performing loans of SOCBs and other financial institutions have been growing sharply as Pei and Shirai (2004) state.

If the measures needed to solve the problems of the financial and banking sectors are not taken, China may face a crisis. Siackhachanh (2002) states that there is not an immediate risk of illiquidity caused by weakness of SOCBs since the Chinese economy has been growing rapidly. There is also the advantage of high savings of the Chinese households that have been placed in the SOCBs; however it was predicted that there will be problems when the foreign banks are allowed to enter the sector and conduct Renminbi business with Chinese clients as Siackhachanh (2002) mentions. Hence, it should be given importance to restructuring domestic banks before removing the restrictions on foreign banks. The measures of the government have been as follows according to Siackhachanh (2002):

- SOCBs will be corporatized and listed in the equity markets so that they will gain market discipline and improve their functioning as commercial entities.
- SOCBs will cut their non-performing loan ratios by about 3 percent annually over the next few years.
- Bad loans from SOCBs will not be moved to AMCs any more; instead banks will be required to strengthen loan recovery.[68]

[68] This is also advised by the World Bank (1996) that the governments should avoid interventions in banking system and the banks should manage themselves since such interventions may undermine the credibility of the reforms. China should reduce the planned allocations of credit and rationalize interest rates in line with this view.

- The turnover tax will be reduced to 5 percent by 2003 and supervisory boards similar to those of non-bank SOEs will be established in order to improve profitability and governance. (p.6)

According to He and Fan (2004), the banking sector has been one of the most important issues of WTO accession. In line with this process, foreign banks entered China before and just after the WTO membership and they have been active since 2002.

> By the end of 2001, there were 157 foreign bank branches that had been authorized to conduct designated banking business in China. That number increased to 192 by April 2004, with 35 new foreign bank branches established over the last two years. As shown in Figure 1, the annual number of foreign bank branch openings increased steadily between 2001 and 2003. This presumably reflects the intensified interest of foreign banks in China and the accommodating attitude of Chinese authorities towards foreign bank entry. Though new branches are increasing every year, the number is by no means significant. For example, the number of new branches opened in 2003 outnumbers those in 2002 by only three.[69]

He and Fan (2004) also state that foreign competitors caused Chinese banks to stand by economic performance and market viability rather than government support. Hence, Chinese banks have to solve the problems of non-performing loans and recapitalization and improve corporate governance of banks.

> The statistics are alluring: By November 2004, as many as 62 foreign banks from 19 countries had received permission to establish businesses in China. Another 223 banks had opened representative offices there. In December, china opened up five new cities to foreign banks, bringing the total to 18 cities. These figures, along with China's annual 8 to 10 percent real economic growth, illustrate a positive and growing trend for the financial services industry in China.[70]

These explanations confirm that the role of foreign banks in China's banking sector has increased rapidly. On the other hand, Block (2005) states that China imposed limitations on the number of branches foreign banks can open and the type of

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[69] He L., Fan X., *Foreign Banks in Post-WTO China: An Intermediate Assessment*, China & World Economy, Vol. 12, No.5, 2004, p.4

[70] http://www.atkearney.com

business they can undertake beginning by the end of 2006 as part of the deal for WTO membership.

It is obvious that establishing the legal framework and implementing the laws effectively are essential to achieve these reforms. As Minami (1994) mentions, the legal system is lacking in China which has been "ruled by the power of men rather by law." He mentions that the government and the Communist Party should not intervene in financial institutions any more. World Bank (1997b) mentions that this is important for the development of competition among banks so that their efficiency and loan quality increases. Qian (2003) states that indirect ways such as reducing the information available to the state are used in the countries where the rule of law is not effective in order to constrain the state power. In the Chinese banking system, there was an implication of this way that individuals did not have to register their real names when making bank deposits so that the state does not have information about business transactions and individuals' wealth (Qian, 2003: 32).[71]

3.4.7. Fiscal Reforms

As mentioned before, the initial fiscal reform came in 1980 that is termed as "fiscal contracting system" and included the increase in the authority of local governments to decide their expenditures, keep extra-budgetary funds and a portion of their revenues.[72] According to Qian (2003), the government had two incentives by introducing these reforms. The government wanted to guarantee the flow of revenues from local governments to the central government and to promote the establishment of local economies and their tax systems. Qian (2003) states that these fiscal reforms have been one of the explanations of higher local development in China when compared to other transition economies such as Russia. In other words, fiscal incentives have played an important role in local economic development of China.

[71] Such a system has obviously disadvantages such as rising corruption and preventing taxation. It was required to open household deposits under real names after April 1, 2000 which did not cause a remarkable increase in tax revenues however reduced corruption (Qian, 2003: 42).

[72] According to Qian and Weingast (1996), the principle of this system is known as "eating from seperate kitchens".

During the transition, budget revenues of the central government declined markedly which is a common feature of transition economies. Between 1978 and 1996, total budget revenue decreased from 35 percent of GDP to 11 percent (Harvie, 1999: 1108-1109). Zhu (2003) mentions that the reduction of state's revenue meant that total resources controlled by the state decreased. Before the reform, about 80 percent of central government revenues came from the state sector; however there has been a significant decrease in the central government revenue, expenditure and investment as a consequence of the economic decentralization. The gradual separation of SOEs from the budget deteriorated the tax system which was entirely based on the state sector before the transition and some fiscal operations were moved to extra-budgetary funds (Harvie, 1999: 1109). In 1978, the extra-budgetary revenue was 10 percent of GNP and budgetary revenue was 31 percent whereas the extra-budgetary revenue's share increased to 16 percent and the budgetary revenue's share decreased to 14 percent (Qian and Weingast, 1996: 17). Hence, the transition period of China has been characterized by fiscal problems. On the other hand, Harvie (1999) points out that China's budget deficit has been around 2 percent of GDP on average which is relatively small since budget expenditures were also reduced.

As mentioned above, the centre-local revenue sharing system began in 1980. In 1993, this system was ended and China has had a great incentive to reform the fiscal system since 1994 as Qian and Weingast (1996) state. Fiscal federalism was established in 1994 by distinguishing national and local taxes and their bureaus in line with the international practices (Qian, 2003: 41). This meant that the contract based taxation of peasants was replaced by central tax offices in the counties in 1994 (Sachs and Woo, 1997: 42). In addition, low and uniform taxes were introduced to be applied to all economic actors (Zhu, 2003: 9). There were some local governments still benefiting from fiscal contracting system; however they accepted fiscal federalism not only because they were compensated but also because of the uncertainties under contracting system (Qian, 2003: 42). The World Bank (1997b) states that the problem of low tax revenues was solved in 1996 as a consequence of the reforms and also mentions that the next goal should be to "establish a better tax administration, a broad tax base and new taxes that combine social, economic and revenue objectives" (p.26).

> Furthermore, it is argued that the reforms really introduced a fiscal federal system into the Chinese economy (Montinola, Qian and Weingast 1996; Bahl 1998), which formalised the central-local financial arrangement, balanced the economic powers of the Central and local governments and legitimised the strong role of local government in the Chinese economy.[73]

In addition, there have been efforts to include non-state sector in taxing, reducing tax exemptions and concessions and moving extra-budgetary funds into the budget (Harvie, 1999: 1109). Lin, Cai and Li (1996) state that non-state sector became increasingly important for the fiscal incentives of China since the deficits of state enterprises increased; because "deficits increased due to a faster increase of wages and welfare as a result of the discretionary behavior of the managers and workers in the state enterprises" (p.219). Hence, China experienced fiscal pressures when the government put controls on credits and raw materials of non-state enterprises and had to liberalize these controls. Following the liberalization, growth of the economy was observed; however the imbalance between the reforms on microeconomic institutions and macroeconomic reforms remained a problem as Lin, Cai and Li (1996) mention.

As a consequence, fiscal reforms increased the share of the central government's revenue and measures were taken in order to keep expenditures low. In addition to the improvements in central government's revenue share, local governments were given some guarantees for their revenues. For instance, each province's revenue was guaranteed leastly at the level of 1993 and the extra-budgetary funds remained to be received by local governments (Zhu, 2003: 10). Qian and Weingast (1996) state that the new fiscal system also aimed to increase the fiscal incentives of local governments. Fiscal expenditure was also decentralized that local governments have taken responsibility for providing education, health, housing, local infrastructure..etc (Qian and Weingast, 1996: 10).

In contrast to the optimistic approaches to the new fiscal system, Siackhachanh (2002) states that the tax revenues have only increased from 10.2 percent of GDP in 1996 to about 17 percent in 2001 and reaches 21 percent with fees collected by local

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[73] Zhu T., *Building Institutional Capacity for China's New Economic Opening*, in *States in the Global Economy: Bringing Domestic Institutions Back In* edited by Linda Weiss, Cambridge University Press, 2003, p.10

governments and contributions to social insurance funds. Siackhachanh (2002) mentions that this is not very low when compared to some other countries; however the fact that expenditures of China are expected to increase rapidly has to be taken into consideration. [74]

Siackhachanh (2002) also points out that the Chinese government has had to rely on fiscal policy to achieve high GDP growth in the past decade, because of the weakness of the banking sector mainly caused by non-performing loans. China has a good image on public debt management; however public debt reaches 100 percent of GDP and public debt stemming from only the banking system is about US dollars 800 billion when the contingent liabilities are included (p.8). Siackhachanh (2002) mentions that China seems to have the power to manage this debt in the long-run; however the strong need for measures taken by the authorities cannot be ignored.

To solve the fiscal problems of the Chinese economy, it is obvious that tax revenues should be increased and non-performing loans should be cleaned up as first steps. The large stocks of assets of China could be sold in order to solve the problem of non-performing loans; however there is a fear that a rapid reduction of government's holdings would cause instabilities according to Siackhachanh (2002).[75] It is also important to include all government spending in the budget, especially extra-budgetary items. Obviously, building transparent fiscal institutions is also a necessity in order to improve fiscal performance as the World Bank (1997b) mentions.

