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WHAT CHINA IS MISSING TO BE A MARKET ECONOMY

CHINA'S POLITICAL & ECONOMICAL MODELS CONTRADICTION

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ECONOMY**

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WHAT CHINA IS MISSING TO BE A REAL MARKET ECONOMY.

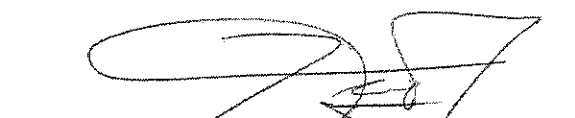
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I. General and specific objectives

China has been growing at a fastest pace than the rest of the world in the last two decades increasing the importance of its economy every day in the global field but sowing uncertainty and confusion among investors and the rest of the world due to the contradiction between its political and economic models. Economically, the People's Republic of China has demonstrated to be more open to capitalism but its politics reveal a communist system in which there is no opportunity for a capitalist economy as it is originally conceived.

In the economic arena, China represents what Christopher A. McNally defines as Sino-Capitalism¹ which is a new model of capitalism that “relies more on informal business networks than legal codes and transparent rules. It also assigns the Chinese state a leading role in fostering and guiding capitalist accumulation. Sino-capitalism, ultimately, espouses less trust in free markets and more trust in unitary state rule and social norms of reciprocity, stability, and hierarchy”².

In the political field, China is considered a communist republic where the Communist Party of China (CPC) governs throughout the whole country based on a mixed model of Marxism-Leninism ideologies and Mao Zedong beliefs adapted to Chinese conditions as the CPC constitution states. CPC ideology supports the idea of having a communist nation compatible with a market economy. Communism refers to a collectively or state owned property and resources, a classless society, a totalitarian state and a single, self-perpetuated political party.

Considering communism and capitalism in its original definitions and China's communist political system along with its particular economic model, it could be said

¹ Christopher A. McNally (2012). World Politics 64. Sino-Capitalism: China's reemergence and the international political economy.

² Christopher A. McNally (2012). Sino-Capitalism: China's Reemergence and the International Political Economy. World Politics, 64, pp 741-776. Article reviewed on January 8, 2016. Link: <http://dx.doi.org/10.1017/S0043887112000202>

that China is missing many factors to become a market economy and that there is conflict between politics and economics. After the 1949 revolution, the country has been exposed to a radical transformation departing from state communism to state capitalism while creating a double path dependency that limits its transition to and pure capitalism. In first place, China is still relying in a “pre-reform” Chinese communism based in Lenin’s New Economic Policy. In second place, the country has decided since 2001 to permit globalization. Although official statements don’t openly accept the transition from state communism to state capitalism, it is no longer a secret but instead, it creates a disjunction between Chinese economic and political models. There are many examples of different situations in which this Chinese dichotomy is revealed and where this thesis objectives become clear.

As a general objective, this thesis intents to go through the pillars of capitalism and communism in its original versions while comparing both systems with the actual Chinese version of both, which after the four modernizations program was launched in 1978 under Deng Xiaoping’s leadership, it was called “market communism with Chinese characteristics”. Political economic history needs to be recalled in order to understand the Chinese model and determine what does Chinese economy is missing in order to be a Market economy.

As specific objectives, the thesis will explain and answer the following:

- I. In its economy, what does China has in its favor that could allow further development and how the lack of transparency and restrictions in other market aspects can hinder economic performance. Trade, foreign direct investment, the currency (Renminbi), capital markets, property rights, among other aspects will be examined.
- II. Up to what point do Chinese political and economic models fit together?
- IV. When will China change its policy if its economic model is going so well?

II. Justification

Over the last 37 years, since Deng Xiaoping became the most prominent leader in China, this country began its opening up policies moving to a more market oriented economy, experiencing an important economic transformation totally guided by the state and creating a new model of capitalism: Sino-Capitalism³. In Addition, integrating wealth and power has been a major characteristic of China's development model that has brought growth and poverty reduction while empowering the private sector and entrepreneurship under the guidance and support of the government.

Since the late 1970s China has stimulated a more market oriented economy changing its centrally planned and closed model and getting to be one of the most important and influential players in the world of economics today. It has been a long process that it is still on progress and in which many different reforms from diverse fronts have been undertaken gradually with the objective to be a more efficient economy while gaining power in the global scenario as well. It is important to clarify that even if openness has been a flag in China during the last years, it also continues having a state guidance in almost every aspect of the economy leading the Sino-Capitalism.

Sino-Capitalism in China involves three main institutional characteristics: I) *Guanxi*, II) a magnified state role and III) an Anglo-American influence in values and institutions. *Guanxi* means having long term, personalized and reciprocal networks of influence, it has brought private capital accumulation to the center of politics as government offers a strong support and benefits to private business and entrepreneurs that support the Chinese Communist Party. A magnified state role is seen in the continuous state intervention in markets and economy throughout reforms with stringent rules that have restricted foreign investment, market transactions and currency free movements while giving to state firms privileged conditions and access to subsidies and loans. Regarding Anglo-American influence, it refers to the global institutions that China is now part of

³ Christopher A. McNally (2012). World Politics 64. Sino-Capitalism: China's reemergence and the international political economy.

such as the World Trade Organization (WTO) and the influence it has had over the country in terms of trade and other economic aspects and social values.

Entering into the WTO has allowed China to increase its international trade by signing agreements in both ways, imports and exports. As of 2014 data, China is the largest exporter and the third largest importer of the world just falling behind of the United States and the European Union (the World FactBook). According to the Central Intelligence Agency (CIA), exports are around USD 2.3 trillion, they are mainly concentrated in machinery, textiles, apparel and integrated circuits and its main export partners are US with 16.9%, Hong Kong 15.5%, Japan 6.4%, and South Korea 4.3%. Regarding imports, they stand at USD1.96 trillion focusing in oil and mineral fuels, nuclear reactor, boiler and machinery components, optical and medical equipment, metal ores, motor vehicles and soy beans. China's principal import partners and participations are South Korea 9.7%, Japan 8.3%, US 8.1%, Taiwan 7.8%, Germany 5.4%, and Australia 5%.

In addition, low labor costs have allowed China to become a big platform for local and multinational companies to build its facilities there and export. It can be said that for local state-owned and private companies the government has been the leader by giving the guidance, support, connections and facilities to start new businesses of businessmen affiliate to the CPC and grow the ones that the government needs the most. Throughout these 37 years of transition, China has opened its doors to foreign companies as well but it has sometimes closed them creating an ambiance of instability for foreign direct investment. Nonetheless, many multinationals have established production centers in different industrial Chinese cities turning China into its main source of profits.

Lastly, but not less important, I should say that China is a very important subject for me as a financial professional due to the high impact its economic and political models have in financial markets around the world whenever traders and investors get news from any changes, interventions and economic data from China. Is impressive how China has become a major

source of global growth but at the same time, how it imposes volatility in markets and loses when is not going so well. Throughout the document, the reader will understand the importance of China in the economic and financial world system.

III. Object

The problem

China is a country founded in communist principles and it has been led by the CPC of China since 1921 when it was formed. CPC's main leader has been Mao Zedong who led a revolution and whose forces won The Chinese Civil War in 1949 proclaiming the People's Republic of China. Even though Mao's successors' have modified the CPC's communist doctrines giving a market orientation in economics, it still has many restrictions based in communism which don't allow talking about China as a market economy.

China has become the second largest economy, just behind United States and it has been working on it since 1978 with particular characteristics but outstanding results. Particular characteristics like having the state as the shaping force of economy and development instead of having the role of just making clear game rules and let the market forces work. Under this state-led development form of capitalism, China has used an exports growth strategy for capital accumulation and foreign technology incorporation while reaching one of the highest growth rate and reducing poverty. According to The Economist⁴, between 1980 and 2010 China took out of misery 680 thousand people and reduced the number of persons living in extreme poverty from 84% in 1980 to 10% as of 2013. Meanwhile, China's growth has been leading the world economic growth (GDP) for the past years getting rates of not less than 7% since 2012 according to CIA's World FactBook.

Furthermore, and despite the outstanding economic performance of the country in the last decades, thinking about China as a market economy is difficult taking into account its communist policy and the fact that it is missing clear property rights, reliable statistics, transparency within institutions, free political affiliation, wider financial markets

⁴ Towards the End of Poverty – June 1st 2013, Article read on January 6 2016. The Economist: <http://www.economist.com/news/leaders/21578665-nearly-1-billion-people-have-been-taken-out-extreme-poverty-20-years-world-should-aim>

openness, a free foreign exchange market meaning little or no intervention at all, and an independent private sector from politics due precisely to its communist political affiliation.

IV. Communism and Capitalism: economic and political aspects and its evolution over time

Communism is an economic and political structure that supports equality and looks for the eradication of social classes. In a communist society, it doesn't exist the concept of being poor or wealthy as everyone works towards the same goal while being all equal. This ideology is conceived under the communal ownership of everything where overall economic output is distributed based upon need among the community, and not by effort or amount of work of each individual. Basic needs are met by the community and everyone has the same access to them, there is no incentive to work more than what it is required as nothing additional will be gained or improved (living standards) with more effort.

Communism father, Karl Marx stated in 1875 in the *Critique of the Gotha Program*⁵ that “from each according to his ability, to each according to his need” which clearly refers to the production and distribution of wealth in a communist society. In one hand, “From each according to his ability” means that every individual has the opportunity to develop its talents and use them to contribute to society's production of goods and services. Under this first part of the principle, every member of society has access to education and a job in which it will have the responsibility of giving back to society what it has received. With no consideration of poor, unemployed or uneducated people, Marx proposal was that each person had to work and contribute to the best of its abilities while others through their work, meet other's needs.

On the other hand, in the second part of Marx's principle “To each according to his need”, Marx sought to explain that the satisfaction of needs was different in every person. Although, there are different kinds of jobs, ones probably harder or more exigent than others, each member of society had to receive what it needed and nothing else to

⁵ *Critique of the Gotha Program* was written by Marx in early 1875, it is a critique of the draft of the program on the United Workers' Party of Germany. In this work, Marx addresses the dictatorship of the proletariat as the transition period from Capitalism to Communism.

avoid greed and maintain an equilibrium. Thus, equality is a matter of everyone getting complete satisfaction of needs which means receiving a certain quantity of goods and services that is different from what others receive without considering if one individual has worked more than another one.

Regarding ownership, it could be said that one of the most important principles of communism is in fact that no private ownership of property should be allowed because if permitted, competition at any cost and consequences along with greed would be the motivation for people to create inequality and continue growing the gap between rich and poor. Property should be shared and the government should exercise control over it. Thus, means of production should be publicly owned and the surplus product accrued among society to avoid disparities.

