THE DRAGON AWAKES: ECONOMIC REFORMS IN CHINA SINCE 1949

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ABSTRACT

The rise of China as a major player in the world economy is likely to become one of the most significant developments in the 21st century. The Chinese economy has experienced a major transformation; from a planned economy to a market economy, from an agrarian economy to an industrial economy, from a relatively closed economy to a relatively open economy.

In 1978, the Chinese government launched a series of economic reforms. Reforms first took place in the agricultural sector and from then on, were gradually extended to industrial sector. Market mechanisms were gradually introduced and the once centrally planned system was slowly relaxed. Economic growth was rapid and consistent based on average annual GDP growth rates. From 1979 to 2005, average annual GDP growth was at 9.6 percent while throughout the 1990s, the growth rate was sustained in double digit rates between 11-12 percent.

Reforms included development of the industrial sector, improvement of labour allocation and opening up to the world, thereby integrating the Chinese economy into the global economy. Policies implemented include privatisation and corporatisation of inefficient state-owned enterprises (SOEs), an export push strategy, improving labour flexibility and promoting the inflow of foreign investments. As this thesis will show, the central element of China's economic growth was the role of the Chinese government in leading reforms in key areas of the economy.

Taking a historical approach, this thesis will chart China's state-led efforts to develop the economy. A historical approach thus allows one to better understand and
appreciate China's development trajectory, the challenges it has faced in this quest for
development and its current achievements as well as its future challenges. In essence,
one can attribute China's economic achievements to the role of its gradualist
developmental state. This means that the Chinese state led the economic development
of the republic in an incremental manner in order to maintain fragile cooperative
relations between economic agents.
ABSTRAK


Dasar-dasar yang dilancarkan telah menyentuh aspek-aspek pembangunan sektor perindustrian, pengagihan tenaga kerja, serta pembukaan ekonomi yang sejurusnya mengintegrasikan ekonomi negara China ke dalam pasaran dunia. Antara dasar-dasar yang dilaksanakan termasuk penswastaan and pensyarikatan firma-firma milik kerajaan yang tidak efisien, strategi mengutamakan eksport, memperbaiki
pengagihan tenaga kerja supaya lebih flesibel, serta menggalakkan kemasukan pelaburan asing. Tesis ini akan mengutarakan bahawa unsur utama dalam pertumbuhan pesat ekonomi China ialah kerajaan negara itu sendiri, yang memainkan peranan dalam mengusahakan sektor-sektor berkepentingan.

Tesis ini akan mengambil pendekatan bersejarah untuk membolehkan seseorang lebih memahami perkembangan China, di samping cabaran-cabarannya yang dihadapi ke arah pembangunan serta cabaran-cabarannya yang bakal dihadapi pada masa depan. Perkembangan pesat China boleh disimpulkan menerusi peranan yang dimainkan oleh kerajaannya yang bercirikan "gradualist developmental state". Ini bermakna kerajaan China telah mengambil langkah secara berperingkat dalam pelaksanaan dasar-dasar ekonominya agar tidak membawa kesan negatif ke atas hubungan antara agen-agen ekonomi negara.
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This thesis is the result of three years of work whereby I have been accompanied and supported by a few people. It is a pleasure that I have now the opportunity to express my gratitude to them.

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I would like to thank my parents, whose love and guidance are with me in whatever I pursue. This thesis would not have been possible without your emotional and financial support. You encouraged my dreams of higher education. I love you both very much.

To my significant other, Rob, thank you for all your help. You were involved in many aspects of this thesis, from proof-reading and sending me books, to assisting with grammar corrections. You always reminded me it is more important to finish what I started, than how quickly I get it done. Your love, encouragement and patience made this journey memorable.