3.4.8. Reforming the State-owned Enterprises

Gang (1994) mentions that the most important problem of the dual-track mechanism is that it preserves the old system for a long time so that it takes time to eliminate economic distortions and efficiency losses. From the point of view of the literature on China's transition, reforming the state-owned enterprises (SOEs) since the

[74] For instance, Siackhachanh (2002) mentions that China's pension system which was established in 1995 is not financially viable and it seems that the government's contributions to this system will have to be increased.

[75] Siackhachanh (2002) states that China's 50 largest companies that are under government control have assets worth USD 1.1 trillion based on their book value according to estimates.

transition began has been one of the best examples in China's transition experience that approves Gang's statement.

According to the World Bank (1997b), China has 305,000 state enterprises of which 118,000 of these are industrial. SOEs depended on state subsidies before the transition and this dependence increased as the reforms put pressure on them. Consequently, the state banking system became the main source of financial support to SOEs as the World Bank (1997b) mentions. Lin (2004a) states that the share of non-performing loans in the four big SOCBs has increased sharply because of SOEs since the transition began. It was found that debts exceeded assets in 40 percent of the 302,000 non-financial SOEs in the mid-1990s (Chunlin, 2002: 6)

One of the main problems of SOEs has been "soft budget constraint" that Lin (2004a) defines as the situation in which poorly performing SOEs ask for preferential treatment and subsidies while private firms in market economies have no choice other than bankruptcy. As a consequence of this system, corruption became widespread since the state sector has been protected by the entry barriers of the government, which increased income inequalities and caused economic and social instabilities according to Lin (2004a). Another problem was that, state enterprises have had some social responsibilities unlike private firms. Providing job security and social services such as housing, education and health care are among these responsibilities that their costs have been one of the the causes of declining profits of SOEs (World Bank, 1997b: 12).

Although the share of SOEs in GDP has declined as a consequence of the reforms, they still have a large share in bank credits that is around two thirds and employ a major part of urban labor according to Harvie (1999). At the Third Plenum, SOE reform was put on the top agenda by addressing key issues such as corporate governance, other forms of ownership, divestiture of social services, mergers and bankruptcies (Harvie, 1999: 1110). According to Lin, Cai and Li (1996), the reforms in state enterprises have had four stages.

> The first stage (1979-83) emphasized several important experimental initiatives that were intended to enlarge enterprise autonomy and expand the role of financial

> incentives within the traditional economic system. The measures included the introduction of profit retention and performance-related bonuses and permitted the state enterprises to produce outside the mandatory state plan. The enterprises involved in exports also were allowed to retain part of their foreign exchange earnings for use at their discretion. In the second stage (1984-86) the enterprises shifted to a formalization of the financial obligations of the state enterprises to the government and exposed enterprises to market influences. From 1983, profit remittances to the government were replaced by a profit tax. In 1984, the government allowed state enterprises to sell output accordingly, thus establishing the dual-track price system. During the third stage (1987-92), the contract responsibility system, which attempted to clarify the authority and responsibilities of enterprise managers, was formalized and widely adopted. The last stage (1993-present) attempted to introduce the modern corporate system to the state enterprises. In a stage of the reform, the government's intervention was reduced further and the state enterprises gained more autonomy[76].

The main purpose of reforming state enterprises was establishing a modern enterprise system with greater autonomy, accountability and harder budget constraints through separating the state's ownership of enterprises from their management (Harvie, 1999: 1110). In line with this purpose, establishing the modern corporate governance in SOEs with board of directors and supervision board has turned out to be one of the main targets of SOE reform since the late 1980s as Lin (2004a) states. However any reform on SOEs should be accompanied by the elimination of "soft budget constraint" in order to achieve the reform since it has been the main reason of lacking incentives to improve the efficiency of SOEs as Lin (2004a) emphasizes. As an improvement in this issue, Chunlin (2002) states that bankruptcy system began to work in the mid-1990s as the government was able to monitor SOEs and their relations with the banking system effectively and the government began to concentrate on bankruptcy procedures by experimenting in some selected cities and sectors.[77]

Lin, Cai and Li (1996) state that SOEs were like puppets. The managers in the Chinese SOEs did not have autonomy in input and output decisions, personnel appointments, wage settings and other managerial decisions as mentioned before (Lin, 2004a: 10). As a consequence of the reforms, many SOEs acquired increasing autonomy over their production decisions and wages and their share of profits rose by 1980. Siackhachanh (2002) states that there has been a significant reduction in the

[76] Lin J.Y., Cai F., Li Z., *The Lessons of China's Transition to a Market Economy*, The Cato Journal Vol.16 No.2, 1996, p.9

[77] Data from the Highest People's Court indicates that 12,181 SOEs went bankruptcy between 1997 and 2000 (Chunlin, 2002: 7).

mandatory production quotas of SOEs and administrative price controls since 1984. These improvements varied across regions, across sectors and between firms and Enterprise Bill of Rights was accepted in 1984 in order to eliminate these differences (The World Bank, 1997: 11). On the other hand, Minami (1994) states that incentives of the managers did not increase much despite these reforms as the ownership problem was not solved.

Despite the reforms, Sachs and Woo (1997) state that total factor productivity increases of SOEs have been lower than the growth of non-state sector's productivity and any productivity improvements in SOEs have been modest. Between 1978 and 1999 gross value of industrial output of all industrial enterprises in the economy increased by 30 times; however industrial output produced by SOEs increased by only 11 times (Chunlin, 2002: 6).

Sachs and Woo (1997) also mention that the profits of SOEs have declined since the mid-1980s[78] and they present three factors that contributed to this decline that are emergence of competition by the non-state sector, failure of SOEs to improve their efficiency and over-compensation of SOE personnel. [79] Hence, the reforms could not prevent the declining profitability of SOEs (Lin, 2004a, Lin, Cai and Li, 1996). Profits, taxes per unit of net capital stock and working capital of industrial SOEs decreased from 24.2 percent in 1978 to 12.4 percent in 1990 and to 6.5 in 1996 (Qian, 2003: 44). In addition to these, non-performing loans increased as the state adopted the policy of providing loans with low interest rates to the SOEs after 1983 according to Qian (2003). Over 70 percent of loans from state banks has gone to the SOEs however most of them have not been repaid because of the poor performance of the SOEs (Lin, 2004a: 24). At least two-thirds of SOEs have been making losses which meant that the funds of the economy have not been used efficiently that also put risks on the banking sector as mentioned before (Siackhachanh, 2002: 5).

[78] For instance, the SOE sector reported a net deficit of 3.4 billion yuan in the first quarter of 1996 (Sachs and Woo, 1997: 24).

[79] Sachs and Woo (1997) state that the perspectives of the experimentalist school and the convergence school on this issue differ by the weights they put on these factors.

Siackhachanh (2002) also mentions that SOEs continue to dominate the capital allocation and fixed assets in the Chinese economy; however there have been some improvements. Most SOEs have been under increasing financial discipline in the past four years that they do not have an easy access to bank loans as it was in the past and small or medium SOEs with poor performance have been liquidated or privatized. Large SOEs have been corporatized and listed in order to improve their corporate governance and bring them under the discipline of security market.[80]

These reforms that aimed to limit the activities of the state enterprises also contributed to the development of non-state enterprises. The strategy of China's SOE reform that has been followed to achieve this aim is termed as "seizing the large and releasing the small" which means that the non-state ownership and control will be permitted in small state enterprises although state ownership will be maintained in the largest state enterprises (Harvie, 1999: 1110). Following this strategy, 1000 state enterprises were chosen initially for reforming from more than 100,000 of total (World Bank, 1997b: 12). According to Sachs and Woo (1997), 90,000 small industrial SOEs were transferred to the non-state sector by sales, leases or mergers as the beginning of full privatization.

> Recent reports indicate that full-scale sales of small and medium SOEs have occurred in several places. The best known example is Zhucheng city in Shandong province which started privatizing SOEs in 1992 when two-thirds of its SOEs were losing money or just breaking even. Almost ninety percent of county-supervised SOEs in Zhuchang have already been privatized. Schuan province has been steadily selling off money-losing SOEs, and Guangdong province has been selling profitable SOEs as well in order to finance local infrastructure and clear the debts of unprofitable SOEs to prepare them for sale. Heilongjiang province has just announced plans to privatize 200 SOEs after having sold 160 successfully.[81]

On the other hand, Hogan (2000) interprets these transfers as the sale of loss-making SOEs and the process of becoming the partial-owner of profitable SOEs rather than

[80] Chunlin (2002) states that only the SOEs that were selected by the government were listed in stock exchanges or formed joint-ventures with foreign firms which means that the state is still dominant in the allocation of capital in China despite the efforts of liberalization. He emphasizes that forming a joint venture or listing in the stock exchange did not mean that these SOEs were sold, instead meant that the state was not the sole owner any more.

[81] Sachs J.D., Woo W.T., *Understanding China's Economic Performance*, NBER Working Paper No.5935, 1997, p.29

privatization. This issue has been significant since ownership reform is a central issue of a transition from a planned economy to a market economy as Qian (2003) mentions. In line with this, Sachs and Woo (1997) state that privatization of SOEs has been a serious economic and political problem of China and because of this reason SOE reform has been based on increasing the operational autonomy of SOEs rather than privatization.[82] According to Shirk (1993), ownership reform is a more radical step than other reforms in ideological terms. Privatization of a major scale was rejected in China; instead the Chinese policy makers preferred to design such policies that maximize state ownership and control in the corporate sector (Chunlin, 2002: 6). Sachs and Woo (1997) state that this approach to privatization is an outcome of *market socialism* while emphasizing that privatization has to be seen as the responsibility of the Communist Party.

