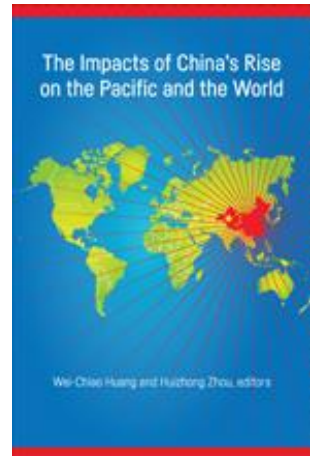


Upjohn Institute Press

Introduction

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Chapter 1 (pp. 1-14) in:

The Impacts of China's Rise on the Pacific and the World

Wei-Chiao Huang, Huizhong Zhou, editors.

Kalamazoo, MI: W.E. Upjohn Institute for Employment Research, 2018

DOI: 10.17848/9780880996358.ch1

The Impacts of China's Rise on the Pacific and the World

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2018

W.E. Upjohn Institute for Employment Research
Kalamazoo, Michigan

Library of Congress Cataloging-in-Publication Data

Names: Huang, Wei-Chiao, editor. | Zhou, Huizhong, 1947- editor.

Title: The impacts of China's rise on the Pacific and the world / Wei-Chiao Huang, Huizong Zhou, editors.

Description: Kalamazoo, Mich. : W.E. Upjohn Institute for Employment Research, [2018] | Includes index.

Identifiers: LCCN 2017055606 | ISBN 9780880996327 (pbk. : alk. paper) | ISBN 0880996323 (pbk. : alk. paper) | ISBN 9780880996334 (hardcover : alk. paper) | ISBN 0880996331 (hardcover : alk. paper) | ISBN 9780880996358 (ebook) | ISBN 0880996358 (ebook)

Subjects: LCSH: China—economic conditions. | China—foreign economic relations.

Classification: LCC HC427.95 .I47 2018 | DDC 330.951—dc23 LC record available at <https://lcn.loc.gov/2017055606>

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Kalamazoo, Michigan 49007-4686

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Cover design by Carol A.S. Derks.
Index prepared by Diane Worden.
Printed in the United States of America.
Printed on recycled paper.

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Introduction

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After three decades of rapid economic growth, China has become the second-largest economy in the world. Its rise has driven its search for resources, opportunities, and outside influences, and economic expansion will inevitably be followed by political influences and potentially overbearing military strength. In just four years, 2014–2017, China’s outward investment and construction combined exceeded \$800 billion. China has also established the Asian Infrastructure Investment Bank, which rivals the World Bank and the Asian Development Bank. Its economic expansion has inevitably brought about conflicts with its neighboring countries, including South Korea, Japan, and Vietnam, and it has recently shifted from being conciliatory to being more assertive toward territorial disputes. The ripples created by China’s first aircraft carrier are bound to travel across the Pacific and reach the shoreline of the United States. One of the contributors to this volume, Murray Scot Tanner, quotes former Deputy Assistant Secretary of State Dr. Tom Christensen: “China’s return to great power status is perhaps the most important challenge in twenty-first century American diplomacy” (Christensen 2015, p. 1). This assessment of the relationship between the two nations has been epitomized by recent events that have occupied the center stage of the U.S. trade and foreign policy, including tensions in the South China Sea and diplomacy toward North Korea and its nuclear and missile activity.

With this background, the 2015–2016 Werner Sichel Lecture Series featured six prominent experts who shared their insights on China and U.S.-China relations. Their lectures help put in perspective China’s rise and its impact on the Pacific region, and the relationship and potential conflicts between the United States and China. This collection presents the edited version of their lectures.

In Chapter 2, Tanner explores five underlying factors in the U.S.-China relationship that pose challenges for the United States: 1) China's rapidly expanding national interests and its increasing power to assert and protect them, 2) China's governance problems and their lack of commitment to cooperation, 3) China's view of security and the complexity of building U.S.-Chinese "strategic trust," 4) mobilizing the United States' allies and partners, and 5) the challenge at home.

China's leadership remains committed to an established set of long-standing, key security interests—most notably its core interests of protecting Chinese Communist Party rule, maintenance of social stability, sustained economic and technological growth, and protection of China's national unity, sovereignty, and territorial integrity. The frontlines of these existing interests, however, are expanding beyond East Asia and to extended arenas of national security. These include maintaining energy security, protecting its expanding overseas investments and the millions of expatriate Chinese workers in unstable environments abroad, asserting and protecting its expanding maritime security interests, advancing and protecting its communications security and military security interests in the space and cyber realms, and helping to secure a stable global environment conducive to the country's sustained development. China's expanding interests inevitably define many arenas in which the United States and China share overlapping but not necessarily identical interests. While these overlaps make the U.S.-China relationship increasingly complex and challenging, they also widen the range of issues on which the two countries actively cooperate.