Politically, communism is characterized by having just one single ruling party or a dominant party system always adhering to the Marxism-Leninism ideology. Central planning of everything is the rule; a communist party is usually understood as the party of the working class with an internal democracy and a single central leadership. Communism was founded in the second half of the nineteenth century by Karl Marx and Friedrich Engels as an economic-political philosophy.

Communism was created by Marx and Engels based on their discontent with capitalism which for them was a social class system that led to the exploitation of workers. Both thought that the proletariat were individuals with labor power being exploited who were going to get conscious of that exploitation and as a consequence, create class conflict that would be resolved through revolutionary struggle resulting in their raise above bourgeoisies. Such revolution would lead society to transform from capitalism to communism first and finally, reach pure communism where "the needs of society would be put above and beyond the specific needs of an individual"⁶.

⁶ Communism and Computer Ethics. History and Background of Communism. Ruven Chu, Daniel Lau, Shane Moriah, Amos Schallich. <http://cs.stanford.edu/people/eroberts/cs201/projects/communism-computing-china/index.html>

“The Communist Manifesto”⁷ was wrote and published in 1848 by Marx and Engels and is considered as the bible of communism. It represents an attempt to explain the goals of communism and the underlying theory of this movement, it is divided in four sessions describing: i) key ideas of Marx’ theory and the relationship between proletarians and bourgeoisie, ii) relationship between proletariats and Communism and how the revolution will be like, iii) the flaws in previous communist and communist literature in Marx’ opinion, iv) relationship between the Communists and other opposition parties.

After the Communist Manifesto, communism began to being implemented in several countries around the world taking a stronger shape in some of them than in others. For example, in the late nineteenth century Russia started to develop the communist philosophy and in 1917, the Bolsheviks increased its power through the October Revolution and later changed their name to the Communist Party. Lenin was the leader here and when Bolsheviks took power in October 1917, a civil war started and the only allowed party was the Bolshevik. Later in 1924, after Lenin’s dead, Stalin continued his “legacy” while concentrating the power in bureaucracy and turning the state into a private enterprise.

At the same time and following the Marxist ideas of favoring the working classes, workers obtained control of the companies which became state property, landowners were expropriated from their land and distributed among peasants, women equated their rights to men and church was separated from state. The fight against opponents was also extended to purge those who thought differently inside the Bolshevik party itself in which one of the victims was Trotsky, who was forced into exile and finally killed. The Russian Communist Party was the first with Marxist ideology to seize power and start sending its ideals to all European communist parties as well as extending its influence over the USSR. Some European and Asian countries began to follow this Russian example of Communism, including China.

⁷ Karl Marx & Friedrich Engels. The Communist Manifesto. Chiron Academic Press – Sweeden. Wischouse 2016.

After Lenin's victory in 1917 of the October Communist Revolution in Soviet Union, Marxism began to spread in China getting some Chinese intellectuals to recognize that Marxism was the right way of managing the revolution to victory. The Communist Party of China was officially formed in 1921 in Shanghai as a political party and a revolutionary movement by Mao Zedong, Chen Duxiu⁸ and Li Dazhao⁹ who came out of the May Fourth Movement¹⁰ against imperialism and feudalism and began to set up communist groups through the country to spread Marxism and workers movements. The CPC started then to lead the New Democratic Revolution which took place between 1919 and 1949 when it finally won and established the People's Republic of China successfully transforming Chinese society from new-democracy to communism.

Marxism and Leninism are the guiding ideologies of the CPC since its foundation along with Mao Zedong thought which is the application and development of the first two in China. Mao, leading the CPC by that time, was in charge of instituting a basic system of communism in the new Republic by developing communism at three stages: culturally, economically and politically. Later in 1978, Deng Xiaoping as main representative of the CPC, very wisely decided to collect and study the country's experience in the last three decades to consider the positive and negative outcomes of the CPC's policies, in order to abandon bad practices, continue with the successful ones and start drawing the new path for China.

Xiaoping changed the mindset of people in regards to what citizens needed to do thereafter to achieve economic success and communist modernization. He introduced a new period of communist construction by reforming some policies and opening up the country to the exterior world. As the CPC constitution affirms in its general program, the Deng Xiaoping Theory was founded:

⁸ Chen Duxiu was one of the Chinese communist revolutionary men who co-founded the CPC. He was known as a leading representative of the Xinhai Revolution and the May Fourth Movement.

⁹ Li Dazhao was a Chinese intellectual who co-founded the CPC along with Chen Duxiu.

¹⁰ May Fourth Movement was an intellectual revolution and communist movement occurred in China between 1917 and 1921. National independence and emancipation were the main purposes of the movement.

*"After the Third Plenary Session of the Eleventh Party Central Committee, the Chinese Communists, with Comrade Deng Xiaoping as their chief representative, analyzed their experience, both positive and negative, gained since the founding of the People's Republic, emancipated their minds, sought truth from facts, shifted the focus of the work of the whole Party onto economic development and carried out reform and opening to the outside world, ushering in a new era of development in the cause of socialism, gradually formulating the line, principles and policies concerning the building of socialism with Chinese characteristics and expounding the basic questions concerning the building, consolidation and development of socialism in China, and thus creating Deng Xiaoping Theory. Deng Xiaoping Theory is the outcome of the integration of the basic tenets of Marxism-Leninism with the practice of contemporary China and the features of the times, a continuation and development of Mao Zedong Thought under new historical conditions; it represents a new stage of development of Marxism in China, it is Marxism of contemporary China and it is the crystallized, collective wisdom of the Communist Party of China. It is guiding the socialist modernization of China from victory to victory."*¹¹

At this point, it is worth mentioning that Xiaoping as leader of the revolution, acted very wisely by not just interposing its views and changing all just in once but applying his thoughts accordingly to the current conditions of the country. Since then, and still today, the CPC promotes the "communist modernization" and states in its constitution the road to follow to achieve it. In fact, in its Constitution, amended and adopted at the Sixteenth National Congress of the Communist Party of China on November 14, 2002, mentions "communist modernization" everywhere and supports it always by referring to reform and opening up, the development of productive forces, the improvement of its communist market economy, the expansion of an economic and technological exchange with other countries, the better usage of foreign capital, the implementation of a political restructuring and the defense of people's democratic dictatorship.

The above mentioned reforming policies in the economic and political systems, started in 1979, can be considered as the establishment of "*communist modernization with Chinese characteristics*". Since then, the country has experienced considerable and important changes that have taken China to be the second largest economy in the world. It is the period where the country has been able to make unprecedented achievements, take out of poverty millions of people (more than any other country in the world),

¹¹ General Program of the Constitution Of the Communist Party of China. *Revised and adopted at the Eighteenth National Congress of the Communist Party of China on November 14, 2012*

increased its per capita income from \$200 in 1990 to \$5,000 in 2010¹² while getting China to reach the ranks of middle-income countries.

Considering all communism history mentioned above, Communism with Chinese Characteristics is then the latest evolution of Marx and Engels theory foundation. It differs from traditional communist economies since its inception as China started to develop Marx's ideology still being a semi-feudal society instead of being full-capitalist. It combines public ownership (from communism) and market economy in some aspects (from capitalism), it's development represents a peaceful road, it has coexisted peacefully with capitalism while building strong relationships with capitalists, and it has used capitalism success in advanced science and technology for its benefit and development.

Capitalism on the other hand, is a system based on private ownership of capital and means of production, entrepreneurship, market allocation, competition, innovation, the search for new capital, and is related to democratic or representative political regimes. It is always associated or known as the representation of market economies. The main incentive for producers of goods and services is the profit while this production is based upon supply and demand rather than through government central planning. The system started with the end of feudal economies and today it is spread around the world, it is associated with clear property rights and remuneration according to the labor specialization and effort.

Government influence in market and in capitalist outcomes in a general sense, is indirect through taxes, regulations and military forces instead of determining what, when and how much to produce. The market by its own is in charge of setting the prices of goods and services. Social classes coexist within capitalist societies. The capitalist class is the one that owns the means of production (land, factories, technology, etc) and takes decisions in regards of the use of resources. The working class which sells its work to

¹² Stuart, Elizabeth. China has wiped out urban poverty. Now it must tackle inequality. August 2015. The Guardian: <https://www.theguardian.com/business/economics-blog/2015/aug/19/china-poverty-inequality-development-goals>

the capitalist class to earn a salary and the middle class created by the division of labor which permits specialization for certain people in certain areas of the economy.

Adam Smith is considered the father of modern capitalism and "*An Inquiry into the Nature and Causes of the Wealth of Nations*" as his masterpiece and basis for capitalism. In his work, Smith makes reference to an invisible hand that organizes the market and creates equilibrium in the economy. He believed in freedom and that the division of labor and the expansion of markets opened unlimited possibilities for society to increase their wealth and social welfare by growing specialized production and increasing trade among nations.

Smith justified his "invisible hand" theory by stating that through the application of people talents and their contribution the manufacture of goods needed by the society, they pursued to receive an income. Every individual should act for its self-interest as an economic agent and dedicate to that economic activity that would bring the highest compensation. He considered that acting under its own self-interest, individuals would also bring welfare to all society. The following piece of "*An Inquiry into the Nature and Causes of the Wealth of Nations*" expresses Smith's sentiment on how economy works:

"But the annual revenue of every society is always precisely equal to the exchangeable value of the whole annual produce of its industry, or rather is precisely the same thing with that exchangeable value. As every individual, therefore, endeavours as much as he can both to employ his capital in the support of domestic industry, and so to direct that industry that its produce may be of the greatest value; every individual necessarily labours to render the annual revenue of the society as great as he can. He generally, indeed, neither intends to promote the public interest, nor knows how much he is promoting it. By preferring the support of domestic to that of foreign industry, he intends only his own security; and by directing that industry in such a manner as its produce may be of the greatest value, he intends only his own gain, and he is in this, as in many other cases, led by an invisible hand to promote an end which was no part of his intention. Nor is it always the worse for the society that it was no part of it. By pursuing his own interest he frequently promotes that of the society more effectually than when he really intends to promote it. I have never known much good done by those

who affected to trade for the public good. It is an affectation, indeed, not very common among merchants, and very few words need be employed in dissuading them from it”¹³.

Smith’s economic model has been criticized as the “invisible hand” doesn’t guarantee equitable distribution and is not enough to get plenty economic efficiency as markets are not always efficient and they contain flaws, imperfections and asymmetric information that make government intervention necessary in some way.