To the university faculty, family relatives and friends, thank you for your support and assistance.
**LIST OF ABBREVIATIONS**

<table>
<thead>
<tr>
<th>Abbreviation</th>
<th>Full Form</th>
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<tbody>
<tr>
<td>APCs</td>
<td>Agricultural Producers' Cooperatives</td>
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<td>CBEs</td>
<td>Communes and Brigades Enterprises</td>
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<td>CCP</td>
<td>Chinese Communist Party</td>
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<td>CNOOC</td>
<td>China's National Offshore Oil Corporation</td>
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<td>COE</td>
<td>Collectively-owned Enterprises</td>
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<td>EEFSU</td>
<td>Eastern Europe and Former Soviet Union</td>
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<td>EPA</td>
<td>Economic Planning Agency</td>
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<td>EPB</td>
<td>Environment Protection Bureaus</td>
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<td>ETDZs</td>
<td>Economic and Technological Development Zones</td>
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<td>FDI</td>
<td>Foreign Direct Investment</td>
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<td>FFYP</td>
<td>First Five Year Plan</td>
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<td>FIEs</td>
<td>Foreign-invested Enterprises</td>
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<td>GDP</td>
<td>Gross Domestic Product</td>
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<td>GLF</td>
<td>Great Leap Forward</td>
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<td>GM</td>
<td>General Motors</td>
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<td>HPAE</td>
<td>High Performing Asian Economies</td>
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<td>HRS</td>
<td>Household Responsibility System</td>
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<td>JV</td>
<td>Joint Ventures</td>
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<td>KMT</td>
<td>Kuomintang</td>
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<td>MFN</td>
<td>Most Favoured Nation</td>
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<td>MITI</td>
<td>Ministry of International Trade and Industry (Japan)</td>
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<td>MNCs</td>
<td>Multinational Corporations</td>
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<tr>
<td>NEPA</td>
<td>National Environmental Protection Agency</td>
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<td>NICs</td>
<td>Newly Industrialising Countries</td>
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<td>NTR</td>
<td>Normal Trade Relations</td>
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<td>PPP</td>
<td>Purchasing Power Parity</td>
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<td>PLA</td>
<td>People's Liberation Army</td>
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<td>RECs</td>
<td>Reemployment Centres</td>
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<td>SASAC</td>
<td>State-Owned Assets Supervision and Administration Commission</td>
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<tr>
<td>SEPA</td>
<td>State Environmental Protection Agency</td>
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<tr>
<td>SEZs</td>
<td>Special Economic Zones</td>
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<td>SOEs</td>
<td>State-owned Enterprises</td>
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<td>TVEs</td>
<td>Township and village enterprises</td>
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<tr>
<td>TFP</td>
<td>Total factor productivity</td>
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<tr>
<td>UN</td>
<td>United Nations</td>
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<td>UNCTAD</td>
<td>United Nations Conference on Trade and Development</td>
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<td>WTO</td>
<td>World Trade Organisation</td>
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CHAPTER 1: IN SEARCH OF THE DRAGON ECONOMY

Introduction

The rise of China as a major player in the world economy is likely to become one of the most significant developments in the 21st century. Since opening up its economy in the late 1970s, China has been developing new forms of industrialisation. The impacts of industrialisation in China affect both the social and political structure. The emphasis on education is growing and the development of technology is expanding. Many of the original industrialised nations, namely the United States and Britain, currently buy more goods from foreign markets (e.g. newly industrialising countries [NICs] in Asia and South America) than they produce for domestic consumption or export.

China is producing goods that the rest of the world depends on because of its cheap labour and resources. It is typical to find the words “Made in China” when one flips over a purchase. China, as the world factory produces 70 percent of the world’s toys, 60 percent of its bicycles, 50 percent of its shoes and 33 percent of its luggage (Zhang 2006). After 30 years of consistently rapid economic growth, it is no wonder scholars around the world are debating the waking dragon. China’s rising importance in the current capitalist world economy raises several questions that are of world-historic significance.

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1 Dragons are considered to be powerful creatures in Chinese mythology. They symbolize celestial power, wisdom, and strength. The Chinese Dragon is comparable as the symbol of the Chinese race itself. Chinese around the world, proudly proclaim themselves “Lung Tik Chuan Ren” (Descendants of the Dragon). Dragons are referred to as the divine mythical creature that brings with it ultimate abundance, prosperity and good fortune. The Chinese Dragon, or Lung, symbolizes power and excellence, valiancy and boldness, heroism and perseverance, nobility and divinity. A dragon overcomes obstacles until success is achieved. Dragons are energetic, decisive, optimistic, intelligent and ambitious (Wikipedia 2006).
In the early 1900s, China was considered to be in a state of poverty. Its economy was in depression after the Opium War. Yet by 1978, according to Fishman (2005), China’s GDP was USD 45.3 billion, and quadrupled to USD 187 billion 10 years later. By 2000, GDP shot up to USD 1.12 trillion. In 2004, China’s GDP totalled USD 1.71 trillion and ranked sixth in the world, behind France, Britain, Germany, Japan and the United States. However, if measured on purchasing power parity (PPP) basis, in 2004 China stood second in the world after the U.S (World Bank 2006).