Another challenge that the United States faces in dealing with China is deficiencies of China's bureaucracy in implementing agreements. With China's prominent and extensive presence economically and politically in the world, it needs China's public support to address key international problems. However, even if leading authorities in Beijing nominally support certain international norms and agreements, China's capabilities to enforce, implement, or oversee its commitments often may be inadequate. Tanner points out that Chinese local officials and state companies often "control more than enough resources to undermine some international problem-solving efforts." China's international partners, including the United States, must work with Beijing to urge it to develop and strengthen its governance institutions and policy-implementing capacities, and get China to demonstrate sustained

resolve in actively supporting and enforcing a wide array of international solutions.

The third challenge is so-called strategic trust between the United States and China. For many years, the Chinese have often told their U.S. partners that our two great powers need to overcome strategic mistrust or build strategic trust. However, according to Tanner, this call has typically “been accompanied by lists of actions that the United States should take that demonstrate respect for China’s core national security interests.” These actions relate to reevaluating the U.S.-Asian alliance structure, ending U.S. reconnaissance flights near China’s territory, decreasing U.S. support to allies and partners locked in tensions with, or lifting restrictions on U.S. technology sales to, China.

The fourth challenge relates to China’s role in the South China Sea and U.S. relations with allies in that region. The United States will have to strike a balance among three missions: 1) signaling a joint resolve between the United States and its allies to protect our common interests in response to Beijing’s assertive behavior; 2) attempting to reassure Beijing that our continued alliance and partnership with Asian-Pacific nations are not aimed at undermining or encircling China; and 3) continuing to search for new areas where the United States and its allies can enhance nontraditional security cooperation with China in the region, such as counterpiracy, antiterrorism, and humanitarian assistance and disaster relief.

Finally, Tanner identifies a challenge here at home. To modify a continual long-term policy toward a rising China, it will require “more focused U.S. attention to China in our mass media, classrooms, and elsewhere. Discussions need go beyond an oversimplified debate over China as partner or China as adversary.” A good understanding of China and its relationship with the United States by the public is required for a stable long-term approach to budgetary politics that supports the policies toward China. According to Tanner, U.S. politics at home in turn has a major impact on our capacity to engage, cooperate with, and compete with China, and work with our allies and partners to promote and protect our interests in the region.

China’s foreign relations have become more assertive in recent years, and its domestic politics has undergone drastic changes. The change in position on foreign affairs is perhaps a result of changes in China’s domestic politics. Since Xi Jinping assumed leadership in

2012, he has launched a series of political maneuvers to crack down on corruption, amass his own political power, and suppress freedom of speech. In addition to the overhaul of the bureaucratic machine, Xi appears to have a different vision of the economy as well, which relies more on governments than markets. In Chapter 3, Barry Naughton gives a timely assessment of the prospects of the Chinese economy under its newly established leader.

Xi Jinping laid out an ambitious program of reform in the Third Plenum Resolution of November 2013. However, since that time, progress on economic reform has been slow and uneven. Naughton, relying on his insightful understanding of the economy, explains why Xi's model may fail. His arguments follow three closely related steps. First, the period of "miracle growth" in China ends; second, Xi Jinping's policy agenda generally relies on a strengthening of government and, especially, party intervention in the society and economy; and third, as a result, Xi's policy regime is marked by and mired in inconsistent and sometimes contradictory objectives.

The Chinese economy grew at an average rate of just over 10 percent a year between 1978 and 2010. However, in 2010 the growth rate fell below 8 percent and in 2016 it was around 6.7 percent. As China moves into middle-income range it faces fundamental challenges. "Cheap China" is not cheap any longer. Wages for unskilled workers have risen rapidly, particularly between 2008 and 2013. Producers of garments, shoes, and sporting goods are beginning to move their businesses to Vietnam and Bangladesh, where wages are lower than in China. This change in labor costs strongly correlates with the end of the miracle growth era in earlier developing economies such as Japan, Korea, and Taiwan. However, the "one-child policy" has exacerbated the labor cost increase in China.