To sum up, pillars (Jahan and Mahmud, IMF 2015)¹⁴ of capitalism are basically six: i) limited role of government, to look after the rights of citizens and provide a helpful environment for the proper operation of markets. ii) freedom with regards of what to produce, consume and where to invest. iii) private property, which allows individuals to own tangible and intangible assets. iv) competition, through firm’s freedom to choose in which markets to be and which to exit in search for more profitability. v) self-interest, where people pursue their own benefit ending up in social welfare. vi) prices of goods and services established by the interaction between supply and demand.

Jahan and Mahmud (IMF 2015) distinguish various forms of capitalism taking into account these pillars and some economists’ views. It can be classified into two based on how production is organized: **Liberal market economies** where there’s a competitive market and the majority of production is decentralized like in the United States and United Kingdom; **Coordinated market economies** where private information is exchanged by non-market organizations like business associations as in Germany and Japan.

According to the role of entrepreneurship and how it drives innovation and the existing institutional frame in which that innovation pushes economic growth, Capitalism

¹³ Adam Smith, *An Inquiry into the Nature and Causes of the Wealth of Nations* 1776, book IV, chapter II. Cannan edition: <http://www.econlib.org/library/Smith/smWN13.html>

¹⁴ Sarwat Jahan and Ahmed Mahmud, What is Capitalism?. Finance and Development, IMF. June 2015, Vol 52, No. 2. <http://www.imf.org/external/pubs/ft/fandd/2015/06/basics.htm>

can be divided in four different categories. **State-guided capitalism** characterized for the government intervention to decide which sectors to grow. It is considered to attract large sums of capital for investments and being susceptible to corruption. **Oligarchic capitalism** focused on the welfare of a narrow fraction of the population which brings inequality and corruption in large scale. **Big-firm capitalism** is oriented in the mass production of goods taking advantage of existing economies of scale. **Entrepreneurial capitalism** is based on generating innovative goods and services and creating revolutions and new developments.

Capitalism, in any of its forms, is the predominant economic system today and its major representative is The United States where you can observe market competition in every sector and government intervention only through regulations in order to provide a better infrastructure and contribute towards markets efficiency. Although Capitalism and Communism are often considered as diametrically opposed and incompatible, the truth is both systems are coexisting now in many countries where some aspects of each system has been adopted to ensure a better economic and social welfare equilibrium. China is one of these countries where there's government planning and limitation on private control of resources at the same time that it opens its economy to the international trade and investment while its currency is now convertible as well.

V. China's Political Economy

Political Economy is about the study of how economic theory impacts politics and vice versa. Both, economics and politics interplay within a system influencing the institutional development of a country. Political economy studies how public policy is shaped and applied in any social and economic system such as capitalism, communism and communism. In the case of China, its political economy is very particular as the political side is dominated by communism while economics are everyday more market-oriented.

Politically speaking, China is a communist country where the only political party ruling is the CPC that has been in charge of shaping and managing the “power-capital” institution in the country. Power-Capital institution is defined by Zhaohui Hong as a “kind of mixture that combines and integrates political power and economic capital essentially embedded in structures, functions, norms, values, faith, discourses, governance, economy, law, and ways of life”¹⁵. In China, a country characterized by the close relationship between a political party (CPC) and the state effort on the CPC’s influence on the country’s overall development, both power and capital are exercised solely by the CPC.

Between 1949 and 1976, during the Maoist era, China was still an agrarian society with no development at all and with a traditional culture. Back in those days, political power dominated every area of the country and economic capital, understood as the one used to create wealth and generate profit through investments, neither had room nor a significant role. Later with Xiaoping’s arrival to power, the path for economic capital started to being built in Chinese society through the introduction of reforms in 1978. Reforms gave economic capital influence within the society and political sphere, its

¹⁵ Hong, Zhaohui. *The Price of china's Economic development. Power, Capital, and The Poverty of Rights*. University Press of Kentucky 2015.

value was boosted and it effectively established a coalition with political power to influence economic policy-making and share political control.

During the Republican China (1930s and 1940s), capital was totally bureaucratic and dominated by four families (Zhaohui Hong, 2015), explicitly the ones of Chiang Kai-shek (president of the Republic of China), Charlie Soong (minister of the treasury), Kung Hsiang-hsi (minister of finance and governor of the Central Bank of China), and Chen Li-fu (minister of education). Bureaucratic capital was basically an invisible merge of official position and political power, they were both synonyms of the other and in fact, they can be considered as the same entity. Today, they are not the same entity but it is clear that power dominates capital, and power being exclusively monopolized by the unique political party and its officials who handle the central planning of the economy.

Some analysts call the Chinese development model as “crony” or “phony” capitalism which is a term used to describe an economy in which success in business is determined on how close the relation of a businessman is to the government officials. State interventions in this type of capitalism are directed and driven towards the benefit of friendships and family ties between business people and the government in form of special tax breaks, legal permits, public grants, among other permissions that without the government consent would be illegal. It could be considered as the marriage between state and its specific interests as government supports the businesses connected to them, political leaders make arrangements with business people to benefit themselves, and they have the ability to affect capital and land allocation which by the way, China’s constitution affirms that urban land is state-owned.

Today, after all reforms performed since 1978, Chinese economy is less totalitarian and more capitalist if we consider that the CPC seeks profit while looks for society welfare and at the same time has globalized its economy. Nonetheless, China is not yet a capitalist society or economic system, though it increasingly embodies many capitalist configurations. On one side, China’s political system “still controls the media, personnel

selection, and the police”¹⁶, protects certain sectors, manipulates prices and doesn’t let the market “do its magic”. On the other side, currency is now freely convertible, private sector is widening its capital shares, government is encouraging innovation more every day, services industry is growing and foreign direct investment has surged.

It seems that the CPC refuses to release its control over the capital and economy as a whole while trying to protect its Leninist and Maoist principles and itself to not disappear over time with a more market oriented economy and democratic political transition. CPC officials show few signs of adopting political changes towards democratization in China’s political system but it is worth mentioning that we have seen a party adapting to changes and learning from other failed communist societies that rules and ideals can’t remain as originally conceived forever. For some scholars of the party-state school, “the CPC is not in imminent danger” (Bruce Dickinson, 2006) but for others, “China cannot remain a completely closed political monopoly and remain stable” (Larry Diamond, 2006) and have predicted a change or regime no later than the first quarter of the current century.

This close relationship between capital and political power, have opened the doors for corruption in large scale in almost every economic sector and although reforms have brought more freedom to people and economic growth, they haven’t bring a “sense of personal ethics and social morality” (Zhaohui Hong, 2015). China’s economy has grown at the expense of high environmental, health and social costs due to the rapid industrialization and poor regulation for many years.

¹⁶ Fewsmith, Joseph. *The Political Economy of China’s transition. Rule of Law in China: Chinese Law and business.* The Foundation for Law, Justice and Society in collaboration with the Centre for Socio-Legal Studies, University of Oxford.

VI. China's politics on investment and economic development

China has caught the attention of many economists around the world and it is not for less when talking about a country with the highest growth rate for almost half a century and when having one of the largest populations in the world. Additionally, it must be curious and why not interesting for contemporary analysts to think about a communist government with a market economy within the same frontiers when historically one ideology has been the opposite of the other one. Despite this contrasting philosophy, China has been able to shine in the world economy and to catch investors' funds from all around the globe (including the largest economies) bringing economic and social development to its citizens.

The following paragraphs intent to go throughout the last 50 years of economic history in China to briefly explain the country's factors of success in becoming the rival of the US economy and getting to be the first investment recipient country in the world. Over this period China has experienced reforms in different economic areas and as a result it has undergone a change from an agrarian society to an industrial center. During this process, China has become the world's second-largest economy representing almost 15 percent of global GDP.

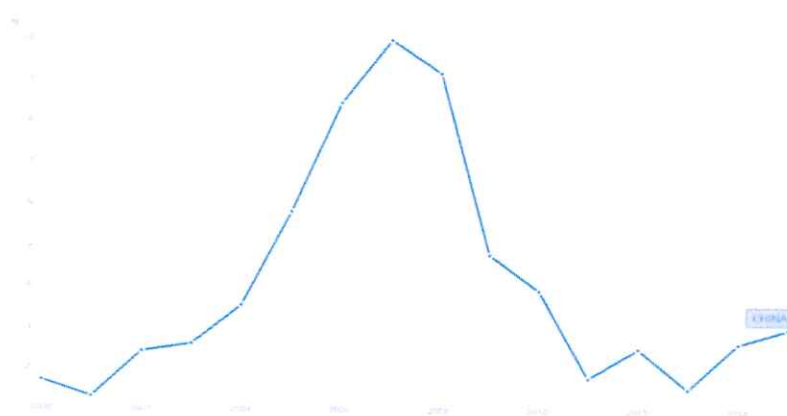
China's extraordinary growth in the last four decades speaks for itself; it has brought economic development, reduction of poverty and investment to the country. Chinese economy has been growing at a rate of nearly 10 percent¹⁷ in the last 40 years driving the country to become the second largest economy in the world. Since the introduction of the Four Modernizations economic reforms in 1978 under the leadership of Deng Xiaoping, the country started its insertion into the global economy by stating some opening up policies to foreign investment and joining the IMF and the World Bank in 1980.

¹⁷ <http://data.worldbank.org/indicator/NY.GDP.MKTP.KD.ZG?page=1>

The Four Modernizations program along with the low labor costs allowed China to become the world's manufacturing hub. Local and multinational companies from abroad took advantage and established facilities in China to export to the rest of the world while turning this Asian country as the main source of profits. During the 90's decade Jiang Zemin was the one in charge of implementing more economic reforms giving more power and weight to the private sector with the privatization of state-owned companies, reducing trade barriers, introducing competition and new taxes, reforming the banking system and finally guiding China to join the World Trade Organization in 2001 which has allowed the country's trade to boost in the last decade.

In 2002, Ju Hintao became the leader of the People's Republic of China bringing with him subsidies, slowdown in privatizations, social welfare promotion and an aggressive stimulus of USD 585¹⁸ billion package after the 2008 financial crisis in order to prevent the economy from suffering the worst effects of it. This stimulus boosted the economic growth while supporting the investment in certain industries apparently without hurting China's public finances as it had a very strong fiscal position at the moment, however, the demand downturn and recession of the world's main economies did affect the external sector of the current account and its surplus started to contract (see Figure 1).