Research Questions

What happened in China that led to such growth-staggering figures? Much research has been done on the reasons of China’s current economic position. Many are quick to point out the 1978 economic reforms as the leading cause of China’s massive economic growth. However, it is not common to find research that discussed the circumstances which led to the decision of implementing a more open market. It is important to grasp the developments that led to the 1978 reforms. There were pre-conditions in China’s socialist economy (1949 – 1978) that shaped the pace and nature of China’s reform process and economic performance. This research intends to take into considerations these pre-conditions. In addition to the pre-conditions, this study will look into the reasons behind the success after 1978. The extensive look into this era will range from 1978 to 2001, before the accession of the republic into the World Trade Organisation (WTO) in December.
The closed system ruled by Mao Ze Dong severely impeded China's growth, while the opening up policy adopted by Deng Xiao Ping brought China a long term booming economy. Opening up has somehow become a holy doctrine among the Chinese people but at the same time the Chinese Communist Party (CCP) is still in control over the country’s market stability. Although most agree that opening up was a necessary condition for the rise of China, it is important to note that the Chinese government took on a gradual state-led approach which meant the adoption of a step-by-step trial and error approach in policy implementations. The government oversaw the process of development and managed the economy. This research aims to explore this point. Thus, this research will seek to answer the following research questions:

1) How did government interventions improve China's economy?
2) How did the 1978 economic reforms shape China's current economic condition?, and
3) What areas of the economy did the Chinese government intervene in, in order to promote economic growth?

Literature review

While substantial literature described China's rise by exclusively examining post 1978 reforms and how they shaped China's economic growth (for e.g. Hu & Kan 1997, Overholt 1993, & Bell et al 1993) or by examining growth data (for e.g. Chow 1987, Sharma 2007), this thesis will address both these methods. In addition, I will also explore the historical factors of the second half of the 20th century, including China’s role as a developmental state.
China’s economy continues to expand rapidly, affecting world markets. The country’s emergence as an economic powerhouse is a success story in itself. The 21st century could witness a significant change of power in the global economy should China achieve its vast potential. China’s massive growth and potential has caught the attention of the world.

Fishman (2005) in his book *China Inc.* provided an abundance of facts detailing the incredible growth that the Chinese economy has experienced since the 1980s. Though he did not answer the question whether this growth could be sustained, he did provide a plethora of statistics for one to draw his/her own conclusion. Fishman paid special attention to the contribution of the Chinese population as a reason why China was such an economic giant. The supply of labour was almost endless with massive migration of rural folk to the urban manufacturing areas located mainly on the coasts. He pointed out that cheap labour drew foreign companies to invest and open up manufacturing plants. The 1.3 billion people also drew attention of new foreign businesses to set up branches to cater to domestic demands. However, his study only concentrated on the impact to the United States and to some extent Germany.

Perkins (1975) suggested that prior development created values and traits that made many Chinese generally effective entrepreneurs, workers, and organisational managers when given the opportunity. Pre-1978 China, then a poverty-stricken republic, “had a hardworking, readily trainable population already experienced in the operation of or participation in a commercial economy” (1975, p. 7). Historically, the
working class of China had to work very hard to simply survive. With this work ethic historically prevalent within Chinese society, the labour source was a ready supply of workers eager to participate in the new commercial economy. This was evident through the strong work ethic of the Chinese population as a whole.