Another challenge is the debt overhang that China has built up over the past seven to eight years. China has been aggressively expanding bank lending to cope with the global financial crisis and maintain high rate of growth. For example, the debt accumulated by local government jumped from 17 to 35 percent of GDP between 2007 and 2014. Naughton says that "while the overall debt level is not yet unsustainable, the trajectory certainly is. China needs to find a way both to slow the increase in debt and to restructure the portion of debt that will never be repaid."

In the face of such economic challenges, Xi Jinping's administration adopted an approach that relied more on government intervention than markets. As an economy approached the world technological frontier, it became less likely that bureaucrats had an advantage over private actors in predicting technological or sectoral evolution. Both Japan and Korea had successfully followed this approach. Naughton writes, "Although China has a very different political and economic system from Japan and Korea, the general direction in which China has evolved since 1978 seemed consistent with the earlier evolution of Korea and Japan. Since the 1980s, the Chinese government has stepped back from many aspects of society, and as China became richer, Chinese society became more diverse and tolerant. However, to a remarkable extent, Xi has sought to reverse this direction. He has consolidated his own individual power more rapidly than anyone expected, and he has established his own personal dominance of the political process more thoroughly than most believed possible." In particular, he took over a new "leadership small group" (LSG), which had direct authority over the economic reform process. This group represented a significant departure from past Chinese practice, by which economic policy was run directly out of the State Council by the premier. Xi's direct control of economic policy meant that the success or failure of economic reforms in China today would be a reflection on the validity of the "Xi Jinping model." Naughton then examines three major reform initiatives during 2015: restructuring local government debt, opening the stock market, and reforming state enterprise.

Beginning in 2014, the minister of finance laid out an ambitious program of local debt restructuring. The plan was to cap debt at the 2014 level and then begin to transform debt into new, local government "municipal bonds." However, this initial program of debt restructuring failed. Buyers and sellers were unable to agree on an interest rate. The government was forced to withdraw the offer.

Chinese policymakers also laid out an ambitious reform of equity markets. The Chinese stock markets are highly "political"; that is, stock prices swing with intended, perceived, or rumored changes in policies. Anxious to revitalize the markets, some policymakers and government media zealously promoted a rosy picture of the markets. The entire political leadership, including Xi Jinping, had been complicit in state-

ments that directly or indirectly encouraged the stock market bubble. As a result, the Shanghai Stock Exchange Index soared in June and then crashed in July, leaving China's leaders anxious. After the plummet, Premier Li Keqiang presided over a series of meetings designed to bail out the stock market. The China Securities Finance Corporation was provided with unlimited liquidity to buy up "red chip" stocks. After the bailout, new listings were once again suspended. Interest by overseas investors quickly evaporated. Not only was the market still in a bear mode, but the added risk of unpredictable government policy was too great for most foreign investors to take.

Attempts to further reform state-owned enterprises (SOEs) did not fare well either. The Resolution of the Third Plenum (November 2013) introduced several innovative approaches, such as an expanded role for "mixed ownership," new investment funds that would manage government wealth, and a role for employee share owning. The efforts to turn these ideas into reality quickly froze. Then, as Naughton explains, "in the summer of 2014, the Reform LSG made several decisions that thoroughly upended the stalled SOE reform process. Most strikingly, the LSG approved a limitation on the salaries of SOE managers, which was designed to bring SOE managers' salaries in line with those of bureaucrats at a similar level. The abrupt adoption of these salary caps underlined the extent to which Xi Jinping was seeking to achieve mixed objectives in his approach to state-owned enterprises." Another case of confusion of policies and setback of SOE reforms was a decision to set up a new specialized "SOE Reform LSG," which gave the economic bureaucracy more control over SOEs.

Naughton summarizes that by the end of 2015, all three of these reform initiatives of the Plenum had failed. He further points out that "there may be a deeper contradiction between the requirements of this stage of economic reform and the exercise of authority by a single individual. An authoritative leader may be helpful in the first stage of reform, adapting to crises and throwing off old constraints. However, at a certain point, market-oriented reforms require that leader to step back and allow market forces to work without constraint." China today has developed into a satisfactorily functioning market economy. It needs at this stage independent regulatory and financial institutions, which have not been a prominent part of the Xi Jinping reform package. The year 2015 thus "provides little support for the idea that an authoritative Xi

Jinping leadership can contribute effectively to the economic reform process.”