Figure 1. China's current Account



Source: World Bank

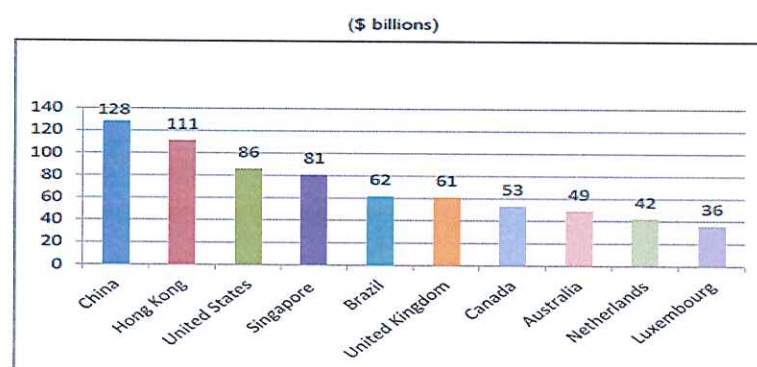
¹⁸ http://www.businessweek.com/executivesummary/archives/2008/11/chinas_585_bill.html

Later in 2012, Xi Jinping stepped up as the president of China and his main pillar has been to limit the role of the government while permitting a more market-oriented economy and ensuring a sustainable growth model even at lower growth rates in the upcoming years. Furthermore, Xi has launched a program to consolidate local government finances, a system of property rights for agricultural land to protect farmers and has also assumed new commitments in different international negotiations like completing free trade agreements with two of its largest trading partners: Australia and South Korea.

VII. Investment and Economic Development in China

As mentioned before, in the 1990's under Jiang Zemin governance there were trade and investments reforms undertaken letting Foreign Direct Investment (FDI) surge and letting it become the main source of economic growth and productivity gains. According to China's 2012 Statistical Yearbook, there were 445,244 foreign invested enterprises in China in 2010 employing around 16% of the whole urban workforce and being responsible for a major level of China's foreign trade. More recently, and in terms of foreign direct investment inflows, the United Nations estimates that China was the larger FDI recipient in 2014 followed by Hong Kong and the United States (See Figure 2).

Figure 2. U.N Estimates of Largest Recipients of Global FDI Inflows in 2014



Source: United Nations Conference on Trade and Investment.

Note: U.N. FDI data on China's FDI inflows differ from China's official data.

Economic reforms on trade and investments in the 80's and 90's decades were key to attract FDI into the country, modernize the economy and develop the local firms. Helped by these reforms, China started to be seen as a giant market in which to sell products, to incentive local companies to produce and to receive FDI through companies from overseas that decided to produce goods and made of China a strong competitor and a major global exporter. On the contrary, investment outflows were more restricted for private and state owned companies until 2000 when the government decided to encourage domestic firms to go global and invest abroad with the main purpose of

getting natural resources such as oil and minerals in order to sustain China's rapid economic growth (Wayne M. Morrison).

Chinese market is still considered unexplored because of its size as it has a big potential domestic market with 1.3Bi¹⁹ consumers, with an attractive expected growth rate of around 6 percent²⁰ for the upcoming years and still has low labor costs in some industries. Besides this facts, it is time for China to start thinking differently by innovating in high-technology, developing a strong services industry, investing in science and creating green energy industries instead of relying in its manufacturing capabilities, the "Made in China" label and high-polluting activities. Otherwise, the country won't be able to continue growing and attracting FDI as it has been doing in the last years.

Investment reception and economic development from now on will depend on innovation, domestic consumption and the development of a stronger services industry instead of manufacturing. If the government pretends to continue delivering wealth to its citizens, it must continue performing economic reforms to ensure a lower savings rate as a percentage of GDP and privatizations in the corporate sector and banking system while lifting restrictions on financial markets. Furthermore, the country needs to attack government corruption, reduce or eliminate preferential policies given to state-owned companies, lower investment and trade barriers to increase economic efficiency, boost competition and address income disparities.

Moreover, economic development will no longer rely on I) people moving from agricultural jobs to value added city jobs as it has already happened in the last 50 years, and II) the *catch-up* process that has provided productivity growth in China as technological sophistication is closer to other advanced economies today. Chinese government will need to let the market forces work freely to obtain a more balanced economy and boost consumers' spending power. These reforms will help the country to

¹⁹ <http://data.worldbank.org/country/china>

²⁰ <https://www.imf.org/external/pubs/ft/weo/2016/update/01/>

reach sustainable and healthy growth overtime, reduce inequality, gain a larger soft power among other countries, and avoid economic stagnation which would affect other countries as well.

Finally, it is worth mentioning that China's economic development and FDI growth is key not only for Chinese citizens but for the rest of the world that has become increasingly dependent on it and suffered the consequences of the latest slower economic growth. Commodities prices have been going down in the last two years due to a lower demand of them in China and other major consumer countries, financial markets around the globe suffer turmoil whenever Chinese economic data is not as good as expected and when corruption scandals arise within public institutions. China has become not only the second largest economy but a major player in the trade, financial and economic field as important as the European Union and the United States in terms of relevance to the world and that's why it is very important for the Chinese government to understand its new challenge. From now on, challenge needs to consider that further development will rely on different factors from the ones that have served until now and structural reforms in certain areas along with more liberalization will help those new factors to potentiate growth, investment and development.

VIII. Among other contradictions

How are there so many billionaires in China, a communist country?

This is the question that many people ask themselves everyday trying to understand the dichotomy between China's communist political model and sino-capitalist economy and the implied contradiction. Furthermore, it is important to mention that wealthy people in China do not come from being entrepreneurs but from having a close affiliation to the CPC; this is political patronage creating billionaires. Sino-capitalism is precisely about generating very close relationships within the party in order to create networks in which the more connections a businessman has with the government, the more successful his company is. Chinese state plays a key role in the development of many businesses by supporting them economically and facilitating them different aspects. Large companies do not operate without the cooperation of the government.

In fact, Chinese government still owns a large percentage of China's major corporations. State-owned companies are the larger ones in the country and although how much politicians are personally benefited from this system is heavily scrutinized, it is still a constant and it is what prevails. Having the government support, allow these state-owned companies to have easier access to loans, to be insulated from competition, among other benefits. Fortune 500 published in July 2015 that 103 companies of the world's largest companies are from China putting the country in second place just behind the United States that has 128. From those 103 companies, the top twelve are state-owned including banks and oil companies that have Chief Executive Officers appointed directly by the government and only twenty-two are private.

This is probably one of the most important contradictions in China as a communist country is not supposed to have rich people and social classes; government should be distributing the income equally among everyone avoiding poverty. At this point, it could probably be questioned if there has been a communist society in this sense in modern history. Still, China has 335 billionaires identified by Forbes in 2015, all from mainland China representing an

increase of 38% from a year ago. Meanwhile, poverty is still an issue as the country has 70 million remaining poor according to China's last five-year plan launched in early 2016 but it must be highlighted that over 800 million people have been taken out of poverty in the last 4 decades. Moreover, one of the main points of the five-year plan is to lift 10 million people out of poverty per year starting 2016 and ending in 2020 (Forbes²¹).

Official statistics reliability

It is not a secret how much official statistics veracity has been questioned in China recently mainly due to the country's slowing pace of growth that has alarmed and shake the global economy. China's National Bureau of Statistics as any other office in the world in any other country, is supposed to deliver not only China's leaders but common investors and society in general (local and foreigners) accurate figures about the health of the economy. Economic figures are used by corporate and investors leaders to make thorough decisions on financial and economic prospects of projects and investments so, how could you be sure of investing in China if the official economic data is not reliable? This could be a problem for the country if not corrected soon.

The most controversial statistics are the ones coming from provincial and other local governments due to the fact that officials managing those governments are evaluated on their performance measured statistically. Additionally, these officials oversee and control the bureaucrats responsible for producing this information which creates a path for the government to control the information that wants to be publicly known. Furthermore, the same local authorities are given growth target rates incentivizing them to manipulate numbers and show a different reality.

Although few doubt that China has experienced a great expansion in the last years based on market reforms, the implementation of international standards and other factors, it is worth mentioning that many do believe that the bureau of statistics manipulates the data to show it

²¹ Can China Wipe Out Poverty By 2020? Sara Hsu. <http://www.forbes.com/sites/sarahsu/2016/08/19/china-wipe-out-poverty/#7326894f461b>

smoothly while underestimating growth in booms and overestimating it during downturns. Independent economists dedicated to Chinese studies have collected data and made their own numbers for 2015 GDP and they stand with a lower growth of around 3% against the 7% divulged by Chinese government officials.

Accurate statistics contribute to the transparency of institutions and in the case of China to reaching the goal of promoting and developing a more open and market-oriented economy. More trustworthy statistics and statistical methods should be put in place in China to show everyone the risks they face in that economy. Accurate statistics represent a powerful tool for any nation and a method to avoid information asymmetries, to realize and oversee sensitive problems such as income gaps, which has been in fact one the main subjects to attend in the Chinese government agenda.

IX. Capital Markets Controls

China still has a strong capital control regime in place, but it is worth recognizing that it has been removing these controls in a selective and cautious way. In many cases, controls have become more relaxed but they have not been eliminated at all which can be seen as a positive fact if it is seen as part of the process of the country's liberalization. According to Eswar Prasad²² in his testimony before the U.S. China Economic and Security Review Commission on the status of market-oriented economic reforms in China on April 27, 2016 these are the main facts that have been put in place in China to loosen inflows, outflows and two-way flows:

Channels for Inflows

Qualified Foreign Institutional Investor (QFII) Scheme: Launched in 2002. Allows qualified foreign institutions to convert foreign currency into RMB and invest in Chinese equities (both A shares and B shares) and a range of other RMB denominated financial instruments. As of October 2015, a total quota of \$78.9 billion had been granted to 277 foreign institutions, including 8 central banks and 10 sovereign wealth funds.

Renminbi Qualified Foreign Institutional Investor (RQFII) Scheme: Launched in 2011. Allows qualified institutions to use offshore RMB funds to invest in Chinese equities and other RMB-denominated financial instruments. As of July 2015, a total quota of \$68.4 billion had been granted to 135 financial institutions.

Channels for Outflows

Qualified Domestic Institutional Investor (QDII) Scheme: Launched in 2006. Allows Chinese domestic financial institutions—commercial banks, securities companies, fund management companies, and insurance companies—to invest in offshore financial products such as securities and bonds. As of November 2015, a total quota of \$90 billion had been granted to 132 financial institutions.

Qualified Domestic Individual Investor (QDII2) Scheme: Proposed in 2013; not yet launched. Will permit individual retail investors with at least RMB 1 million (\$160,000) in assets to invest in certain offshore financial products.

²² Prasad, Eswar: China's economy and financial markets: Reforms and risks: <http://www.brookings.edu/research/testimony/2016/04/27-china-economy-financial-markets-prasad>. Prasad is a Senior Professor of Trade Policy at Cornell University, Senior Fellow at the Brookings Institution, he was chief of financial studies division in the IMF research department and former head of FMI's China division.