> …Nevertheless, a more active and dynamic reform program for changing the ownership structure is needed to more efficiently use of state assets to speed up economic growth and to make the institutional transformation smoother, healthier, and fairer. Ownership of state assets should first be clearly defined to make it transferable and tradeable; state enterprises then should be converted into corporations with at least some stock shares distributed among workers and managers. Corporatization does not necessarily mean privatization, but will provide a more flexible mechanism for further ownership changes.[83]

In the early 1980s, it was believed that the main problem of SOEs was the lack of autonomy of managers who also did not have any incentive to improve the efficiency of SOEs since there were no rewards given for performance according to Lin (2004a).[84] As mentioned above, the reforms increased the autonomy of managers to some extent which also allowed SOEs to retain a portion of their profits.[85] On the other hand, Lin (2004a) mentions that these reforms were successful in some pilot experiments where they became ineffective when implemented to the whole system.

[82] Sachs and Woo (1997) have an inconsistent approach to the privatization in China. Here, they are pessimistic; however they are not when they give the number of transfers to the non-state sector as presented on page 95.

[83] Gang F., *China's "Dual-Track Transition" Toward the Market: Achievements and Problems*, The 1990 Institute August, 1994, p.5

[84] World Bank (1996) states that changing the incentives lies at the heart of transition.

[85] As the autonomy of managers increased, the enterprises began selling their output that is above the planned quantitity at market prices and as a consequence the growth has been mainly achieved by market prices according to the World Bank (1997b)

For instance, the reforms introduced to increase incentives did not prevent the decline in SOEs' financial performance according to Qian (2003).[86]

Rather than the other explanations, Lin (2004a) interprets China's problem with SOEs in the context of "viability" that he defines a viable firm as a "normally managed firm, which is expected to earn a socially acceptable normal profit in an open and competitive market" (p.5). On the contrary, non-viable firms have to be supported by subsidies and protections in order to continue operating. The neoclassical theory assumes that the firms in the market are viable and the problem stems from corporate governance problems, incentive mechanisms, property rights arrangement and other market interventions that are found in socialist economies as Lin (2004a) states. By shock therapy strategy, the neoclassical theory aims to eliminate these factors in order to manage reforming state enterprises as a part of a successful transition program according to Lin (2004a).

On the contrary to the neoclassicals, Lin (2004a) states that the firms in the developing countries and transition economies are not viable like the firms in the developed countries that rarely receive subsidies and protections. Since the World War II, the developing countries have concentrated in establishing advanced sectors that were against their comparative advantages by intervening factor prices, financial system, international trade and investment. Lin (2004a) states that these countries achieved to establish advanced sectors; however the firms in these economies have not been viable and have needed government interventions in order to survive, such as loans at low interest rates or import barriers that are set in order to protect domestic industries.

> ….many firms in transitional economies and developing countries are not viable, i.e., they cannot earn acceptable profits in an open, competitive market even though their management are normal. The non-viability of a firm arises from the fact that the sector in which the firm operates, the products it produces, and the technology the firm uses in production are inconsistent with the comparative advantages determined by the factor

[86] Qian (2003) terms the reforms that were introduced in the 1980s in order to give incentives to managers as "managerial contract responsibily system".

> endowment structure, namely the relative abundances of labor, capital, and natural resources in that particular economy.[87]

Lin (2004a) has two remarkable conclusions. First, the success of the SOE reform and the transition depends on how the viability problem is solved. Second, Lin (2004a) states that the neoclassical economics has been able to explain what happens in developed countries but has a limitation in analyzing the problems in developing countries and economic transition. This statement is "based on the failure of transitional policies designed according to neoclassical economics and the unexpected adverse effects of "Washington Consensus" in handling many economic crises in developing countries" (p.26). It may be stated that this conclusion is also applicable to the neoclassical analysis on the East Asian economies as it was presented in Chapter 2.

What were the consequences of the SOE reform that started with a high motivation? In 1999, new reforms were introduced to SOEs according to Qian (2003). The government decided to reduce the sectors that SOEs operate. Another reform was the diversification of ownership that SOEs except a few ones with 100 percent state ownership would become joint ventures with multiple owners which could be domestic or foreign investors.[88] In addition, these companies could be listed in domestic or foreign stock markets (Qian, 2003: 48).

SOEs produce about one-quarter of industrial output, more than one half of total government revenue on the one hand and they are the most significant factor of weaknesses in the banking system on the other hand (Qian, 2003: 47). The SOE reform has been successful according to the experimentalist school whereas the convergence school is opposed to this idea (Sachs and Woo, 1997). In fact, state enterprises are still among the problems of the Chinese economy; however there have been some improvements. Bankruptcies have been limited by the help of reforms. In addition to this, SOEs' social functions have been transferred to local

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[87] Lin Y.J., *Viability, Economic Transition and Reflection on Neoclassical Economics*, Tiger Working Paper Series No.50, 2004, p.6

[88] Also, overseas equity investments were introduced to SOEs by forming joint ventures. The share of joint ventures, other forms of foreign enterprises and joint stock companies in industrial output was 39 percent in 2000 (Chunlin, 2002: 7).

government social welfare units and unemployment and retraining programs (Harvie, 1999: 1110). On the other hand, non-performing loans remain to be a problem.

Qian (2003) states that the key problem of the state sector has been the continuing control of the Communist Party over the appointment of SOE managers that the process is politicized. From another perspective, the impact of the incomplete SOE reform becomes less important according to Qian (2003) as the non-state sector has grown fast. On the other hand, ignoring the importance of SOEs in the Chinese economy by claiming that most of them have been privatized or non-state sector has gained more importance is misleading.

3.5. Conclusion

The transition of China from a central planning system to a market-based system that began at the end of 1970s continues. This process did not end because most of the requirements of a market-based economy have not been satisfied such as a legal framework, especially of property rights. Although the state sector is not dominant in the economy any more, the state still determines in which sectors state enterprises should operate and which sectors should be opened to non-state enterprises. In addition, the Chinese financial market has been under strict control which is an important difference between China and the other East Asian economies. Hence when saying that China has integrated to the world economy, financial integration should not be included although the literature has not paid attention on this issue. It is obvious that the control of the Communist Party over the economy continues as well as its monopoly in politics.

On the other side, China has been successful since the transition began with its sustained high growth, increasing per capita income, reduced poverty and mostly integration to the world economy according to the literature on her transition. Although it is the common tendency in the literature to view China's opening the economy and integration successful, it is not correct to define what China has done as a full integration within the different definitions of this term. As mentioned above, one of the most important components integration that is financial integration is lacking in China. Because of this reason, China's integration may be termed as trade integration. It is observed that there is an expectation of financial integration in the literature that even advices for this period are given. It is correct that China is more open to international trade than the central planning period; however commenting on the level of trade integration requires a wider study on the decline in protectionist policies.

Baek (2005) states that there may be different explanations of China's development that has a contradictory nature as it was the case for on the East Asian miracle. The market-oriented structure of the Chinese economy may be seen as the cause of the success by the neo-classicals. The declining role of SOEs in the economy and the fast rise of the non-state sector, especially foreign enterprises may be evidences of this view. The fact that foreign enterprises account for half of China's international trade with 50.85 percent in 2001 and operate mainly in labor-intensive industries in line with China's comparative advantage strengthen this view (Baek, 2005: 487). On the other hand, it is also possible to view China as a developmental state according to Baek (2005).

> Conversely, however, China can also be interpreted as the latest heir of the "developmental state." Chinese aspects of this developmental state include: the high rate of domestic savings, the huge infrastructure of heavy industry, the promotion of industrial policy, the legacy of central planning, labour-intensive industry accompanied by import-substitutive capital-intensive industry; a strong central government with a huge bureaucracy; and corporatist control over the society. Although SOEs are decreasing in their importance, they are still a major part of the economy and occupy 60.9% of the total assets of large industrial enterprises in 2002 (all industrial SOEs plus large non-SOE industrial enterprises with over 5 million yuan output value) (ZGTN 2003). These characteristics seem to fit into Wade's ten policy advice for "governed market" to promote government-guided development (Wade, 1990:350-77).[89]

Baek (2005) states that the characteristics of China that are attributed to the developmental state diminishes because of the transition process. On the other hand, he mentions that the dual structure of the Chinese economy will continue for a long time because of the gradualist nature of the transition. As presented in this chapter, the purpose of China was not establishing a developmental state or fully adopting a market-based economy. The purpose of the reforms has been establishing a socialist

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[89] Baek S. W., *Does China Follow "the East Asian Development Model"?*, Journal of Contemporary Asia Vol.35 No.4, 2005, p.487

market economy. Yu (2004) states that China purposed to build socialism with Chinese characteristics. According to Yu (2004), the failures of socialism in China, especially output decline and poverty, caused the questioning of the system. As a consequence of this process, it is understood that the necessity of combining the socialist system and socialist market economy could not be ignored. What China experiences is the initial stage of socialism and passing to the other stages will take a long period of time and has to be built on a material, cultural and ideological progress according to Yu (2004).

> This is a breakthrough from traditional thinking that a planned economy equals socialism and market economy equals capitalism. Besides, the CPC has also come to realize there is no fundamental contradiction between socialism and a market economy. A market economy is indispensable to the allocation of resources in socialized production. By making the establishment and improvement of a socialist market economy as the goal of China's economic restructuring, the CPC has found the ideal economic structure in the process of the socialist modernization drive. Combining socialism with the market economy is a creation and breakthrough in the Marxist theory on socialist economies. It is an extremely important and significant innovation during the development of the socialist-system.[90]

When this chapter is viewed, it is seen that the literature on China's transition is on the side of China's liberalization and integration to the world economy. In other words, China has been getting far away from her features of the central planning period. This transition to a market-based system has been gradual as the experimentalist school approves and should have been rapid according to the convergence school. Gradually or rapidly, there is an agreement in the literature that China's transition has purposed to establish market-oriented economy and has achieved much in this way except some basic problems. This is the approach of the neoclassical view as presented in Chapter 2 and this chapter of the thesis indicates that the neoclassical view is dominant in the literature on China's transition and economic success.