Sharma (2007) explained China's economic growth through analysing labour, capital and total factor productivity (TFP) growth. His calculations indicated that China's average annual GDP growth rate was about 7.6 percent for the period of 1952–1998. If broken into two parts, average GDP growth rate was 6 percent during from 1952 to 1978 period and 9.3 percent from 1978 to 1998 period. During the period of 1978–1998, Sharma found that the annual growth rate of capital and labour was 9.14 percent and 2.78 percent respectively. However, the main focus of Sharma's calculations was to determine the sources of growth in China for the years 1978 to 1998. It was concluded that capital has been the most vital source of economic growth in China, contributing to 62 percent of GDP whereas productivity and labour contributed 28 percent and 11 percent respectively.

Economic reforms were considered one of the driving forces of China's current economic expansion. The key to China's economic growth, according to Overholt (1993) was its entry into global markets, not only through foreign direct investment, but also, significantly, through its impressive growth of exports and imports. He discussed the Chinese emphasis on prioritising industries and sectors where limited government investments would produce rapid growth. The government also gave back farms to the farmers so that productivity, income and output would be increasingly generated. In addition, the government was very encouraging of foreign
investment and gave priority to light and medium industry. Yan (2001) also believed that the rise of China as an economic powerhouse rested on the open door policy. Yan saw China's previous isolationist approach as a major hindrance to economic development. However, since the open door policy was launched the republic was able to participate in world affairs through its integration into the global economy. Yan’s view was similar to that of Hu and Khan (1997).

Hu and Khan (1997) agreed that China’s vast populace and large physical size alone mark it as a powerful global presence. However, they pointed the 1978 market-oriented reforms as the leading cause of China’s unprecedented economic performance. For them, China’s open door policy generated massive inward foreign direct investment (FDI), linking the republic to international markets which resulted in colossal technology transfers. Furthermore, those reforms granted enterprise managers greater autonomy to set their own production goals, sell products at competitive prices and basically greater room for private ownership of production. That in turn allowed the creation of jobs, development of much-wanted consumer products and gave the national economy a flexibility and resilience that it did not have prior to the reforms. The result of those attributes was a productivity boom of unmatched proportions.

Prestowitz (2005) had a more general assumption that China and India and to some extent the European Union which he dubbed “the new capitalists”, were taking a lead in economic growth, manufacturing, and even research and development. He argued that these new capitalist economies were succeeding because these nations had constructed and implemented sound economic policy goals such as encouraging
savings, and attracting foreign investment. However, Prestowitz (2005) may have overlooked the inability of workers to demand higher wages, better working conditions or minimum safety standards because the restrictions and laws in place by the communist government ironically attracted foreign companies to set up shop in China. These legal restrictions coupled with the financial incentives\(^2\) showered on investors by the communists made China an incredible value, even better than other low wage countries such as India. Prestowitz (2005) believed that government influenced open market economies had an advantage because truly free market policies could create intense competition within its own economy, undermining the economic achievements of middle class societies in first world nations, such as those in the United States. In essence, Prestowitz's opinions had some characteristics in common with the theory of a developmental state, which supported government intervention to stabilise the market.

While many believe that China is an economic success in itself, there are equally as many that were sceptical whether its growth would be sustainable. Some strongly believed that there was no such thing as a rising economic superpower in China. Some were quick to point out that even though China enjoyed a trade surplus with the U.S., it has noteworthy trade deficits with countries like Japan, South Korea, and Taiwan (Gillboy 2004). Gillboy (2004) saw China's huge population demanded the import of consumption-based materials, making it a major importer in North Eastern Asia. Furthermore, the massive foreign investments in its domestic market pose a threat of dependency on such foreign funded enterprises, especially when the

\(^2\) The Chinese government imposes “business-friendly” regulation for companies to relocate to China as well as giving incentives to foreign companies such as tax holidays and free land (Fishman 2005)
Chinese lack the technological capabilities of their Japanese, South Korean, and Taiwanese counterparts, thereby failing to develop a strong domestic technology supply network.

Although China may acquire much of its technology from outside sources, it also has the capacity to copy and reverse engineer that technology. This represented a significant risk to high-tech open market firms that outsource production to China in order to reduce operating costs. As pointed out by Fishman (2005), this has resulted in a serious influx of counterfeit technology products which are primarily sold in Second and Third World nations. Outsourcing technology by foreign firms to China also provided China with access to some of the world's most advanced technology, and it was only a matter of time before China had the ability to develop advanced technology on its own, surpassing other nations.