Channels for Two-Way Flows

Free Trade Zones (FTZs): Shanghai FTZ launched in September 2013. Three new FTZs in Guangdong, Tianjin, and Fujian launched in April 2015. The FTZs use a “negative list” approach to regulate foreign investment—there are few restrictions on foreign investment in industries not on the list. Cross-border capital transactions and establishment of financial institutions within the zones have been liberalized.

Shanghai-Hong Kong Stock Connect: Launched in 2014. Allows mainland Chinese investors to purchase shares of select Hong Kong and Chinese companies listed in Hong Kong, and lets foreigners buy Chinese A shares listed in Shanghai. HK-to-Shanghai annual quota: RMB 300 billion (\$47 billion); daily quota RMB 13 billion (\$2 billion). Shanghai-to-HK annual quota: RMB 250 billion (\$39 billion); daily quota: RMB 10.5 billion (\$1.6 billion).

Mutual Fund Connect: Launched in July 2015. Allows eligible mainland and Hong Kong funds to be distributed in each other’s markets through a streamlined vetting process. Initial aggregate investment quota: RMB 300 billion (\$47 billion) each for inward and outward fund flows.

Source: Brookings

These measures allow the government to maintain some control over capital flows in terms of volume and composition, which could be understandable if seen as a cautious way to evade economic misbalances in an economy that is not totally prepared for a complete liberalization. Nonetheless, all of these schemes show a great effort from the government to continue working towards a smooth transition into a market-based economy, yet, investors and people abroad are expecting bigger reforms and openness in a shorter period of time. Other restrictions on capital markets include: i) an annual individual foreign exchange quota of USD 50,000 which is being monitored by the government both, online and in branches; ii) in QFII, investors are supposed to have their quota but they are still waiting long for approval which restricts their room for maneuver; iii) government intervention on the stock exchange market by imposing circuit breakers that stop trading for 15 minutes if the main stock index rose or fell more than 5% and for the day if it changes more than 7% which can lead to panic and a sell

off collapsing the market²³; iv) the bond market²⁴ is subject to overlapping jurisdictions as there are three supervisory entities within China's capital markets' regulatory structure: China Banking Regulatory Commission (CBRC), China Securities Regulatory Commission (CSRC), and China Insurance Regulatory Commission (CIRC); v) Securities market is based on retail investors due to problems²⁵ in the system and short term investment motives that keep away institutional and corporate investors who seek for markets with depth and liquidity.

China's financial system is still bank-dominated and the state controls most of the banking system. The People's Bank of China (PBC) is the Central Bank, the main banking authority in the country. During the first years of the 80's decade, the government started to open up the system by allowing four specialized banks (state owned) to enter in deposits and the overall banking business. These four banks are the China Construction Bank (CBC), Industrial and Commercial Bank of China (ICBC), Agricultural Bank of China (ABC) and Bank of China (BOC). Later on in the mid 90's, government established three more banks with specific lending purposes: Agricultural Development Bank of China (ADBC), the China Development Bank (CDB) and the Export-Import Bank of China. Additionally, with the opening up of its economy, the country started to receive foreign banks branches and develop a bigger network of commercial banks operating in the country.

Setting new banks, allowing foreign ones to open operations in China and instituting a number of reforms have helped the financial sector to develop in recent years. Bank deposit and lending rates have now been totally liberalized allowing commercial banks

²³ Although this measure was lifted by the end of May, it is important to highlight that investors are watching closely if government and companies will really respect the new rules and how do they apply them in practice. In theory, new rules implemented on May 2016, limit companies' ability to self-suspend, "Halts will be capped at three months for major asset restructuring and one month during private placements. The bourses will have the right to reject trading-halt applications under extreme market circumstances in order to protect investors, the statements said" (Bloomberg).

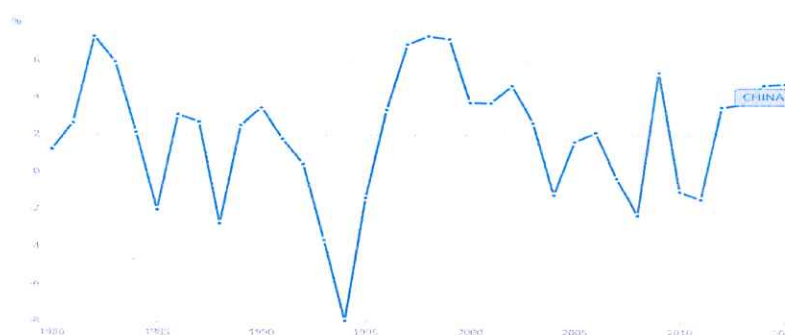
²⁴ The NDRC examines and approves Enterprise bonds, CSRC regulates the stock exchange's bond market, PBoC controls the interbank bond market and the MoF runs the government securities primary market.

²⁵ Problems in the system refers, for example, to poor governance of listed companies, lack of fiduciary duty of the company management to shareholders and lack of products available in the market.

to set both rates, although the central bank sets a reference rate to guide them. Banks can now agree on the minimum rate at which they will lend money allowing lower funding costs and favoring a larger competition among them. On the deposits side, margins were gradually amplified since 2012 until October 2015 when all restrictions were lifted ending with historical low and negative rates²⁶ (Figure 3).

Furthermore, worldwide experience shows that whenever a country liberalizes its interest rate policy and lets it be market-oriented, industrial restructuring is promoted. According to World Bank statistics²⁷, out of 18 countries that reformed its interest rate to made them more market-oriented, 17 countries experienced an increase in the interest rate and a continuous labor and capital outflow from the primary industry to the secondary and tertiary industries. Fixed income markets have developed substantially in the last decade reaching a stock of government bonds of 3.5 trillion yuan while nonfinancial corporate debt reached 1.5 trillion, however, as it is a nascent debt market it lacks depth and liquidity which should improve over time with more market participants. As Eswar Prasad mentions in his testimony, effective regulation for corporate debt markets should be a priority in order to avoid financial instability and inspire confidence for investors.

Figure 3. Interest Rates in China 1980 - 2015



Source: World Bank

²⁶ Interest Rates are defined by the World Bank as “the lending interest rate adjusted for inflation as measured by the GDP deflator. The terms and conditions attached to lending rates differ by country, however, limiting their comparability.”

²⁷ Zhong Tang, Jie LV. Renmin University of China. Agricultural Productions constraints and Rate Liberalization in China. August 2016: <http://ageconsearch.umn.edu/bitstream/235758/2/Agricultural%20Productions,%20Credit%20Constraints,%20and%20Rate%20Liberalization%20in%20China.pdf>

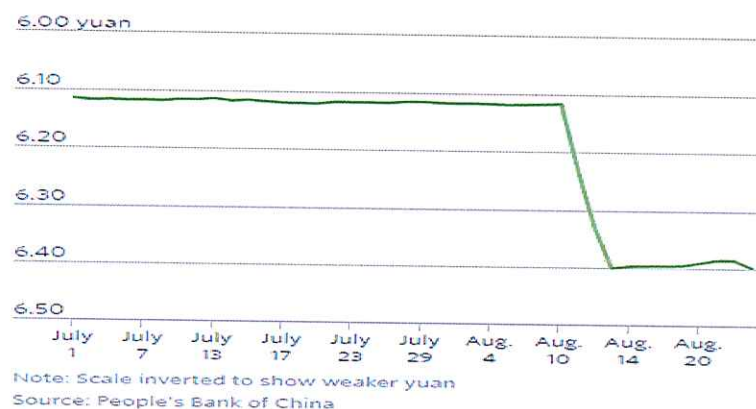
Regarding the currency, which is at the same time one of the main assets in a country's financial markets, the government has been promoting it as an international currency in an attempt to encourage their trade and finance transactions with the rest of the world. In the past few years China has taken a number of measures that include permitting the settlement of trade transactions with RMB, allowing some of the banks to offer offshore RMB deposit accounts, creating clearing centers in different financial hubs in the world, permitting issuance of RMB-denominated bonds in Hong Kong, and setting up the China International Payment System.

This last mechanism, is said to be more aligned with international standards while it facilitates RMB cross-border transactions such as trade and investments not only for Chinese firms but for many other companies and people outside the country that are willing to grow its relations with Chinese counterparties. Moreover, it is worth mentioning that RMB's exchange rate against dollar opening price for trading is set by the PBC every morning in the Shanghai China Foreign Exchange Trading System (CFETS) and that it has a floating band in which it fluctuates that has been intervened by the central bank to expand it from 1% to 2% in March 2014. This floating band means that every business day, the RMB (against USD) trading prices can fluctuate within a band of +/- 2% around the mid-rate set up by the CFETS.

Political and economic uncertainty appears every time the PBC intervenes its currency because it is a signal that the government can manipulate the RMB for the economy convenience instead of letting it move according to market forces. In this case, China being a net exporter "needs" a devaluated currency to sell its products abroad artificially cheaper and bolster the economic growth. Last intervention in RMB by the PBC was on August 2015 when government decided to depreciate the trading range by 2% arguing that "it made the move as part of an adjustment to how it values the yuan that will make it more sensitive to market sentiment"²⁸. The following graph (figure 4) from the Wall Street Journal shows the fixing rate before and after intervention.

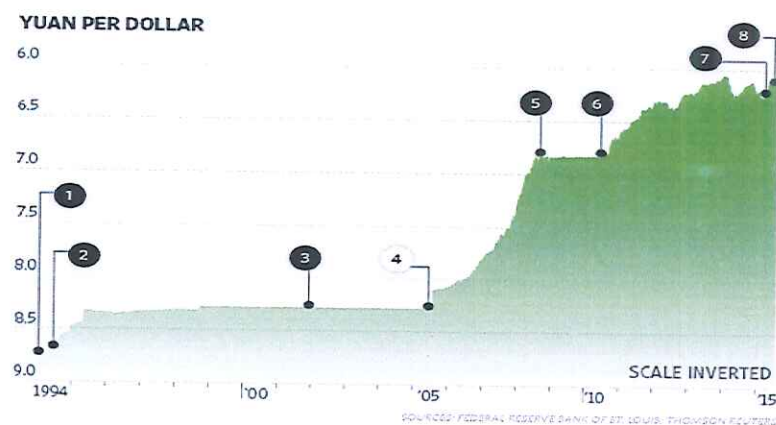
²⁸ China Moves to Devalue Yuan, August 11, 2015: <http://www.wsj.com/articles/china-moves-to-devalue-the-yuan-1439258401>

Figure 4. Fixing Rate



The following graphic (Figure 5) from the Wall Street Journal²⁹ illustrates CNY's behavior since 1994. It shows the evolution of the currency over time:

Figure 5. CNY Behavior



Each number in the graph represents either one intervention in the RMBUSD exchange rate or an important event that has impact on RMB. 1) in January 1994, the consolidation of the two existing exchange rates into one single pegged to the US dollar happened. 3) December 2001, China joins the WTO lowering trade barriers and promising to lift currency restrictions. 4) July 2005, Yuan is pegged to a basket of currencies and its