In the *Introduction to the 2003 Paperback Edition* of *Governing the Market*, Wade states that the main point of development strategy is to combine the principle of comparative advantage and the principle of import replacement. In line with this statement, he points out that China aggressively exports in line with comparative

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[90] Yu W., *Our Way: Building Socialism with Chinese Characteristics*, www.politicalaffairs.net/article/view/36/, 2004

advantage and aggressively replaces some imports at the same time by following Japan, Korea and Taiwan. He mentions that China has benefited from more open markets and international investment opportunities in the past two decades; however China's fast growth rate began before trade growth and trade liberalizations. In addition, it is obvious that China has constrained trade liberalization in order to protect domestic firms against imports.[91]

In *The Rise of the Rest: Challenges to the West from Late-industrializing Economies* (2001), Amsden states that the success of "the rest" has stemmed from "getting the control mechanism right" rather than "getting prices right" (p.11). "The rest" refers to economies which acquired enough manufacturing experience to move from mid-technology to high-technology sectors by learning. Amsden includes China and the other East Asian economies in "the rest". She also explains the crises in "the rest" by liberalization policies imposed by the West. These discussions of Wade and Amsden fit to developmental state that is presented in Chapter 2 and seems to be consistent with socialist market economy although it is not known what this term exactly refers to.

Although Baek (2005) discusses the similarities of China and other East Asian countries in terms of developmental state, any revisionist interpretation of China and her transition other than Wade's brief explanation presented above could not be found for this thesis. Hence, it is not possible to make a comparison of the features of developmental states of China and other East Asian countries by quoting from the authors who created this theory. Perhaps, this is again caused by political and ideological facts as the interest in the East Asian miracle was.

On the other side, it seems that the problem of China is more than neoclassicals view. According to the neoclassicals, the problems of China are the barriers to market-oriented economy, most importantly the continuing importance of SOEs in the economy and the lack of legal frame work on property rights. Actually, the problem is whether China fully wants to adopt the market-oriented system although she has

[91] Wade identifies also India and Vietnam with these features.

adopted some of its elements. It is not difficult to understand the celebration of neoclassicals because of China's reforms; however it is evident that China is more close to developmental state currently than a market-oriented economy.

It is evident that China has introduced and adopted some of the elements of market-based system to its economy on the one side. On the other side, key elements of this system are lacking. Most importantly, China managed economic success without a political reform unlike the other transition economies. The lack of democracy in China has been debated widely which is not included in this thesis. Within the thesis, the continuing state control over the economy is important. The industrial policy is based on the state ownership of industrial enterprises and directed credit mechanism. The state does not only control the SOEs, but also continues to subsidize them. For instance, Price (2006) states that the subsidization of the steel industry in China by various ways causes some problems in the process of WTO accession. The international trade policy includes export promotion and import protection and financial movements are under strict controls.

As a conclusion, it is difficult to view China as a market-based economy or a very close candidate of it at the moment as nearly the whole literature has viewed since the features described above fits more to developmental state like the other countries in East Asia. It is certainly difficult to predict China's future since it is even difficult to interpret her current situation. It is possible to conclude that China has been trying to establish a unique system that they termed as socialist market economy. Although this term sounds strange, it fits Wade's interpretations of China. In this sense, the motivation of the Chinese reforms since 1978, especially integration to the world economy, may be explained by the fact that China understood that it cannot resist the economic globalization.

CHAPTER 4

THE FUTURE OF THE EAST ASIAN GROWTH

In this thesis, the literature on two different success stories of Asia is overviewed. In Chapter 2, the rapid growth accompanied by other improved economic and social indicators of newly industrializing economies of East Asia for three decades and the Asian crisis that paused this period are explored. The high growth of China since its transition from a central planning economy to a market-based economy that began at the end of the 1970s is overviewed in Chapter 3.

The economic success of the East Asian countries as developing countries and China as a transition economy has been an important issue in the international political and economic order as mentioned many times and both the developed and developing parts of the world have been following the developments in these economies. The emergence of a wide literature on the East Asian and Chinese successes may be seen as one of the consequences of this interest.

In this chapter, another issue is analyzed that connects the previous two chapters. This is to ask whether China has modeled the development strategies of East Asian economies. In order to answer this question, the similarities and the differences of the two experiences should be explored. The situation of China during the Asian crisis may contribute to the investigation of differences between China and the crisis economies. Another issue that is discussed in this chapter is whether China damages the other economies of East Asia, especially their exporting activities and FDI receipts.

4.1. Comparing China and the Other East Asian Economies

According to Yao and Zhang (2003), China and the first-tier NIEs (Taiwan, Hong Kong, Singapore and South Korea) have common features in terms of openness, investments in physical and human capital and to some extent strong governance. These features distinguish China and these economies from many of the low-income countries in Africa, Latin America and South Asia (p.73).

With these common features, it is worth to question whether China has succeeded by following the development strategies of the East Asian economies. According to Baek (2005), the integration of the Chinese economy to the world economy coincides with the integration of the newly industrializing economies of Southeast Asia. The development of Southeast Asian economies was different than the other East Asian economies of the earlier stage of development.

> Compared with earlier stages of East Asian development, however, this stage, that has incorporated the Southeast Asian region, shows few characteristics of precedent Japanese, Korean or Taiwanese models of development since these Southeast Asian countries are wholly exposed to the "globalised" world of free trade, free movement of finance capital, strong protectionism of core countries, least role of government intervention, and decreasing importance of Cold War geopolitics (Clark and Jung, 2002; Burkett andHart-Landsberg, 2000). Since these Southeast Asian countries do not have enough capacity to control financial markets and to establish autonomous industrial policies, they are in fact at the mercy of foreign capital. Their economic growth only means their subordination to the Japanese economic hierarchy and to the external expansion of the Japanese financial system and industrial policy (Burkett and Hart-Landsberg, 2000).[92]

On the other hand, the characteristics of the Chinese economy, especially its integration to the world economy, have been very different from the Southeast Asian economies as Baek (2005) states. Historical and cultural factors have always played an important role in China‘s political and economic decisions which is a fact that has also been observed during the transition period. In other words, the reform program has not included altering the whole central planning system, its institutions and the habits brought by it as discussed in the previous chapter. China has adopted gradualism rather than shock therapy as a reform strategy in line with this approach.

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[92] Baek S. W., *Does China Follow "The East Asian Development Model"?*, Journal of Contemporary Asia Vol.35 No.4, 2005, p.486

This approach has not included denying the whole existing system as mentioned above; however purposed to combine it with the market-based system. Baek (2005) summarizes the consequences of this approach as follows:

- SOEs still constitute an important part of the economy.
- The open-door policy has been restricted to eastern coastal areas.
- The underdeveloped financial market is controlled and protected from the fluctuations of foreign capital.
- Overseas Chinese have been the most remarkable source of FDI to China.
- TVEs have been the most significant factor of the development of labor-intensive industries.
- High savings of households have been one of the main sources of financing SOEs. (p.486)

Most of these features of the Chinese economy have stemmed from the nature of its transition process and they are not present in the other East Asian economies. On the other hand, there have been similarities of China and the other economies in the region. As mentioned before, high savings rate as an important factor of growth is one of the common features of China and the other East Asian economies. As a consequence of export-oriented growth, there are also similarities in terms of the position in the international trade as Baek (2005) points out. Like the East Asian countries, China's trade within Asia is high. In 2002, 52.3 percent of Chinese exports and 64.5 percent of imports were within Asia. As it was the case in the East Asian economies, the US has become the largest export market for China and China has become dependent on the imports of machinery and technological equipment from Japan (Baek, 2005: 485).

The similarities of the positions in the international trade may be seen as a consequence of being emerging markets in the same region. On the other hand, having the characteristics of developmental state may be seen as the most important common feature of China and the other East Asian economies as mentioned in the previous chapter. Baek (2005) describes this feature as guiding the economy by controlling the financial system and directing financial resources in line with the development strategies. This feature has been reflected in the industrial policies and the export-oriented strategies of China and the other East Asian economies. Although it is a discussion of different views that this approach of the states in East Asia as described by Baek has been efficient or inefficient for development objectives, it is evident that the Chinese government and the governments of the other East Asian countries intervened markets effectively. It may be claimed that China has done more than guiding as a consequence of being a transition economy. In other words, controls have already been present in the Chinese economy and the controls on strategic areas have not been removed while the gradualist approach has contributed to this process.

Despite the similarity of having the characteristics of developmental state, there have been remarkable differences in industrial policies of China and the other East Asian countries which have mainly stemmed from the differences in the structure of their industries. According to Baek (2005), the growth of targeted industries was managed by financial resources that were controlled by the government in Japan or Korea. On the other side, the strict control of the Chinese government over financial resources and SOEs continues where the role of SOEs in the economy is still important. The privatization of TVEs which also have had an important share in industry has begun recently and does not mean that the state control is eliminated. As a consequence, the Chinese government has had a more direct control over the industry when compared to other economies in the region.

Another issue is that the Japanese or Korean governments have supported big enterprises which have led export-oriented industrialization while supports of the Chinese government have been limited to SOEs that produce for the domestic market (Baek, 2005: 494). The continuing importance of SOEs in the Chinese economy has given rise to different criticisms that most of them are discussed in the previous chapter. In addition to causing macroeconomic weaknesses, especially in the banking sector, SOEs mainly operate in heavy industry which is against the comparative advantage of China.