China’s economic figures were staggering, but Miller (2005) was sceptical about the continuity of these spectacular rates which needed to be maintained if China was to achieve the “superpower” status. Militarily speaking, China did not seem to be acquiring military might for the purpose of projecting a superpower characteristic. China’s political influence has grown during the past three decades and its seat as a permanent member in the United Nations Security Council was its greatest asset of leverage in international politics. Nonetheless, China’s political influence worldwide was comparably limited. In terms of cultural power, Miller saw that Chinese culture had long enthralled the West and China has become a major tourist attraction. More and more American students were studying Mandarin as opposed to French as their second language and taking time out to actually study China itself. Still, the number
of Chinese studying English or studying in the U.S. and other Western countries were a lot higher. Mandarin was also unlikely to replace English as the language of international politics anytime soon. Miller (2005) thus concluded that China was not a superpower and unlikely to emerge as one at any time soon. However, he did not draw any conclusions as to when China will become a superpower.

Terrill (2005) pointed that China’s ability to rise to the top was vastly exaggerated. Even though figures showed the prospect of China becoming a superpower to be highly likely, Terrill (2005) believed it was unlikely that the United States would allow China any opportunity to take over its place as world’s hegemon. The U.S. would resist accommodating or sharing global leadership with China as a rising power. This brings up the question, is this something the U.S. has any real control over as long as the U.S. maintains liberalised open market policies?

There were even U.S. government agencies that were aware of this possibility. The U.S. National Intelligence Council predicted, in a report named Project 2020 that by the year 2020, there would be an emergence of new global players, particularly China and India (as cited in Shradder 2005). However, whether these new players fit into the world cooperatively or competitively remains an important uncertainty for the United States. There would be changes in political and economic aspects. In addition, the report revealed that the head of the World Economic Forum saw China and India as players in reshaping globalisation trends. There was a sign of shifting power centres, as the once Western-dominated club, which meets annually in Davos, Switzerland, has ceded to demands that the meeting be held in Asia every other year.
The Forum head wrote, “To be frank, America is no longer quite the engine it used to be. Instead, the markets are now oriented eastwards” (Schrader 2005).

Holz (2005) examined China's future in growth prospects and the potential drivers of future economic development by investigating how China's development matched standard growth patterns. This was done by comparing the growth of China with Korea, Japan and Taiwan. It was found that China's growth patterns were similar to those countries. The similarities included structural change, catching up and factor price equalisation.

Holz (2005) found that China was positioned in the initial stage of structural change. As a result, China would enjoy continued growth for another 40 years. This conclusion was reached upon analysing the growth of productivity in China. As surplus labour shifted from the agricultural sector to the industrial sector, it created high productivity growth. According to Holz (2005 p.7), “with an annual [1978 - 2002] reduction in the share of labourers in agriculture by approximately an absolute value of 0.01 every year (thus for example, from 0.7 to 0.69 in one year), China has another 40 years to go before its agricultural labour share reaches the level of just below 10 percent at which Japan, Korea and Taiwan appear to bottom out”.

By Holz’s calculations, China's labour productivity between 1978 and 2002 was 1.2 percent to 2.4 percent of that of the U.S. The rate was low and this gave China the ability to catch up in production techniques and technologies. By regarding the U.S. as a leader in research and development, the distance between a nation’s labour productivity and that of the U.S. could be used as a measure of the potential scope for catching up. Holz found that Japan experienced highest growth rates when
its labour productivity was 10 – 15 percent of the U.S. In comparison, China was still at the lower development level of economic growth which was where Japan, Korea and Taiwan started out more than three decades ago. Because of this large potential to grow and catch up, the Chinese economy would continue to develop.

The availability of an abundance of low cost labour relative to capital gave China the factor price equalisation. As the demand for cheap labour arises, many more were employed. The immediate effect of this was labour productivity growth. Holz calculated that China's wage rates were relative to investment prices at an extremely low level, which was around 2 – 5 percent. This rate was even lower than the other three Asian countries in the early levels of growth. The rate also suggested that from a relatively low labour costs standpoint, China would have another 30 years to grow. Holz summed up that because China's position in all three areas was in the early stages, the republic will continue to enjoy growth and gains in the future. However, Holz may have overlooked the differences of initial conditions between China and the other Asians countries in comparison.