²⁹ China Moves to Devalue Yuan, August 11, 2015: <http://www.wsj.com/articles/china-moves-to-devalue-the-yuan-1439258401>

trading prices are allowed within a band. 5) July 2008, after three years of Yuan's appreciation, China re-establishes its peg to the USD. 6) June 2010, as a consequence of United states and G-20 countries pressure on the informal peg, China lets the Yuan moves again with limitations. 7) April 2015, The IMF says that the currency is fairly valued mentioning that the measures taken in the past years to free up Yuan have helped the currency to be close to its right trading-range. 8) August 2015, China devaluates Yuan by almost 2% raising concerns on its commitment to liberalize its currency

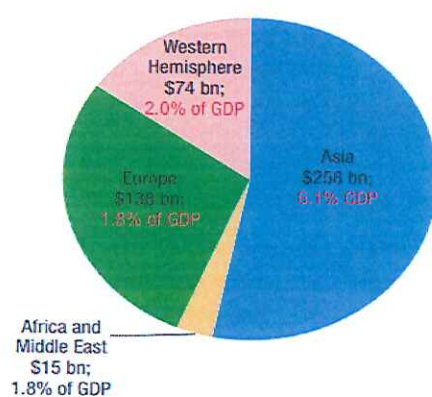
According to the PBC, RMB's floating range would be expanded in an orderly manner always considering the foreign exchange market development and the economic and financial situation of the country. Since this last intervention in 2014, the government has stopped its interventions in the foreign exchange market letting supply and demand have more impact on the exchange rate. In fact, companies across China can settle cross-border transactions for current account related items and since June 2014, people may use RMB as well for payments related to international trade of goods and services.

Although RMB has become more flexible over time, China still does not have a flexible exchange rate at all, it is not traded freely and it is not wholly market determined neither; instead, RMB is a closely government managed exchange rate. If this fact is not overcome in the near future, it will be very difficult for RMB to be considered by international financial community as a reserve currency and it will be difficult to manage it if capital account becomes more open every day. Being a reserve currency will depend mainly on two facts: i) the availability of high quality financial assets (bonds, notes, ETFs, loans) denominated in RMB and ii) the ease of moving financial capital for investors either into and or out of China. Undeniably, a more open capital account accompanied of a greater or complete flexible exchange rate will result in more investors pouring money into China which will also affect the patterns of global capital flows as investors will be more confident on Chinese markets to invest in the second largest economy while withdrawing money from other countries.

In an attempt to make the RMB more international and encourage its use for trade purposes, the PBC has also signed bilateral local currency swap arrangements with other central banks or monetary authorities of 34³⁰ countries. According to Prasad, the total volume that is implicit in these agreements is equivalent to half a trillion dollars approximately making China's financial links with the rest of the world bigger and its integration with the global financial system more important. The IMF in its Regional Economic Outlook ³¹ shows the average size of the swap lines per region as a percentage of the recipient country's GDP (Figure 6).

Figure 6. China Bilateral Currency Swap Agreements, End-2015

(Billions of U.S. dollars; percent of GDP)



Source: IMF staff estimates.

Note: Figures in red indicate the average size of swap lines in each region as a percent of recipient-country GDP.

³⁰ CNY, FX Regime Details in Bloomberg Terminal.

³¹ IMF Regional Economic Outlook, Asia and Pacific – Building on Asia's Strengths during Turbulent Times, April 2016: <http://www.imf.org/external/pubs/ft/reo/2016/apd/eng/pdf/areo0516.pdf>

X. What could be the consequences of a liberalized economy?

As stated before, the Chinese economy has been undergoing structural changes in search of a more open model that is slowly shifting from exports to domestic consumption and services seeking more sustainable growth overtime. The world has been expecting this transition that would be good for China as well although it involves some risks and spillovers while reaching a complete liberalization such as great market volatility as seen recently. Volatility that will necessarily affect not only Chinese market but global financial markets as China has gained relevance in the world as an economy per se and it is now more integrated with the rest of the world.

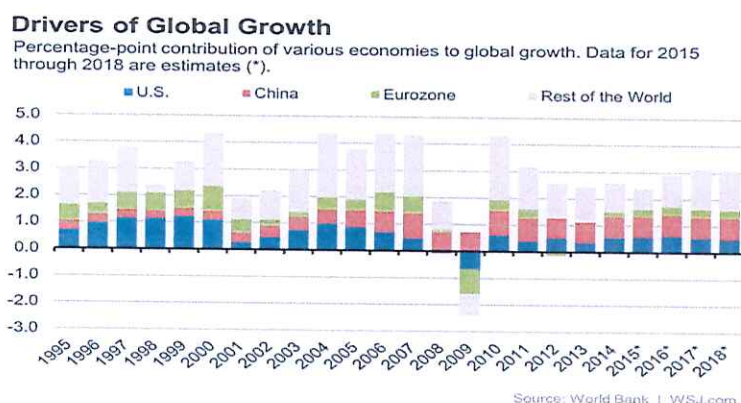
Evidence of Chinese integration in the world's economy is that its rise has been one of the main drivers for the global growth in the last 15 years where it accounted for almost one third of that global growth and for 9 percent³² of world exports (Figure 7)³³. Meanwhile, the United States accounted for a 23%³⁴ of the global growth in 2015 which is in fact the largest contribution since the latest recession in 2009 (Figure 8)³⁵. These facts are evidence of how intertwined is China with the world and it makes more clear the point that with no doubt, a slowdown or any decision affecting its economy and markets, will affect other countries' trade and finance as well. Asian countries, the ones nearer and with greater exposure to China will suffer more and larger shocks in the short term than any other country or region with any Chinese decision in terms of investment, capital flows, consumption and trade.

³² IMF Regional Economic Outlook, Asia and Pacific – Building on Asia's Strengths during Turbulent Times, April 2016: <http://www.imf.org/external/pubs/ft/reo/2016/apd/eng/pdf/areo0516.pdf>

³³ Harrison, David. The U.S. May Not Be an Engine of the World Economy For Long. <http://blogs.wsj.com/economics/2016/03/08/the-u-s-may-be-an-engine-of-the-world-economy-but-perhaps-not-for-long/>

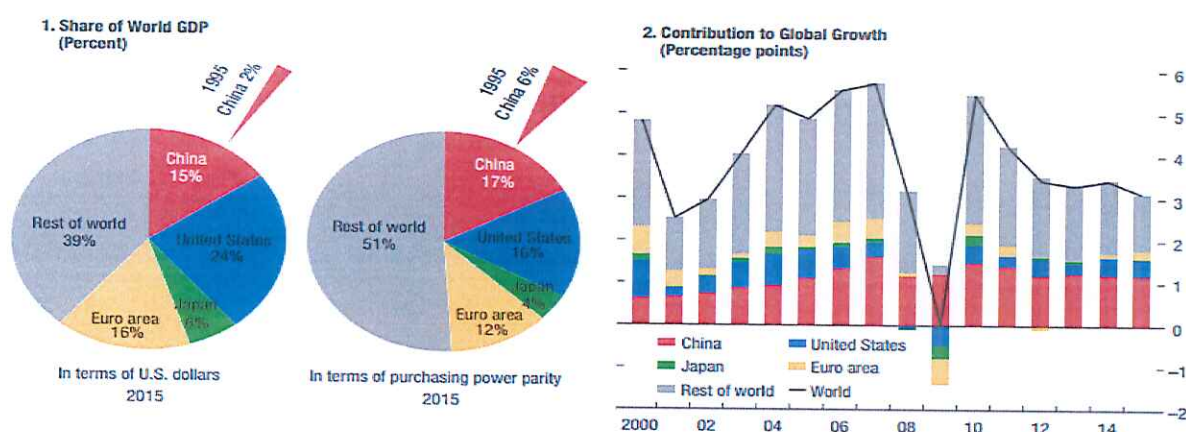
³⁵ IMF Regional Economic Outlook, Asia and Pacific – Building on Asia's Strengths during Turbulent Times, April 2016: <http://www.imf.org/external/pubs/ft/reo/2016/apd/eng/pdf/areo0516.pdf>

Figure 7. Drivers of Global Growth



Financial shocks from China to regional foreign exchange and equity markets are expected to increase with China's RMB internationalization and capital account liberalization. In fact, even though China still have an incomplete capital account liberalization, the world have recently seen how the shocks originated inside China can be transmitted to other economies beyond trade channels also affecting risk appetite in international markets.

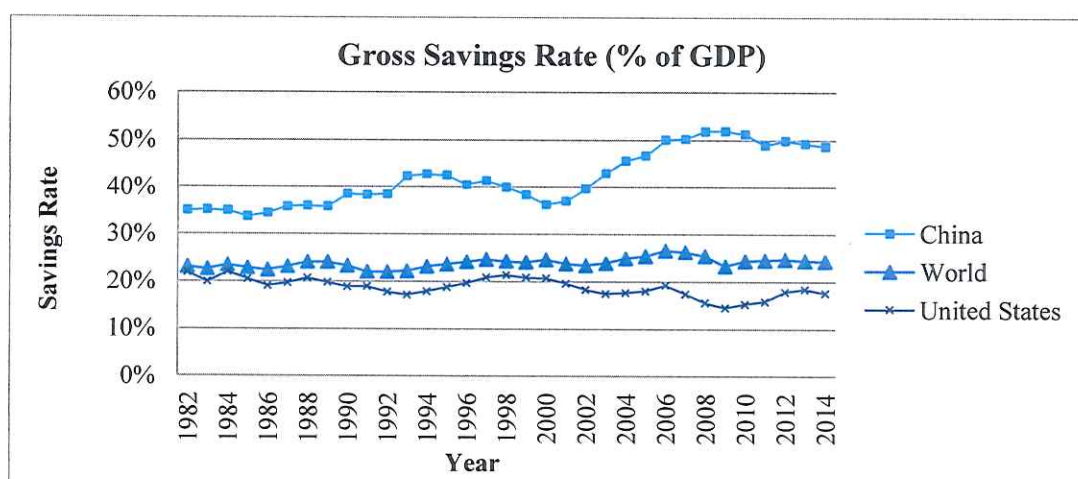
Figure 8. China's Role in Global Economy – Global Growth



For China, liberalizing its financial system is important for many reasons. It is an essential element in the process of rebalancing the economy towards a greater private

consumption over the PIB while reducing the domestic savings rate (Figure 9)³⁶ and the canalization of financial resources to a more productive investment which must be motivated with the interest rate liberalization as well contributing to a more efficient allocation of credit. Along with the liberalization of interest rates, the opening of China's economy and its currency should give Chinese companies another funding resource: issuing debt in international markets in RMB without having foreign exchange risk. Regarding China's savings rate, it is considered to be very high compared to the world's average and to The United States rate. This fact it could be partially explained because of the rapid economic expansion relative to the rest of the world and the weak financial sector that encourage enterprises to rely on its own savings to finance fixed-asset investments (Dennis Tao Yang, Junsen Zhang, Shaojie Zhou 2011)³⁷.