> However, exports have been mainly led by small and medium-sized non-SOEs that are the main beneficiaries of FDI and are indirectly supported by functional industrial

> policy not by the inclined industrial policy of the government. This structure gives rise to a dual system of public ownership and non-public ownership. In the field of finance, China is different from Japan where main banks have superintended subordinate enterprises. Though the formation of big enterprise groups have been pursued by China, they are also different from those in Korea or Japan where business groups display hetero-combination by diversification while Chinese groups are oriented towards dominance by horizontal merger of similar enterprises.[93]

When compared to other East Asian countries, Baek (2005) states that China's position is more similar to the conditions of Taiwan during 1970s and 1980s with the dual system of state and non-state sectors. In Taiwan, the state sector specialized in capital-intensive industries as in China and non-state sector drove export-oriented industrialization. The control over the flow of financial capital is another similarity. On the other hand, Baek (2005) also mentions the differences of these two economies that would drive China to different characteristics of development model than Taiwan's. The main difference is their sizes which causes different requirements for the implementation of the export-oriented strategy. The size of China is a factor that makes its comparison to any other East Asian economy difficult. It is obvious that opening the economy and implementing export-oriented strategy is more difficult and complex for a large country. On the other hand, there is an advantage of large size that the economy is less vulnerable to speculative financial attacks when compared to small countries. In addition to their differences in sizes, the dominance of the state sector which is supported by the underdeveloped financial market is higher in China than in Taiwan according to Baek (2005).

The conclusion is that China and the miraculous East Asian economies share a very important characteristic although there have been differences such as land sizes, levels of state control, industry structures and industrial policies which have given rise to different economic measures. It seems that most of these differences has stemmed from the fact that the starting points of China and the other economies in the region were different. On the other hand, having the features of developmental state as termed by the revisionist literature is the important characteristic of the East Asian economies shared by China as mentioned above. This does not directly mean that China has modeled the strategies of the East Asian development; however this

[93] Baek S. W., *Does China Follow "The East Asian Development Model"?*, Journal of Contemporary Asia Vol.35 No.4, 2005, p.494

means that China's development has not been within the neoclassical framework as the East Asian development was not.

4.2. China during the Asian Crisis

China was one of the leastly affected economies from the Asian crisis. In addition, by fixing Renminbi with the US dollar to avoid depreciation, China played a role in reducing the damages of the crisis.[94] According to Engelbrecht and Hua (1999), the depreciation of the Chinese currency could be the worst thing to happen during the crisis because the crisis could become global. One of the discussions in the literature is that China would have preferred devaluation to increase exports and keep foreign exchange reserves which would affect the other economies in the region as Fernald and Babson (1999) state. Instead, China has taken some measures in order to encourage exports and FDI.

The growth rate of China was 7.8 percent in 1998 which was its lowest rate since the early 1990s; however it was a success when compared to most economies in Asia that experienced negative growth after the crisis (Fernald and Babson, 1999: 1).[95] Fernald, Edison and Loungani (1998) expected a fall in China's exports because of the Asian crisis since it would face more competition with the other Asian economies whose currencies depreciated considerably. This expectation occurred; however the fall was not very dramatic that China's export growth was 10.9 percent between 1995 and 2000 while it was 19.4 percent between 1990 and 1995 (Lall and Albaladejo, 2004: 1445). Although it was fixed, the Chinese currency depreciated relative to US dollar and European currencies in real terms by the help of the deflation This led to an increase in exports in the early 1998 (Yang and Tyers, 2000:

[94] Yang and Tyers (2000) state that this policy was the consequence of "get the exchange rate right" approach that was adopted in 1994.

[95] The growth rate of China had been declining since 1992; however this trend reversed in 1998 according to the official statistics. At this point, it should be mentioned that Fernald and Babson (1999) point out that the reliability of official data has been questioned, especially because of the 8 percent growth target (p.6).

4).[96] As a consequence, how China survived the Asian crisis has turned out to be another discussion point of the literature. There have been arguments that the devaluation of the Chinese Renminbi in 1994 accompanied by high performance in the exports of labor-intensive products was among the main factors of the crisis. In Chapter 2, it is presented that the Asian crisis had more important factors. There should be other features of China that explain her performance during and after the Asian crisis. Baek (2005) lists these features as follows:

- strict control by the government
- absence of capital convertibility
- manageable short-term external debt
- a large trade surplus
- large amount of foreign exchange reserves
- high FDI inflows (p. 485-486)

China's performance during and after the Asian crisis was more interesting for some of the authors which thought that China shared the macroeconomic weaknesses of the crisis economies such as non-performing loans and other problems of the banking system and other institutional weaknesses. On the other hand, the use of the non-performing loans is very different in China and the other East Asian economies according to Engelbrecht and Hua (1999). Fernald and Babson (1999) mention that such problems do not bring the expected negative consequences to China since adjustment mechanisms of market-oriented system does not operate fully in China, instead government intervention takes place. For instance, SOEs with poor performance are supported by loans with low interest rates instead of allowing to go bankruptcy.

On the contrary to the problems in the domestic economy, China's external position has been strong when compared to the rest of Asia as it is also seen in the list of Baek (2005) above. China has current account surpluses and a strong currency in the period 1996-1998. The ratio of total debt to reserves, most importantly short-term

[96] According to Yang and Tyers (2000), the real appreciation, restrictive monetary policy and the substitution of savings for consumption caused a decrease in domestic demand and gave rise to deflation.

debt, was lower than most Asian economies (Fernald and Babson, 1999, Engelbrecht and Hua, 1999, Yang and Tyers, 2000).[97]

Table 4.1: China's External Position

	Exchange Rate (USD eop)	Trade Balance (USD bn)	Current account (% of GDP)	External Debt (% of GDP)	Short-term Debt (% of reserves)
1991	5.43	133.5	3.3	20.7	109.3
1992	5.75	8.2	1.3	20	143.1
1993	5.8	-7.1	-1.9	19	155.5
1994	8.45	12.3	1.2	23.8	71.2
1995	8.32	23.3	0.2	21.2	58.3
1996	8.3	19.5	0.8	20.2	46.8
1997	8.27	46.2	3.9	19.4	38.5
1998	8.28	46.6	3.1	17.9	32.1
1999	8.28	36	1.9	16.9	27.9
2000	8.28	34.5	1.7	15.6	29.2
2001	8.28	34	1.3	14	23.5
2002	8.28	44.2	2.4	12.8	20.2
2003	8.28	44.7	2.8	12.7	19.6
2004	8.28	59	3.6	12.9	17.4
2005	8.07	133.9	7.2	12.3	15.6

Source: http://www.dbresearch.com

According to Engelbrecht and Hua (1999), capital controls may be seen as one the important factors of China's performance during the Asian crisis. Chinese firms, banks and other financial institutions have not been allowed to borrow directly from the international capital. The major sources of foreign capital inflows to China were official borrowing and FDI. The RMB is not convertible for capital account transactions which prevents the currency from speculative attacks. There have been limits to foreigners to enter Chinese equity markets.

According to Fernald and Babson (1999), the strong external position was the most important factor that prevented the Chinese economy from the contagion effects of the Asian crisis rather than capital controls. Despite their negative impacts, they accept that capital controls have played an important role in this period by preventing Chinese financial institutions from borrowing abroad excessively which was one of the main problems of the crisis economies.

[97] At the end of 1997, China's foreign debt was about US dollars 131 billion that more than 80 percent of this debt was long-term according to Engelbrecht and Hua (1999).

As a conclusion, China did not experience the serious macroeconomic weaknesses of the crisis economies before the emergence of the Asian crisis, especially in the financial sector. As mentioned above, there were problems in the banking system; however even the problems of the banking system were under government control. Four state-owned banks that constituted an important share of the system were the main financial source of SOEs so that they were directly controlled. Hence, the problems of the banking sector were a part of the problems in the state sector as Engelbrecht and Hua (1999) mention. Other institutional weaknesses stemmed from the incompleteness of the reforms and seem to be less related to this kind of crisis. The question is whether China will experience another crisis.

Table 4.2: The Contributions of FDI and Foreign-Invested Enterprises (FIEs) in China

	1991	1995	1998
FDI flows as a ratio of gross domestic investment (%)	3,9	15,1	15,2
Exports by FIEs (billions of US Dollars)	12,1	46,9	88,6
Share of exports by foreign-invested enterprises in total exports (%)	17	31,3	44,1
Share of industrial output by FIEs in total industrial output (%)	5	11,7	14,9
Number of employees in FIEs (million persons)	4,8	16	18
Tax contribution from FIEs as share of total tax revenue (%)	4,1	10	13,2

Source: Zhang (2001), p.682

It is unlikely that China would experience a currency crisis since she would overcome problems related to currency by the help of its strong balance of payment position and high foreign exchange reserves. Despite the deficits of SOEs, bank insolvency is also unlikely because of the government control in the sector. The government may increase the banks' capital in case of insolvency. Fernald and Babson (1999) state that there may be a sharp decline in economic growth which will decrease FDI and make the continuity of the reforms difficult. They point out that the Chinese economy does not depend on foreign capital; however FDI have played an important role in China's economic reforms. First, FDI was the main source of new products, technology and knowledge. Second, foreign firms have constituted a significant part of the non-state sector and played a role in the development of this sector. In other words, they took part in the SOE reform. As a conclusion, the role of FDI in establishing market-oriented institutions and integration to the world economy cannot be ignored according to Zhang (2001). Hence, the decline in FDI would cause some difficulties in the Chinese economy as the table below also indicates.

According to Fernald and Babson (1999), the consequence of such a crisis would be a decrease of the growth rate to 3 to 4 percent which is a decline lower than the crisis economies' experiences in 1998. On the other hand, such a crisis would put pressure on China's reforms especially in the banking system and SOEs and damage the development of the non-state sector. As a consequence, is that the unemployment problem of China would deepen.

Table 4.3: China's Unemployment Rate (Percentage)

1995	1996	1997	1998	1999	2000	2001	2002	2003	2004
2.9	3	3.1	3.1	3.1	3.1	3.6	4	4.3	4.2

Source:Liu and Ng (2006), p.3

4.3. The Impact of China on the Rest of East Asia

One of the most important developments affecting the global system since the 1980s is China's integration to the world economy in terms of trade. China has been trading with the various parts of the world and not only developing countries but also developed countries have been discussing the negative impacts of China to their economies. This growing market has been viewed as a threat to other economies and their positions in the international trade. The same kind of discussions rose for the East Asian economies. As a consequence of being in the same region and being at similar development stages, China's entrance to the international trade is expected to affect the other East Asian economies by reducing their exports and FDI inflows.[98]

> China's impact on the trade and investment of other countries is evident not just in Asia but in Europe and the Americas as well. Europeans see China, as a producer of an increasingly broad range of high-quality manufactures, as further compounding its

[98] It is stated that their development stages are similar; however the differences among the Southeast Asian economies cannot be ignored. According to Liu and Ng (2006), Singapore is close to a developed economy, Malaysia and Thailand have high industrialization level and the Philippines and Indonesia are less developed.