It is undeniable that the rise of China as an economic superpower has sparked many debates regarding its approach in economic reforms. China which has been taking a gradual and pragmatic approach towards its economic reforms has experienced spectacular growth over the last three decades (Refer Table 1.1 and Table 1.2). China's experience was a contradiction of the conventional big-bang approach that suggested the shock therapy, consisting of immediate liberalisation, privatisation and price deregulation. On the other hand, Eastern Europe and the former Soviet Union (EEFSU) nations took a totally opposite approach by adopting the big-bang
approach (also referred to as the Washington Consensus). The results of the big-bang approach were less than fruitful for the EEFSU nations, with large output declines and hyperinflation (de Melo et al. 1997).

Using the interpretations of the experimentalist school and convergence school, Woo (1999) explained China's economic development. The experimentalist school consisted of two basic economic propositions with regards to China's reform. First, the key to China's rapid development came from a gradual approach in market reforms. Secondly, the experimentation of non-capitalist institution has been successful in areas of agriculture, township and village enterprises (TVEs) and state-owned enterprises (SOEs). According to Sachs and Woo (2003), the discovery of new economic mechanisms such as the TVEs created crucial growth for the Chinese economy. Furthermore, the experimentalist school saw China's gradualist strategy as transferable to other economies in transition from central planning.

On the other side of the debate, the convergence school viewed China's economic success as the result of institutions being allowed to converge to non-socialist market economies. This occurred in SOE reforms, where policies such as privatisation and corporatisation were introduced to improve the performance of SOEs. In other words, these enterprises were converged with market oriented policies to promote competition among them and thereby improve productivity. In fact, this school of thought viewed that the faster the convergence, the better the results will be. Thus, the convergence school saw gradualism as an impediment to growth. In addition, the availability of massive surplus labour in the agricultural sector enabled
the republic to engage in labour intensive export-led growth. Table 1.3 adapted from Woo (2003) summed up the propositions of each school.

Jefferson (2008 p.169) explained that China’s economic transition as a “series of interrelated process rather than a collection of events”. At the core of the transition process, China’s government has played the central role. For example, as will be discussed in Chapter 3, the Chinese government through state-owned enterprises and non-state enterprises have played a substantial role throughout the republic’s industrialisation. The creation of non-state enterprises exerted pressure on the state enterprises, which in turn triggered the government to give more autonomous power to state-owned enterprises, thereby improving their performances. Jefferson further pointed out that while the transition of EEFSU nations resulted in the collapse of their political systems, China’s ruling party and central government was able to maintain its legitimacy and administrative capacity throughout its transformation.

In addition, Jefferson (2008) also set forth three elements of China’s reform process. They were transitional institutions, competition and learning, and a generally, stable, pragmatic political environment. Jefferson saw the interaction of these three elements as ingredients to China’s successful economic reform process. According to him, there has been literature in the study of China’s economic reform that sufficiently discussed all three elements and their interactions. With this research, I hope to incorporate these elements into explaining the awakening of the Dragon.

To summarise, most literature offered an “either/or” type of perspective about China’s rise to economic power. Some authors credited economic reforms as the driving force behind China’s explosive economic development, while others
suggested that the massive population was the main driving force and some supported China's decision to integrate into the global economy. While the literature that was reviewed offer valid insights and information on China's economic growth and transition, most authors rarely looked at China's growth in economic power from a historical standpoint.

Such an approach would suggest that China's economic development dwelled deeper than post-1978 economic reforms. The policies which were implemented were the result of complex historical factors. To quote Wu (2005 p. 43) “various reform measures in various stages were often interwoven; in other words, reform measures in the previous stage often nurtured something forthcoming in the subsequent stage, and reform measures in the coming stage often contained legacies of measures instituted in the preceding stage”\(^3\).

**Theoretical Framework**

China has awakened to a new era of concrete socio-political-economic and technological development. These new developments have been explained via different theoretical perspectives such as the neoclassical or market-friendly view. However, in China, the state played a vital role in maintaining market stability as well as imparting an environment for which economic growth can continue. If the state did not impose partial control over the economy through public policies, market stability would have been disrupted.