In Chapter 4, Wing Thye Woo notes that China has been experiencing or may encounter in the near future three classes of failures that will interrupt the miraculous growth that China has achieved in the past 30 years: 1) a hardware failure from the breakdown of an economic mechanism, 2) a software failure from flaws in governance that create frequent widespread social disorders, and 3) a power supply failure from hitting either a natural or an externally imposed limit. He then elaborates and illustrates these failures by citing important cases and factors.

Of the hardware failure, Woo stresses state banks' solvency and the central government's fiscal health. The state-owned banks (SOBs) had in the past accumulated enormous bad debts to the point of insolvency. The central government previously had rescued the banks by injecting new capital. If the state is perceived to be able and willing to bail out the SOBs, depositors would retain their confidence in the banks regardless of the actual state of their balance sheets. The important question is, how many more rounds of bank recapitalization can China afford without generating a fiscal crisis? Woo claims that the government can hardly afford to recapitalize the SOBs without upsetting confidence in the financial markets about the soundness of China's fiscal regime. The task then is to stop losses in the SOBs in order to ensure fiscal sustainability. The solution lies in imposing a hard budget constraint on the SOBs.

Woo suggests that the operations of SOBs could be improved by bringing in foreign strategic investors who would be part of the management team, and by removing the influence of the local governments on bank operations. He writes, “Another way to harden the budget constraint faced by the SOBs is to privatize some of their branches and use the performance of the new private banks to gauge the performance of the remaining SOBs. The privatization of some branches will also help convince the SOB managers that the government is indeed determined not to recapitalize SOBs in the future.”

Citing two cases, Woo deems government corruption and dereliction as major factors of software failures. In one, the former director of China's Food and Drug Safety Agency took bribes from pharmaceutical and food companies in exchange for approvals of drugs and produc-

tion licenses. The market was flooded with counterfeit products and tainted and substandard food and drugs, and tens of thousands of people were sickened or killed every year as a result. The other case pertains to government failure to protect workers. Child labor and slaves were not uncommon in rural and remote regions, especially in the mining businesses.

For power supply failures, Woo's main concerns are trade conflicts and environmental disasters. China's chronic and growing overall trade surplus reveals a serious problem in China's economy—its dysfunctional financial system. The banking system favors SOEs to the extent that the returns of investment have been extremely low and eventually created huge excess capacity. High ratios of nonperform loans in the state banks and excess capacity have triggered a slowdown in bank loans. This cutback has created an excess of savings because the SOB-dominated financial sector does not rechannel the released savings to finance the investment of the private sector. Woo suggests that the optimum solution to the problem of excess saving is not for the government to absorb it by increasing its budget deficit, but to establish an improved mechanism for coordinating private savings and private investments.

While the nonstate sector has risen tremendously in China throughout the reform process, the state-owned and state-controlled enterprises have remained an important aspect of the Chinese economy. In fact, despite three decades of aggressive enterprise reforms involving privatization of some state firms and retaining/restructuring of others, the remaining state enterprises continue to dominate some major sectors of the Chinese economy and have also emerged as global titans. In Chapter 5, Mary E. Lovely and Yang Liang address the issue of state enterprise reform that Naughton touches on in Chapter 3. They examine the characteristics of firms that were retained by the Chinese state and those that were released to the private sector between 1998 and 2006. Their empirical analysis is conducted using microdata from China's National Bureau of Statistics, specifically, China's Annual Survey of Industrial Production.

Lovely and Liang begin their analysis by tracking the evolution of enterprises away from China's state sector over time. They first describe the inherent difficulties encountered by researchers to identify the state-owned and state-controlled firms. The difficulties stem from various definitions of state control, limited data, and opaque owner-

ship arrangements. They then explain their approach to defining a firm as state owned and state controlled when it is registered as an SOE, when the share of registered capital held directly by the state exceeds or equals 50 percent, or when the state is reported as the controlling shareholder. Using this classification, they contribute to the literature by providing new estimates of the size of the state sector. Specifically, they find that about 5 percent of total enterprises were state owned and controlled in 2006, and that these enterprises supply more than 30 percent of industrial output.

Lovely and Liang's major contribution to the literature, which also constitutes the main part of this chapter, is the insight gained from their econometric analysis examining the characteristics of those enterprises chosen by the state to be released and which it chose to grasp. Based on the various perspectives in the literature on how the state chose which assets to grasp and which to release to private owners, they formed hypotheses about the relationship between initial firm characteristics and the likelihood that they remained state controlled. They test these hypotheses using a linear probability model for two time periods, 1998–2002 and 2002–2006. Their main findings are that in both periods, firms that were larger and more viable financially, but had lower revenues relative to assets, were more likely to be retained by the state. Firms with low labor productivity, an indication of legacy burdens, were also more likely to be retained. Additionally, after 2002, firms affiliated with higher levels of governments were much less likely to be privatized.