> competitive difficulties. North Americans enjoy the flood of cheap electronics and apparel from China and see the country as an increasingly important market for their technology and capital goods. South Americans see China as a market for their natural-resource-based exports, while Central Americans feel mainly the pain of Chinese competition. In Asia, where proximity presumably magnifies the impact of China's growth, all of these effects are evident.[99]

These discussions do not mean that China's rapid growth do only damage to the other East Asian economies. Most importantly, China became a trade partner of most of the countries in the region. The economies in the region have been the largest trading partner of China that their share in China's exports is twice the share of US and over fives times the West Europe (Lall and Albaladejo, 2004: 1454). For the Association of Southeast Asian Nations (ASEAN) as a whole, China is the fourth largest trading partner and ASEAN is also the fifth largest trading partner of China (Liu and Ng, 2006: 15).

Table 4.4: China's Trade with Other East Asian Economies (Percentage of Total Exports and Imports of China)

	1990		2000	
	Exports	Imports	Exports	Imports
Japan	9,4	15,9	15,8	22,3
Korea,Taiwan, Singapore	4,7	7,8	7,9	28,1
Hong Kong	50,6	29,8	18,1	5
Indonesia, Malaysia Thailand and the Philippines	2,4	1,9	3,3	6,6
Total East Asia	67	55,4	45,2	62

Source: Lall Albaladejo (2004), p.1455

On the other hand, there has been a perception that China's growth has damaged the exporting and FDI capacities of the other economies in the region. As China became the fourth largest trading country in the world and the largest exporting country in East Asia followed by Korea, Taiwan and Singapore, it is natural to expect some impacts on the other economies. Liu and Ng (2006) state that it is inevitable that China will take the share of economies that have been exporting labor-intensive

[99] Eichengreen B., Tong H., *How China Reorganizing the World Economy*, The Asian Economic Policy Journal, 2005, p.28-29

products as the world demand for these products have decreased in the past ten years. In addition, the East Asian economies have had more reasons to worry about China.

> The effects of these trends are likely to be felt especially intensely by China's Asian neighbors. Geographical proximity, shared borders, linguistic commonalities, and the existence of extensive networks of overseas Chinese are among the reasons to expect large amounts of trade between China and the rest of Asia. In some cases, similarities in stages of economic development, factor abundance, technological capability, and production costs mean that other Asian economies will compete head to head with China in third markets. Thus, China's emergence may intensify the competitive pressure felt by other Asian economies, slow the growth of their exports, and challenge the sustainability of high growth more generally.[100]

The impact of China on the exports of other Asian countries has an importance for both Asian economies and the world economy. As Eichengreen, Rhee and Tong (2004) state, this impact may affect the development strategies of other economies. For instance, the effect of China on driving the prices of labor-intensive manufactures down may cause incentives in other economies to specialize in technology-intensive production. According to Lall and Albaladejo (2004), the East Asian economies with higher wages than China should have such incentives in order to continue rapid export growth. Eichengreen, Rhee and Tong (2004) also mention that balances in the region have changed that any agreement within East Asia should include China as the largest economy of the region. The impact of China on East Asia would also have effects on the global system since the region has been important for the international trade.

As the economies in East Asia have different industrial capabilities and resource endowments, the export growth of China affects these economies differently (Eichengreen, Rhee and Tong, 2004, Eichengreen and Tong, 2005, Lall and Albaladejo, 2004). China is mainly the exporter of consumer goods and at this stage of exporting, its export growth does not damage the exports of advanced Asian countries such as South Korea and Japan which mainly export capital goods. They even benefit from China's export growth since her imports also grow. On the other side, the Asian economies that are the exporters of consumer goods will be affected negatively by China's exports. The overall impact is unclear according to

[100] Eichengreen B., Rhee Y,Tong H., *The Impact of China on the Exports of Other Asian Countries*, NBER, 2004, p.2

Eichengreen, Rhee and Tong (2004). The increasing share of China's high technology exports is also another factor although the shares of most of the other East Asian economies were higher than China in 2000 as Lall and Alabaladejo (2004) state.

Table 4.5: Technology Structure of Manufactured Exports in East Asia (Percentage)

	RB		LT		MT		HT	
	1990	**2000**	**1990**	**2000**	**1990**	**2000**	**1990**	**2000**
China	14.3	9.5	51.9	44.9	26.9	21.2	6.9	24.4
Korea	7.1	11.7	40	17.1	31.3	34	21.6	37.1
Taiwan	6.9	4.4	41.3	23.8	26.1	25.5	25.7	46.3
Singapore	27.8	14.9	9.6	6.5	23.4	17.4	39.1	61.2
Hong Kong	4.2	4.5	55.5	58.9	19.5	9.4	20.8	27.2
Malaysia	31.9	13.1	14.8	9.6	18	17.8	35.3	59.4
Thailand	24.2	18.4	40.1	21.5	15.1	23.8	20.6	36.3
Indonesia	54.2	33.7	32.6	31.3	11.3	17.5	1.9	17.4
Philippines	37.6	6.5	33.7	11.9	12.9	11.6	15.8	70

RB: Resource based, LT: Low technology, MT: Medium technology, HT: High technology Source: Lall and Albaladejo (2004), p.1446

From another perspective, Fernald, Edison and Loungani (1998) relate the export competition between China and the other East Asian economies to the exchange rate. They state that China's export growth was higher than other Asian economies between 1989 and 1993 because China's exchange rate depreciated sharply during this period. On the other hand, China's exchange rate has appreciated since 1993 and its export growth has been similar to other Asian countries.

As the overall picture indicates, it is difficult to claim that the problems of the East Asian economies related to international trade have stemmed from only China's increasing performance. On the other hand, they would feel the pressure of China in the future. For instance, the balances in the region may change, if China will be able to increase its share of high technology exports. There is the possibility that China would advance its technology level and human resource and become a competitor of economies like South Korea and Japan in the international trade; however Eichengreen and Tong (2005) state that this would take a long time. In a conference in 1998, W.G. Cheeney presents three scenarios for China's impact on the exports of the other economies in the region. First, these economies would not be able to compete against China's large and cheap labor supply and China's exports would increase further. Second, these economies would have a better position in the international trade by devaluing their currencies relative to RMB. Third, China would increase its domestic demand while the world demand would also increase so that every country in the region would gain.[101] At this moment, it is difficult to estimate which scenario will occur.

In this sense, Lall and Albaladejo (2004) advice these East Asian economies to specialize according to their competitiveness with China. Eichengreen and Tong (2005) state that China will continue specializing in labor-intensive manufactures and the reduction of trade barriers as a consequence of WTO membership will contribute to this process. This means that China will continue to compete with less advanced Asian economies and depend on the imports from more advanced ones. The role of industrial specialization cannot be ignored that it would be a better strategy for her neighbors to take the advantage of complementarities. In line with this strategy, Singapore and Malaysia produce intermediate electronic components and export to China while Indonesia, Malaysia, Myanmar and Thailand which are endowed with rich natural resources export China raw materials including oils and gases according to Liu and Ng (2006). In addition to the contributions to trade within the region, Qian and Wei (2001) state that WTO membership of China will bring benefits to the region by increasing capital accumulation and total factor productivity and encouraging being in line with comparative advantage. On the other side Lall and Albaladejo (2004) mention that the technology improvement of the economies in the region is important to follow China since complementarities may not grow.

The impact of China's growth on FDI to other East Asian economies is another issue. As discussed above for exports, it is also argued that China has received the FDIs that were received by the other East Asian countries previously. China's share in FDI flows to Asia has risen 70 percent by 2002 while it was 10 percent at the beginning of the transition according to Mercereau (2005). In addition, 70 percent of FDI to Southeast Asia has changed direction to China in recent years (Liu and Ng, 2006: 8).

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[101] The conference organized by Harvard University was held on May 30, 1998 with the title *The Asian Financial Crisis, Challenges and Opportunities*.

A sharp decline in FDI flows will cause similar problems in these economies that are presented for China in the previous section. In such a case, most important problem of these economies is losing manufacturing industries and jobs provided by these industries as Fung, Iizaka and Sue (2004) state. Most of these economies in the region have expressed their complaints about the impacts of China's rise on their FDI inflows and have begun to take some measures.

As another perspective, Eichengreen, Rhee and Tong (2004) state that the increasing FDI flows to China would be advantageous to other economies in the region since these economies may also invest in China and receive higher returns than they would in their own economies. It is also possible that China's development may have contributed to FDI growth in the countries that have been the importers of raw materials and components to China as Mercereau (2005) states. Similar to exports, the overall effect of China on FDI flows to the other East Asian economies is unclear.

Table 4.6: FDI Inflows to China and ASEAN-5 (billion US dollars)

	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003
China	27.5	33.7	35.8	40.1	44.2	43.7	38.7	38.3	44.2	49.3	53.5
Indonesia	2	2.1	4.3	6.1	4.6	-0.3	-2.7	-4.5	-3.2	-1.5	-0.5
Malaysia	5	4.3	4.1	5	5.1	2.1	3.8	3.7	0.5	3.2	2.4
Philippines	1.2	1.5	1.4	1.5	1.2	2.2	1.7	1.3	0.9	1.7	0.3
Singapore	4.6	8.5	11.5	9.3	13.5	7.5	13.2	12.4	10.9	7.6	5.5
Thailand	1.8	1.3	2	2.3	3.8	7.3	6.1	3.3	3.8	0.9	1.9
ASEAN-5	14.7	17.9	23.5	24.4	28.4	19	22.2	16.4	13.1	12	96.7
ASEAN-5+China	42.2	51.7	59.4	64.6	72.7	82.7	60.9	54.8	57.3	61.3	63.1
ASEAN-5/Total	35	35	40	38	39	30	36	30	23	20	15
China/Total	65	65	60	62	61	70	64	70	77	80	85

Source: Liu and Ng (2006), p.9
It should be noted that sources have given different numbers for China's FDI inflows. Table 2.3 from UNCTAD, *World Investment Report 2006* on page 67 indicates a different amount of FDI inflows to China from the number given in this table.