Figure 9. Gross Savings Rate (% of GDP)



Source: World Bank Database, own figure (see Annex 1).

Internally, China has showed little progress on restructuring its banking system ownership structure where public entities dominate the market representing almost 50

³⁶ Gross Savings is defined by the World Bank as “the difference between disposable income and consumption and replace gross domestic savings, a concept used by the World Bank and included in World Development Indicators editions before 2006”.

³⁷ WHY ARE SAVING RATES SO HIGH IN CHINA?, National Bureau of Economic Research - Dennis Tao Yang, Junsen Zhang, Shaojie Zhou. <http://www.nber.org/papers/w16771.pdf>

percent³⁸ of the total banking assets and where foreign capital is still reduced as it has grown in recent years but at a slower pace than local entities have experienced. In addition, the banking sector has also experienced the development of what it has been called “Shadow Banking” that has facilitated regulatory arbitrage. Shadow Banking refers to the activity of credit intermediation and other banking activities executed by entities outside the “regular” banking system, the PBoC defines it as “as credit intermediation involving entities and activities outside the regular banking system that serves to provide liquidity and credit transformation and which could potentially be a source of systemic risk or regulatory arbitrage”³⁹.

In simple terms, shadow banking can be defined as loans outside the formal banking sector that usually go to new business models that the state can't finance. A study of the Chazen Institute of International Business from Columbia Business School⁴⁰ shows that the lending markets for shadow banking are small and medium enterprises as well as entrepreneurs involved in local estate developers, miners and shipbuilders; it also shows that half of all Chinese shadow banking instruments fall into two categories: wealth management and entrusted loans. According to Moody's Investors Service, China's shadow banking transactions equaled 65 percent on its 2014 GDP and it has been growing at an average rate of 30 percent since 2010. What is really interesting about shadow banking is that it exists all over the world in both, developing and developed countries and China is well below the world's and the US average. Moody's affirms that these kinds of transactions represent 120 percent of the world's GDP and 150 percent of The United States GDP.

38 Cuadro Lucía y Gallego Sonsoles, Bank of Spain, Economic Bulletin May 2016: La Liberalización Financiera de China: Perspectivas Para la Política Económica e implicaciones Globales.

39 Douglas Elliot, Arthur Kroeber and Yu Qiao. Shadow Banking in china: A Primer, March 2015: https://www.brookings.edu/wp-content/uploads/2016/06/shadow_banking_china_elliott_kroeber_yu.pdf

40 The Future of Shadow Banking in China. http://www8.gsb.columbia.edu/chazen/globalinsights/sites/globalinsights/files/Shadow%20Banking%20in%20China_Chazen%20Institute.pdf

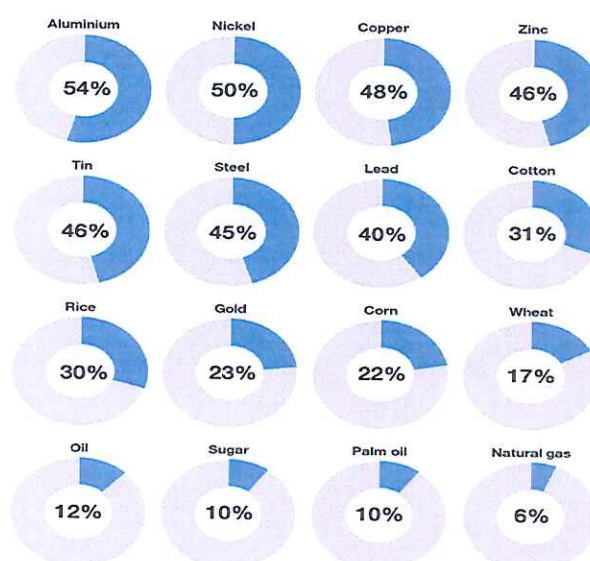
XI. Conclusion

Finally, financial liberalization in China has had a significant progress internally and externally in the last five years. Market-oriented principles have been incorporated in the banking and financial system as a whole, the Renminbi inclusion in the IMF's SDR basket that recognizes the currency as a reserve one, interest rates are now liberalized and a deposit insurance scheme has been put in place since May 2016. Considering these changes in China's policies, it is important to mention that a lower savings average rate should decrease in the upcoming years with a stronger financial system and credit should be better assigned by banks to the best investment opportunities. All in all, these reforms along with the progressive openness of its current account, are creating a proper environment for the "new normal" economy that the country is experiencing and that people around the world are getting used to. Shanghai and Hong Kong stock exchanges have now been connected in order to give investors a broader range of investments possibilities, institutional investors have been granted with a greater access to foreign exchange and bond markets, which will provide more liquidity to markets.

Economic situation in the world and inside China is not the best right now, the world has not recovered from the subprime crisis since 2009 and it seems to be far from it. In fact, for many analysts, things could get worse before they improve and there are bets on a new recession in the US before it can be considered to be in boom again. The US Federal Reserve is said to raise interest rates since mid-2015 and it has only increased 25 basis points, China's economy is growing at a slower pace, Renminbi has depreciated in the last 2 years incentivizing capital outflows while "complicating" the currency transition towards a larger FX market flexibility. However, all these reforms and the ones expected to happen towards a industrialization, a service sector development, and a more transparent and flexible government should support an equilibrium in the Chinese economy as well as its stable GDP growth rate from now on.

It is clear, from recent years' experience that when China is growing other economies are doing good as well as a consequence of rising and strong commodities prices and that when China's economy slows, markets around the world and other countries economy suffer. China with its large population and second largest economy is responsible for a large part of the world's commodities consumption (Figure 10). According to the McKinsey Global Institute and estimates from the OECD, IMF and the World Bank, it is estimated that global economic growth could be hurt by 0.2 percent while Asian economies could decrease its growth by 0.3 percent for every 1 percent in China's economic slowdown. Obviously and as mentioned before, economies that suffer the most are the ones that are more connected to China through trade and capital markets.

Figure 10. How much does China consume?



Source: The Wall Street Journal, World Bureau of Metal Statistics, World Gold Council, BP Statistical Review of World Energy 2015, Metalytics via Morgan Stanley, US Department of Agriculture.

Source: World Economic Forum⁴¹

China has become the world's largest trader of and the second purchaser of goods, buying USD 1.9 trillion of products in 2014 (McKinsey). It has also become a land of

⁴¹ Figure taken from the World Economic Forum⁶ charts that explain china in the global economy. Hanley, Mike: <https://www.weforum.org/agenda/2015/09/six-charts-that-explain-china-in-the-global-economy/>

major source of revenues for multinationals not only for its cheap labor force but also because of its huge market, and it is today the largest importer of resources such as iron ore. Investment growth model has worked for several years now for China but it has left some industries - such as cement, steel and state - with overcapacity, they are "overbuilt" which signals the need to stop receiving investment and give room to other potential businesses or industries that could raise productivity while creating new jobs. China has reached unprecedented urbanization and industrialization rates in the last four decades, it has been able to raise middle-class disposable income more than 10-fold since 2000 and take out of poverty more than 600 million people since 1980.

According to McKinsey, urbanization led to growth in the number of Chinese living in cities of 2 to 3 percent a year and now that rate is expected to be 1 to 2 percent slowing down 1 percent progressively diminishing one of the major drivers of economic growth in the last years. Along with this urbanization deceleration, there exists other risk within the Chinese economy. Income inequality distribution is expected to raise, according to the government, the portion of income going to the top fifth of the population rose from 33 percent in 1995 to 43 percent in 2012 (McKinsey). Likewise, due to overcapacity in some industries, China now faces a skills shortage as developed industries trained workers on their fields. Lastly, labor costs are rising which means that China's competitiveness in low wage and labor-intensive industries could be in danger as well forcing the economy to develop other sectors.

At this point, is necessary to go back to the objectives and research questions proposed at the beginning of this thesis and give an answer to each of them considering the research done and shown through the whole text:

- I. In its economy, what does China has in its favor that could allow further development and how the lack of transparency and restrictions in other market aspects can hinder economic performance.

As mentioned before, the openness to the world has benefited the country by bringing foreign direct investment and with it, prosperity and wealth to Chinese people along with development to its financial market. China still has that openness to exterior world in trade which will continue along with a greater financial liberalization that helps to foresee more development as investors will increase confidence in the economy to continue investing. This fact, will generate liquidity and depth to Chinese capital markets attracting more investors every day.

Furthermore, China still has a huge domestic market that is ready to be developed by domestic and foreign companies. Savings rate is high and has great room to decrease with a more developed financial market which can generate more internal demand of goods and services. In the past four decades China has developed a strong goods sector and exporting growth model but not a services one which gives another opportunity to have further development.

On the other hand, corruption and government close ties with certain businessmen from the private sector and the lack of transparency in public data or statistics can block that economic development because it can generate distrust among investors and scare away foreign capital. Additionally, government intervention in the currency, the stock exchange and in markets in general is not a good sign for the one investing in the country as it creates uncertainty that can be eventually followed by a sell-off in some assets while losing capital. Lastly, property rights must be more clear and protected to avoid losing credibility and trust and therefore scare off foreign direct investment which has been until now, largely responsible for getting China to be the second largest economy.

II. Up to what point do Chinese political and economic models fit together?

They have fit together for the last decades but today, is evident that china will have to leave political communism or economic capitalism as the coexistence of both is creating conflict. With communist politics it might be impossible to have a market economy as it is originally conceived. Market economies need to be independent from politics and government to work alone in the search of equilibrium. Introducing market economy elements in which was once a

closed economy has produced great result for China, they have brought economic and social development to its society and the government would like to continue seeing that progress. At last, it will benefit government officials as well, not only the common citizens.

Communism is about restrictions, central planning, communal ownership and distribution of economic output based upon need among community while capitalism or market economies which are related to democratic models, are about profit, competition, innovation, private ownership of capital and means of production and labor specialization. In China, the world has seen how some of these market characteristics have been implemented and although some other are still missing, it is highly probable that they will be adopted as well to continue shaping the Chinese market economy while government loose power to markets.