After presenting their regression results, Lovely and Liang review recent assessments made by several groups of researchers on the performance and productivity gaps between the state and nonstate sectors. They summarize the findings of recent analyses of the success of the restructured state enterprises in reducing factor misallocations and, hence, in contributing to productivity growth. Considering their estimates, the lower productivity of state-controlled firms appears to be a natural consequence of how enterprises were grasped and released. Therefore, it is not surprising that average state sector productivity continued to lag behind the private sector, despite innovation in the form of state control. Finally, they use their analysis of the grasp-or-release decision to highlight some of the challenges of continued SOE reforms in the future.

In Chapter 6, Guanzhong James Wen advocates for a significant reform in the land tenure system in China. Despite the phenomenal growth of China's economy, which is an unprecedented achievement and probably cannot be surpassed by other nations, its income disparity has become the worst in East Asia. In particular, its urban/rural income ratio has become one of—if not the—worst in the world. Unlike the experience of China since 1979, developed economies and more recently East Asian economies, such as South Korea and Taiwan, have been able to achieve growth without suffering from substantially worsening rural/urban disparity. Why can they achieve that? According to Wen, it is because the farmers in those economies were allowed to freely trade their land, and freely migrate to and settle in urban areas.

Why can't China also achieve that? Wen explains that China's rural population is constrained by two institutional barriers depriving them to legally share urban prosperity and to accumulate wealth on equal footing: the hukou system and the land tenure system. China's hukou system has made urbanization almost exclusively inaccessible to the rural population, turning urbanization into urbanizing mainly land instead of rural population. The hukou (family registration) system was officially promulgated in 1958 by the Chinese government to control the movement of people between urban and rural areas. Individuals were broadly categorized as a rural or urban worker. A worker seeking to move from the country to urban areas to take up nonagricultural work would have to apply through the relevant bureaucracies. The number of workers allowed to make such moves was tightly controlled. Migrant workers still need to obtain several passes to work in provinces other than their own. People who work outside their authorized domain or geographical area do not qualify for employer-provided housing, health care, or other urban amenities. Even their children are not eligible to attend municipal schools where their parents are working since they don't have urban hukou. As a result, there are an estimated 60 million children left behind in rural areas, separated from their parents working in urban areas. The poor educational condition in rural areas dictates that most of them will have limited human capital and will acquire low social mobility and low income in the future. This vicious cycle dampens the prospect for China to improve its urban-rural income distribution, even though the central government is now moving to gradually dismantle the hukou system. Big cities are given some autonomy to decide on their own

hukou policy, and the towns and small cities are also urged to open up to rural migration. Only time will tell how effective and how soon China can ultimately eliminate control over free migration and free settlement.

According to Wen, the prevailing land tenure system is an even bigger barrier than the hukou system, as it provides “local governments either a legal basis or an excuse to take rural land for urban development. Under this system the government becomes a monopsony in buying farmers’ land and a monopoly in auctioning off the leaseholds to developers.” The land price is thus seriously distorted, either inflated or suppressed. Wen articulates the impossibility of developing a true land market under the current constitution, particularly Article 10, which stipulates that land in the cities is owned by the state and land in the rural and suburban areas is owned by collectives. Rural collectives are not allowed to trade land among themselves, let alone the individual farmers. Even if a collective is inefficient or corrupt, or its leaders are abusive, members cannot exit with their share of land to regroup a new collective on a truly voluntary basis. Wen points out that in the absence of a truly functioning land market, inefficiencies and distortions abound, manifested by the contrasts of “on one side, ghost towns, idling apartment buildings, and deserted industrial parks are emerging everywhere, especially in China’s vast inland, but in its coastal areas, housing prices are skyrocketing; on the other side, most of the 2.6 hundred million migrant workers are living in shelters, slums, ghettos, or urban villages, which are being bulldozed by the local governments, aggravating the shortage of affordable housing.”

Wen concludes his chapter with a proposal of how to reform the land tenure system in China. The key, he says, is that farmers should be given the exit rights from the compulsory collective land ownership and that land trading should be legalized as long as the land use (zoning) is not changed. Wen also advocates that China should abolish its Hukou system as soon as possible. He expects that with these two reforms implemented, China can accelerate the absorption of rural surplus labor and significantly improve its urban-rural income disparity.