As mentioned in Chapter 3, China became the largest recipient of FDI among the developing countries. It is also mentioned that FDI has played an important role in the development of other East Asian economies; however indicated a declining trend for some period. Wu, Siaw, Sia and Keong (2002) state that FDI flows to Singapore, Thailand and Malaysia were high before the Asian crisis that they received more FDI than Taiwan, South Korea and Japan. On the other hand, the crisis reversed the FDI flows to these economies and there has been a tendency to relate this decline to the increase in FDI flows to China.

Wu, Siaw, Sia and Keong (2002) search for the validity of the claim that there have been negative impacts of China on FDI to five East Asian countries, Indonesia, Malaysia, Singapore, Thailand and the Philippines that they term as ASEAN-5.[102] They state that these discussions depend on the assumption that any increase in FDI flows to one country decreases FDI to other countries that they term as a "zero-sum game". In the table above, Liu and Ng (2006) have a similar approach. By holding other factors constant such as other investment areas in the world and equating the sum of FDI flows to China and ASEAN-5 to 1, they indicate that the share of China is increasing while ASEAN-5's share is volatile. By rejecting this approach, Wu, Siaw, Sia and Keong (2002) state that it is possible that FDI to China and the other East Asian economies may increase simultaneously.

It is expected from a country with a high GDP to attract more FDI than another country with a lower GDP when other factors are equal according to Wu, Siaw, Sia and Keong (2002). On the other hand, they indicate that according to the data for the period 1989-97, China's growth and integration to the world economy did not have any negative impacts on the FDI to the other East Asian economies. In this period, the annual growth rates of FDI to China and ASEAN-5 were 38 percent and 17 percent respectively. This rate of FDI growth for ASEAN-5 in this period is not low because it was 16 percent in the period 1979-1989. In addition, FDI to China declined when FDI to these countries declined sharply between 1998 and 2000 and

[102] These countries are the original members of the Association of Southeast Asian Nations (ASEAN) which was established in 1967. Brunei, Vietnam, Laos, Myanmar and Cambodia are the other members of ASEAN.

increased in 2001 while also increasing in these economies (Wu, Siaw, Sia and Keong, 2002: 103).[103]

Table 4.7: Real GDP Growth Rate of ASEAN-5 and China (Percentage)

	Indonesia	Malaysia	Philippines	Singapore	Thailand	China
1987	4.9	5.4	4.8	9.4	9.5	11.1
1988	5.8	8.9	6.3	11.1	13.3	11.3
1989	7.5	9.2	6.1	9.2	12.3	4.3
1990	7.1	9.7	2.7	8.3	11.6	3.9
1991	6.6	8.7	-0.7	6.7	7.9	8
1992	5.8	8.5	0	5.8	7.5	13.2
1993	5.9	8.4	1	9.9	7.7	13.5
1994	7.5	9.2	4.4	11.4	9	12.7
1995	8.2	9.8	4.7	8	9.3	10.5
1996	7.8	10	5.8	7.6	5.9	9.6
1997	4.7	7.3	5.2	8.5	-1.4	8.8
1998	-13.1	-7.4	-0.6	0.1	-10.8	7.8
1999	0.8	6.1	3.4	5.9	4.4	7.1
2000	4.8	8.9	4.4	9.6	4.8	8
2001	3.8	0.3	1.8	-2	2.2	7.5
2002	4.4	4.1	4.3	3.2	5.3	8.3
2003	4.9	5.3	4.7	1.4	6.9	9.5
2004	5.1	7.1	6.1	8.4	6.1	9.5

Source: Liu and Ng (2006), p.2

Another issue that Wu, Siaw, Sia and Keong (2002) mention is whether the main investors of these East Asian economies have been taken away by China. They again reject this perception because they state that developed countries have invested more in ASEAN-5 than in China between 1995 and 2000 while Hong Kong has been the largest investor of China in this period. In addition to the continuing FDI from US and EU to ASEAN-5, Japan has invested in ASEAN-5 more than in China.[104] FDI to ASEAN-5 at the end of the 1990s are indicated in Table 4.8.

Fung, Iiazaka and Siu (2004) make another analysis to search for the impact of China on FDI flows to ASEAN-5 by adding Hong Kong, Taiwan and South Korea and they

[103] FDI to ASEAN-5 declined by 67 percent in 2000 when compared to 1997 and this rate was 7.8 percent for China. The rise in FDI flows in 2001 was 31 percent for ASEAN-5 and 15 percent for China (Wu, Siaw, Sia and Keong, 2002: 103).

[104] The annual average FDI from Japan to ASEAN-5 was US dollars 4.5 billion between 1996 and 2001 while to China was US dollars 1.5 billion in this period (Wu, Siaw, Sia and Keong, 2002: 103).

reach similar results. First, FDI flows to China and these economies are positively related. Second, when there is an increase in FDI to China, the share of FDI to these economies declines. Finally, there are more important factors than China for these economies to ensure more FDI inflows such as lower corporate taxes, higher degrees of openness and even lower degrees of corruption. Mercereau (2005) reach the same conclusions by adding six countries to the analysis.[105]

Table 4.8: **FDI to ASEAN-5 (US Dollars billion)**

From	1997	1998	2000
East Asia (Including Japan)	13,3	5,7	2,3
US-and EU-4	8,5	-0,4	11

EU-4 is the UK, Germany, France and the Netherlands. Source: Wu, Siaw, Sia and Keong (2002), p.106

The competition between China and these economies cannot be ignored when the potential of the Chinese market and the efforts to provide a favorable environment as in SEZs are considered. It is obvious that these economies would have received more FDI if China did not open her economy to international trade and foreign direct investment successfully. On the other hand, Wu, Siaw, Sia and Keong (2002) state that the main cause of the decline in FDI to ASEAN-5 was the Asian crisis.

Wu, Siaw, Sia and Keong (2002) state that the increase in FDI flows to China would have been higher if foreign investors have shifted from the other East Asian economies to China; however this does not mean that such a diversion cannot occur in the future. Because of this, they advice these economies to keep their balances in order to be able to attract more FDI by mentioning that they still have advantages such as cheap and productive labor and foreign firms that have already made important investments in these countries. In other words, the growth of FDI to the other East Asian economies is more related to their own macroeconomic stability than the growth of FDI to China.

There have been some measures within ASEAN such as establishing investment areas or signing free trade agreements with other countries in order to prevent the

[105] These countries are Bangladesh, India, Papua New Guinea, Sri Lanka, Myanmar and Vietnam.

negative impacts of emerging exporting economies like China.[106] These measures would bring benefits to the region such as increasing the economies of scale, strengthening the trade within the region and increasing the competitiveness of the region in the international market (Liu and Ng, 2006: 14). On the other hand, Wu, Siaw, Sia and Keong (2002) state that it would be a better strategy for ASEAN to view China as a *growth engine* and should search for integrating with her. Liu and Ng (2006) state that these countries have accepted this fact on the one side and try to increase their technology levels in order to be able to compete with China on the other side. It is obvious that these economies should strengthen their trade relations with China which have already began to expand. The imports of ASEAN-5 from China was US dollars 16.4 billion and China's imports from ASEAN-5 was US dollars 22.9 billion in 2001 (Wu, Siaw, Sia and Keong, 2002: 110). In addition, ASEAN-5 may also benefit by receiving FDI from China that US dollars 108 million which was about one-fifth of China's outward FDI, was received by Southeast Asia in 2000 as Wu, Siaw, Sia and Keong (2002) mention.

> In addition, ASEAN and China have signed a landmark deal to form the largest trade zone in the world, which encompasses a total population of 1.7 billion people and a combined GDP of about US$ 2 trillion. The ASEAN-China Free Trade Area (ACFTA) would involve the reduction and elimination of tariffs by 2010 for China and the six senior ASEAN member countries, and by 2015 for Cambodia, Laos, Myanmar and Vietnam. It is estimated that the ACFTA would bolster ASEAN's and China's GDP by 0.9 per cent and 0.3 per cent respectively. The ACFTA would also increase ASEAN's exports to China by 48 per cent and China's exports to ASEAN by 55 per cent. The ACFTA also provides for an "early harvest", in which the six senior ASEAN members and China would begin to lower tariffs in several product categories from 1 January 2004.[107]

According to Wu, Siaw, Sia and Keong (2002), the other East Asian countries should view China as both a competitor and a partner. This is required for economic growth and welfare of these countries. China is a partner of the other East Asian economies because she is a fast growing economy with an increasing demand of investment and consumption that would play a role in the improvement of these economies (Liu and

[106] ASEAN Free Trade Area (AFTA), ASEAN Investment Area (AIA), the ASEAN Industrial Cooperation (AICO) scheme, the ASEAN Framework Agreement on Services, e-ASEAN and the ASEAN Integration of Preferences were formed in line with these measures (Liu and Ng, 2006: 15).

[107] Wu F, Siaw P.T., Sia Y.H., Keong P.K., *Foreign Direct Investment to China and Southeast asia: Has ASEAN Been Losing Out?*, Economic Survey of Singapore,Third Quarter, 2002, p.110

Ng, 2006: 12). On the other side, having a competitor does not always mean that there will be only negative impacts, instead competition may encourage the other East Asian countries for good macroeconomic management.