III. When will China change its policy if its economic model is going so well?

China has made a great progress in all aspects of its economy in the last forty years thanks to Xiaoping's ideas of progress and multiple reforms starting in 1978. Although the Chinese government affirms that China is a communist country, it has been also in charge of setting up and introducing more capitalist thoughts, ideas and elements to its economic model creating the dichotomy between politics and economics and not allowing China to be thought as a market economy. Restrictions mentioned in this document constitute evidence of the distortion in both, capitalism and communism as socio-economic models. No one can think of China as a capitalist neither as a communist country as it has strong elements embedded of both models.

China will continue experiencing big changes in its communist policies always advancing towards a more capitalist country and the reason is that so far, the adaptation to capitalist practices has created a virtual circle for the country that needs to continue. Adopting capitalism in economics, has worked for Chinese society to become wealthier and embrace development in all aspects although it has had high environmental costs as well but nevertheless benefits have been greater and environmental issues has been addressed to be corrected and overcome them along with other disparities. Being strict with terminology, a nation is capitalist or

communist but no communist with capitalist characteristics or vice versa as China officially says it is a “communist country with Chinese characteristics”.

Ambition for a more prosperous country, a more developed society and reaching the tittle of the first world's economy will push the government to continue abolishing restrictions and adopting more capitalist principles becoming a more “friendly” market for investors and embracing a more democratic political model. State intervention should not be eliminated at all but it should be controlled and always strategic to allow further market development, fair competition, freedom of speech, disclosure of complete information, equal footing and to respect society rights.

XII. Recommendations:

1. Chinese government, lead solely for the CPC, needs to continue releasing the power to the economy itself so it can equilibrate the economic misbalances. Any economy will always need state intervention but in the form of creating the institutional frame in which the economy should operate under transparent rules for everyone, guiding monetary and fiscal policies always ensuring the economic and population welfare, creating a fair and equitable market for every player while eliminating monopolies and corruption. To legislate and supervise are one of the main functions of a state along with having competent state institutions to stabilize and adapt the changing socio-economic conditions. Government needs to intervene in an indirect way by indicatively programming a nation's political economy path giving recommendations and stimulating the desired direction.

On the other hand, the state role should be directed towards the satisfaction on the population needs not only human basic needs but social ones as well. In this sense, the state needs to create the proper environment to ensure that prices are correctly determined, that there is employment for every citizen, that there are competitive conditions and international economic relations. Additionally, the state needs to guarantee social security, health and education services to its society - independently which type of political regime it follows- , ensure sustainable growth, social progress and environmental sustainability. In conclusion, state intervention should never be limitless.

2. In China, key industries for economic growth have been dominated by state owned enterprises as the communist party has instructed, generating greater benefits for them in comparison with the private enterprises, creating monopolies and corruption inside SOEs and the government. CPC has been in charge for many years now of leading and dominating the economy through SOEs, which needs to be stopped at all if the country is working towards a market economy. In market economies, market forces need to be bigger and more powerful than government ones.

SOE's supporters –mainly government officials- think that they have been a symbol of vitality, efficiency and the potential tool for common prosperity and stimulating the economy. The reality of these SOE's is that they have been serving the political interests of the country creating profit while leading monopolies in different sectors. Consolidating SOEs has been the preferred method of reform in China whenever one firm is bankrupted or when they simply want to avoid price wars of local companies abroad. The Brookings institute affirms that the majority of the 83 firms that disappeared in the last 13 years were merged with other central SOEs while the others were combined creating bigger conglomerates.

For China to reduce corruption and improve SOEs efficiency, the government needs to focus more on its capital management instead of its assets creation policies for the long run to ensure growth and an efficient capital allocation. It also needs to avoid creating differentiation between the private and the public sector in terms of benefits and easing policies.

3. Besides providing national defense, addressing environmental concerns and attempting to make markets more competitive, the government needs to define and protect property rights in order to generate confidence among investors in general. When doing so, the individuals have the right to use their resources as they need and as they see fit while voluntarily transferring them when efficient and convenient. It is important to state that individuals can have the exclusive right to use their resources as they want as long as they do not disturb and violate others' rights creating a better competition in markets and wealth to society given that individuals will always want to use its properties for the best possible satisfaction of consumers and themselves. For consumers to increase demand and for themselves to create wealth or seek to maximize their utility, otherwise they would be penalized by losses.

China still has a lot to improve in this sense. Different institutions, governments and economists have studied the relationship between property rights and development and it has been affirmed that Nations prosper when private property rights are well defined and

enforced”⁴². Poorly defined or weakly enforced property rights leads to corruption avoiding the proper use of resources and investment. Clear and enforced property rights makes an economy work properly assigning resources and prices efficiently, they create confidence in market activities and investment possibilities are broader making investment inflows more stable and liberalizing the economy.

Compared to a developed market economy like The United States, China is still behind in this regard. According to The International Property Rights Index⁴³, China’s score in the overall is 5.4 (in a scale from 1 to 10) ranking place 55 over 128 while the US scores 7.7 and ranks place 15. The lowest score within the Intellectual Property Rights category is the Copyright Protection, which scores 2.6 over 10 while the US gets a score of 8.2.

The recommendation in this sense is to establish a stronger institutional frame to ensure a higher protection of property rights. Improving legal and political aspects as well as intellectual property rights and copyright protection that are the lowest items in the index could allow further growth for the country in the coming years due to the lesser incentive to exercise public power for private gain avoiding corruption, creating confidence among investors, and enforcing property rights. A virtuous cycle should happen to support economic growth and social welfare when property rights are clear and protected by the government as more stable investments go the economy, research and development is encouraged, innovation is stimulated, economic productivity is fostered and sustained competitiveness in global markets is fueled.

4. Information is a vital element for markets, it provides efficiency to them as individuals have more tools to take informed decisions. Transparency reduces market uncertainty in regards to economic policies and financial markets providing stability and competitiveness in global markets as well. Media is responsible of providing information to agents under transparency and objective principles with the objective to inform people and let them form their own

⁴² The Cato Institute. Property rights, the Key to Economic development by Gerald P. O Criscoll Jr and Lee Hoskins: <http://object.cato.org/sites/cato.org/files/pubs/pdf/pa482.pdf>

⁴³ Levy Carciente, Sary. International Property Rights Index 2016. <http://internationalpropertyrightsindex.org/comparison?c%5B%5D=China&c%5B%5D=United+States&c%5B%5D=&c%5B%5D=&c%5B%5D=> and <http://s3.amazonaws.com/ipri2016/IPRI+2016+Full+Report.pdf>

opinions and decisions. Today, China is considered to have one of the most restrictive media environments in the world.

Internet is highly restricted by the government and people are always trying to employ creatively some kind of technology and proxy servers in order to challenge and avoid restrictions on free expression. The CPC still maintains direct control over news coverage through its Central Propaganda Department and its branches that determine what is permissible to be reported or not. Social networks are restricted as well as content in websites like LinkedIn, Google and even Gmail; restrictions not only include censorship in content but blackout periods. Freedom House ⁴⁴also states that in addition to censorship, “the authorities have taken steps to actively guide user discussion online. Since 2004, CCP and government officials at all levels have recruited and trained an army of paid web commentators. Their tasks include posting pro-government remarks, tracking public opinion, disrupting or diverting criticism, and participating in public online chats with officials to provide the appearance of state-citizen interaction”.

Finance, environmental and corruption related publications are very restricted due to the political sensitivity of the topics. Moreover, in February 2016 the Ministry of Industry and Information Technology issued a new directive in which companies that have foreign ownership are limited to publish unless they have approval from the state Administration of Press. Only Chinese owned companies are able to publish online considering a “self-censorship” taking into account the government’s views. This point of media restrictions and free expression control is delicate as it demonstrates that the government, represented in this case by the CPC, does not want its population to be aware of the reality surrounding them. Whenever something is hidden, it is because there must be something wrong and coming from a government, it gives the image to the world that it does not want the people acting on their own behalf, it simply wants them to keep them ignorant and slept. At last, knowledge is power.

⁴⁴ Freedom House is an independent watchdog organization dedicated to the expansion of freedom and democracy around the world. <https://freedomhouse.org/report/freedom-press/2015/china>

China needs to overcome these information constraints and let its people know whatever they need to know to be informed and take efficient decisions. Investors need to be informed as much as possible to make efficient investment decisions and to determine where to allocate resources. It will be very difficult for Chinese financial markets to keep receiving offshore funds if the government does not play with transparency and media freedom. Media and information in general, definitely have an important role to play in education, social and economic progress. Media improves governance, efficiency of the economy, reduces political risk, among other benefits. China needs to unveil information to economic agents if it wants to continue developing a market economy and have stable growth overtime.

Annex 1

Data Source World Development Indicators
 Last Updated Date 10/08/2016
 Indicator Name Gross savings (% of GDP)

Country Name	China	United States	World
Country Code / Year	CHN	USA	WLD
1982	34,89	21,84	23,02
1983	35,00	19,85	22,51
1984	34,92	21,96	23,37
1985	33,63	20,39	22,78
1986	34,32	18,99	22,32
1987	35,69	19,62	23,09
1988	35,93	20,63	24,00
1989	35,79	19,76	24,00
1990	38,47	18,77	23,26
1991	38,31	18,84	21,95
1992	38,45	17,71	21,91
1993	42,33	17,06	22,15
1994	42,80	17,85	23,07
1995	42,55	18,73	23,60
1996	40,44	19,60	24,07
1997	41,34	20,79	24,57
1998	39,92	21,34	24,21
1999	38,35	20,82	24,04
2000	36,23	20,68	24,57
2001	36,96	19,55	23,69
2002	39,60	18,21	23,38
2003	42,95	17,38	23,83
2004	45,61	17,56	24,85
2005	46,73	17,94	25,33
2006	50,08	19,19	26,50
2007	50,26	17,35	26,24
2008	51,83	15,50	25,37
2009	51,92	14,44	23,23
2010	51,27	15,18	24,30
2011	48,97	15,79	24,47
2012	49,87	17,80	24,67
2013	49,24	18,33	24,38
2014	48,67	17,55	24,29

The above table shows the savings rate of China, The United States and the world's average. Data was taken from the World Bank and it shows how high this rate is in China affirming that

there is still a big consumption potential in Chinese domestic market. The reason why the table is showing China with The United States and the world's rate savings rate is simple: the US economy is the largest one in the world and China is the second one and when talking about these type of indicators, is useful and necessary to check what the other "peers" are doing. Regarding the world's average, it is shown because it works as a wider benchmark that considers all economies.

China data shows how that savings rate has increased throughout the years although it is an economy that has been developing very fast in the last 40 years. This only, confirm that internal market has not been considered in that growth model and that it has all been about supporting the manufacturing sector to export the outcome. Meanwhile, the US has seen a decline in its savings rate supporting a stronger domestic consumption model. Regarding the world's average, it can be that it has increased slightly in the past three decades.

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