In Chapter 7, Xiaodong Zhu provides convincing evidence of the benefits of reducing restrictions on movements of goods and people in an economy, using China’s experience between 2000 and 2005 as a case study. This chapter corroborates with Chapter 6, as Zhu’s findings provide quantitative endorsement of Wen’s proposal to lift restrictions

and facilitate rural to urban migration by granting farmers exit rights from compulsory collective land ownership and dismantling the Hukou system.

Zhu begins by discussing the state of the Chinese economy in year 2000 and then motivates the study by describing some important changes that happened between 2000 and 2005, particularly those that reduced migration and trade costs. Next, Zhu reports findings from a previous working paper (Tombe and Zhu 2015) on the extent of migration and trade cost reductions. Specifically, Tombe and Zhu find that overall, migration costs declined to 84 percent of their initial level, and that costs to switch provinces fell the most, from 32.6 to 19.8 percent. They find that trade costs within China declined by 11 percent, and trade costs between China and the world on average declined by 8 percent. Also, China's costs of importing from the rest of the world declined more than China's costs of exporting to the rest of the world.

Zhu then reports the quantitative impacts of these changes in migration and trade costs on aggregate productivity and welfare. Specifically, because of lower internal trade costs, aggregate welfare increased significantly, by nearly 11 percent, whereas external trade cost reductions resulted in a smaller gain of only 3.1 percent. Further, the reductions of migration costs (mostly due to relaxation of the stringent Hukou system restrictions) increased the number of interprovincial migrants by more than 80 percent. Increased migration flows were also beneficial for China as a whole; real GDP and welfare rose by 4.8 percent and 8.5 percent, respectively. Lastly, Zhu highlights the results from their growth decomposition exercise that decomposed China's overall growth between 2000 and 2005 into four components: 1) productivity growth, 2) lower internal trade costs, 3) lower international trade costs, and 4) lower internal migration costs. Overall, reductions in trade and migration frictions together accounted for about one-third of China's aggregate growth. Specifically, reductions in internal and migration costs contributed roughly one quarter of growth, whereas international trade cost reductions accounted for only 7 percent of the overall growth. This finding challenges the conventional wisdom that the main reason for China's rapid growth is external trade liberalization associated with China's entry in the WTO. Tombe and Zhu's (2015) study shows that, at least for the period from 2000 to 2005, internal policy reforms undertaken by the Chinese government that lowered internal trade and

migration costs contributed more to China's growth than external trade cost reductions (27 percent versus 7 percent). Thus, Professor Zhu concludes that if China continues to pursue reforms to dismantle the Hukou system and further internal liberalizations, we can expect increases in China's aggregate GDP and welfare to continue in the future.

China has been rising rapidly since the late 1970s, when it launched market-oriented reforms and opened gradually to the world economy. Thirty years later, in 2010, China surpassed Japan in GDP and became the second-largest economy of the world. The attainment of this status was regarded as a milestone of the reform movement; it has since been referred to as the reforms of 30 years. The editors of this volume published a collection in 2012, titled *Dragon versus Eagle: The Chinese Economy and U.S.-China Relations* (Huang and Zhou 2012), which summarizes and evaluates the achievements and problems of the 30 years. Now the reform is quickly nearing its 40 years. Can we call it a reform of 40 years, implying that it follows the same direction and spirit of the previous 30 years? The term has not appeared yet, perhaps for a good reason. Recent policies and measures appear to have deviated from the previous path, especially since 2013, when Xi Jinping assumed leadership. In the name of anticorruption, Xi has not only concentrated power in his own hand within the Party but also tightened control over society by cracking down on freedom of speech. The leadership has shown distrust toward the private economy and markets. Private enterprises are required to set up Party branches, and financial markets asked to "place politics ahead of profits." Now that the twice-a-decade Party Congress has ended and Xi Jinping further consolidated his power, the economic and political changes that were cultivated in the past five years will take a more definite direction and shape. The Party documents declared it was a beginning of a new era. While the Chinese populace at large acclimates and becomes desensitized to the rhetoric, scholars, policymakers, and businessmen, in China and abroad, are anxiously watching what these changes will lead to and how they may impact the Chinese economy. The China experts in this collection have touched on some of the concerns and shared their insights on possible consequences. We believe that this volume will provide a backdrop for anticipating and understanding developments and changes in China in the near future.

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