According to Liu and Ng (2006), large economies like Indonesia, Malaysia, Thailand and Vietnam has a two-track approach against the new balances in the region. They continue to implement the export-oriented strategy; however "they also look inward to their domestic market as a new source of economic stimulus for their economic growth."[108] The looking inward of the economy includes supporting local enterprises by increasing their resources and skills, assisting business and re-development of the economy beginning with agriculture and establishing new industries. In this sense, the Chinese economy may be seen as a model to these economies when China's development story that is presented in Chapter 3 is taken into consideration. Qian and Wei (2001) state that the economies in the region would benefit more than other developed or developing countries from the WTO membership of China. This statement can be extended that the East Asian economies would benefit from China's economic achievements more than any other country.

[108] Liu Y., Ng B.K., *Facing the Challenge of Rising Chinese Economy: ASEAN's Responses*, Rewiew of Development economics, "WTO, china and the Asian Economics", June 2006, p.14
They state that this approach is termed as Thaksinomics which is a response to the paradigms of Washington Consensus and the East Asian Development Model that have been unable to explain the new conditions of Asia since the crisis.

CHAPTER 5

CONCLUSION

One of the causes of the deep interest in the rapid growth period of the East Asian economies which is termed as the East Asian miracle in the literature was that it was a consequence of export-oriented strategy. With their economic success and improving life standards on the one hand and with the important positions they gained in the international economic order, these countries became the focus of both developed and the other developing countries. As a consequence, there has been formed a wide literature on the development of East Asia. The neoclassical view has related the success of these economies to following the neoclassical principles. In contrast, revisionists have stated that the features of the East Asian economies have been very different, even inverse of, the neoclassical framework. World Bank has tried to find a way between these two views by the market-friendly view; however this view has not added much to the neoclassical view. As a conclusion, the East Asian economic success gave rise to different responses from the literature.

"Getting basics right" was the main principle that brought success to the East Asian economies according to the neoclassical view and the market-friendly view. The neoclassical view has ignored the role of state intervention in these economies and the market-friendly view has stated that state intervention was limited so that contributed to the good-functioning of markets rather than damaging.

When the main policies on industry and international trade of the East Asian economies are overviewed, it is seen that these policies were based on a subsidy system. The firms were promoted if the requirements of the state were satisfied and exporting was the basic requirement. This system that is termed as directed credit mechanism enabled the state to control and supervise the firms and gave rise to a relationship between the state and business. As another distinguishing feature, the diversified business groups formed the industry structures of these economies.

These features indicate that the East Asian governments intervened their economies effectively and development has not taken place within the neoclassical framework. In other words, these economies developed and functioned by "getting prices wrong" of the revisionist view rather than freely operating markets. In line with this view, the neoclassicals blamed these economies of not following the rules of the market by excessive state intervention which gave rise to poor macroeconomic stance after the emergence of the Asian crisis. In addition to the state intervention, state-business relation was severely criticized. The miraculous economies before the crisis turned out to be the systems of crony capitalism. These interpretations indicate that the whole East Asian development model was criticized after the crisis.

On the other hand, the main cause of the Asian crisis was the financial liberalization process that began in the late 1980s and accelerated in the early 1990s. This process was not accompanied by the regulation and the supervision of the governments on the contrary to the East Asian development model. The short-term debt burden was the most important consequence of these uncontrolled financial liberalization policies and the European and the Japanese banks played a role in the formation of the short-term debt burden. Hence, this process was not a part of the East Asian development model, instead was a factor that came from outside the region. Because of this reason, the revisionists state that the Asian crisis was an outcome of the fact that the East Asian development model has been damaged.

China which nearly got no damage from the Asian crisis and her economic success has attracted the attention of the world as the East Asian miracle did. People's Republic of China which was established in 1949 adopted central planning system and entered a transition period in 1978. According to the literature, this transition from the central planning system has purposed to establish a market-oriented economy; however China has stated her purpose as establishing a socialist market economy. This new term is not consistent with both the Marxist theory and the neoclassical theory. Although their number are not as high as the ones who view the aim as establishing a market-oriented economy, some of the authors emphasize that China's main purpose has been achieving economic growth and improving the life standard and welfare of the Chinese people.

It is evident that there have been a number of changes in China since 1978. One of the most important factors of these changes is decentralization. Decentralization in China has included the rights of local governments on various areas such as taxes, banking and trade that they did not possess before. As a consequence of the increase in the autonomy of the local governments, an economic institution unique to China emerged. TVEs may be seen as a product of the socialist market economy with their collective ownership on the one hand and operating like private enterprises on the other hand. TVEs have had two main contributions to the transition process. First, they became the most important factor of rural development. Second, they challenged the power of SOEs. These were the reflection of the fact that the local governments began to take a part in the economic decision-making.

It should be mentioned that there has not been a political reform in China on the contrary to the other transition countries. The Communist Party has maintained its monopoly in politics. In addition, the reforms which have been implemented since 1978 have been under the central government's control. It is evident that some of the elements of the market-oriented economy such as the non-state sector have entered the Chinese economy; however these were all subject to the permission of the state. The transformation in economic decision-making has a political aspect; however it was the central government that has decided which actors should be in this process.

These features of China's transition have mainly stemmed from the *gradualist strategy* on the contrary to the *shock therapy strategy* which was adopted by the other transition economies. These features also gave rise to two different interpretations of China's transition. The experimentalist school states that the success of China has stemmed from the incrementalist, experimentalist and gradualist nature of the reforms and these reforms will bring a unique system to China. On the other side, the convergence school states that China converges to the capitalist economies, especially to the East Asian economies rather than a unique system. China has succeeded despite gradualism by taking the advantage of her favorable initial conditions according to the convergence school. Despite their differences, it should be mentioned that these two schools share the view that China approaches to a market-oriented economy.

After the reform period of nearly three decades, the main consequence is that the state has maintained its role in the economy in China on the contrary to the other transition economies. The intervention of the central government has been reflected in industrial policies and the way of opening the economy. By following the other East Asian economies, China has adopted export promotion as a strategy. China has not privatized the big industrial SOEs and continued to subsidize them. The privatization of small and medium-sized SOEs since the 1990s has given rise to different interpretations. On the one hand, privatization was welcomed by stressing on the numbers and on the other hand it was stated that the state gave up being the whole owner of the loss-making SOEs.

Actually, there is not much about privatization in China that the neoclassicals who dominate the literature on the transition, would have viewed positively. SOEs have maintained their important role in the Chinese economy. On the other hand, integration to the world economy has been the issue that enabled the neoclassicals to view China's economy as a close candidate of a market-oriented economy. The fact that China's integration has not included financial integration yet has not bothered them although integration as a term has been a source of wide discussions currently and financial integration is an important part of a complete integration. Financial integration is seen as an inevitable consequence of the process by the neoclassicals.

Since the reforms began, it is correct that China's economy has opened to the international trade incredibly, especially when compared to the central planning period. The increasing performance of China in exporting and attracting FDI has brought some problems to the economies all around the world. The economies of East Asia were also affected negatively because of lower labor costs in China, especially the ones which have a similar export structure and technology level with China's. On the other hand, the overview of the literature indicates that the macroeconomic stability and technological improvement have been more important determinants than China for increasing exports and attracting more FDI in these economies.

China has managed the opening by combining her own strategies and the East Asian strategies, rather than the neoclassical methods. The export-oriented growth strategy of China has included the promotion of exports as mentioned above and the protection of industry from imports when needed as Wade (2003) states. Because of this reason, China is more close to a socialist market economy in China's words than a market-oriented economy although it is claimed that the transition process will lessen these features of China. China has experienced a transition from the central planning system; however she has not established a market-oriented economy yet and it is not absolute whether she will in the future although the dominant view in the literature has been the opposite.

Although the starting points of China and the other East Asian economies were different, China is also more close to a developmental state. As presented in the Introduction, developmental state refers to a state which intervenes different areas of the economy in order to achieve economic development in the thesis. According to Wade's definition given in Chapter 2, developmental state is a centralized state interacting with the private sector by holding the control in order to secure development objectives. According to Chapter 3, China fits to these definitions. It may be stated that the relationship between the central government and the newly emerging private sector has been different in China when compared to the other East Asian economies. On the other hand, it is obvious that the central government has continued its control on the private sector in order to secure developmental objectives as Wade's definition.

Also, China's development fits to the *late-industrialization* of Amsden that she connects industrialization with learning and describes the economies with subsidy systems and reciprocal state-business relation. Finally, Amsden puts China in the group of *late-industrializers* that achieved manufacturing which she calls "the rest".

With the continued state control over the economy, it is obvious that “getting prices wrong” is an appropriate term to describe the state-market relation in China.

After the Asian crisis, the revisionists interpreted the financial liberalization process in East Asia as a damaging factor of the development model. In this sense, it may be stated that China is more superior because she has taken a lesson from the consequences of the inappropriate financial liberalization policies of her neighbors. The performance of China during the Asian crisis with the strong external position and continuing controls on the movement of financial capital was the reflection of this fact.

The thesis has a conclusion on both the East Asian experience of development and the literature on this experience. There have been different interpretations of the East Asian miracle and crisis as mentioned above and they have mainly stemmed from ideological and political interests. In China’s transition, there is the dominance of the neoclassical view in the literature that tends to interpret any reform in China as a way to a market-oriented economy and ignores the role of the central government in the development process. As a consequence, it is difficult to find an analysis that views the state as a dynamic actor in the growth and development of the Chinese economy contrary to the literature on the East Asian miracle. In the conclusion of Chapter 3, this fact is explained by the lack of revisionist explanations on China’s reforms and the consequences of these reforms.

The other conclusion is related to a general feature of the East Asian development. Arrighi, Hamashita and Selden (1997) state that the East Asian success has been an example of a development experience that challenged development theories by not fitting *established dichotomies such as “market versus plan”*. The current situation of China is another example of this statement since the purpose of socialist market economy does not fit to either the market-oriented economy or the central planning system. The transition process of China also proves this fact. It should be mentioned that these conclusions that are reached after over hundred pages seem to hold in the short and medium terms; however it is hard to predict China’s situation in the long-term.

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