

# **Chinese Legal and Economic Reforms: Reflection of the Economy and Marketing Strategies**

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*This article addresses the rapid economic growth in China which has resulted in many external opportunities for trade and internal opportunities for the development of industry, banking and finance. All levels of society in China have been impacted by the rapid economic growth, which has resulted in increased buying power for even the poorest rural Chinese. China faces challenges in creating a legal system that can address and keep pace with the economic changes. The historical development of the Chinese legal system is examined in the context of the ever-changing economy. Balancing these competing interests will continue to pose challenges to China.*

## **INTRODUCTION**

China has rapidly progressed economically over the last several decades. A great deal of attention has been directed at the “change agents” responsible for the dramatically ramped up economy. Moreover, there has been additional focus on the related societal changes, i.e. the increase in wealth both at the upper levels and in the middle class as well as the increased wealth even in the traditionally poorer rural areas. This increase in wealth has had the expected increase in desire of the Chinese populace for material goods, access to property ownership, and educational opportunities. In western society, the legal system has provided a framework to promote and regulate such development. This article will address the symbiotic relationship between the changing role of the legal system of China and its influence in promoting China’s economic changes.

## **METHODOLOGY**

A significant portion of this research is based on structured interviews with more than 250 key influencers in Shanghai, Beijing, Tianjin, Chongqing, Hong Kong, Singapore, and Washington D.C. over a period of 24 years beginning in 1988. The most recent relevant

interviews occurred in the summer of 2010 and were conducted with experts from the Royal Institute of International Affairs and the School of Oriental and African Studies both in London, The Council on Foreign Relations in New York, and Imprimatur, a private investment firm in London. A significant effort has also been made to examine historical data and documents from a variety of sources relating to legal developments. This includes published secondary sources when and where they are available. It is important to note that many of the professionals and experts on China wish to remain confidential as they work in China. Therefore, we choose to respect their confidentiality in all cases. We have clearly referenced and documented data where it is public.

The methodological basis for this study where it involves interviews can be described as an emphasis on key stakeholders and influencers. In general, the interviews were conducted with senior analysts, officers, and professionals. In addition to experts from the above listed institutions other institutions include analysts from such organizations as the Economist Group in Hong Kong, Shanghai, and London, The old Bear Sterns Investment firm, Goldman Sachs, Chase Investment Bank, U.S. Chamber Officials, U.S. Dept of Commerce, U.S. Embassy, economic analysts in several Asian countries, the Canadian Chamber of Commerce, and Boston Consulting in at least two locations, Microsoft and a host of other public and private professionals. Generally known history on China that can be found in any data book or is derived from widely known history regarding recent historical developments is not always referenced in detail. We make clear when we draw our own conclusions about developments.

## **DATA ON CHINA**

The purpose of this paragraph is to describe some of the economic background data to provide context for the ongoing evolution of the law. There are huge capital savings in China, with companies holding up to 70 percent and individuals holding a smaller portion of up to 30 percent. By 2020, Shanghai will be an international finance sector. In the five years before the financial crisis of September 2008, China reported 600 billion dollars of foreign direct investment. In the last 5 years, China reports that 200 billion dollars of outward direct investment has occurred. China is arguably the world's largest exporter over second-place Germany. China is also a huge energy importer. China produces 7% of the world's GDP, similar to Japan. In contrast, China ranks about 150<sup>th</sup> in per capita income. There are deep pockets of poverty, particularly in rural areas. Water quality is often compromised. Pollution flows into the Yangtze. There has also been substantial deforestation. Whatever other problems China has, China has lifted 350 million people out of poverty and the middle class continues to expand with many entrepreneurs now in the party. This economic growth has occurred in a large part due to the development of efforts to create and follow the rule of law. Other industrial nations have long recognized that governance by the rule of law promotes economic growth and stability. A recurring theme in studying China involves spurts of rapid development and the resulting and often negative consequences that follow. The legal system has followed this pattern and further economic development is inexorably tied to development of a mature system which recognizes the rule of law.

## **Education Concerns**

The Chinese are concerned about a massive quality issue in their education system. A country with similar rapid growth, India, has planned another 30 universities, but it is short 30% in the number of faculty needed in leading institutions, creating a credibility gap. The Organization for Economic Cooperation and Development “OECD” issued reports on India and China – suggesting neither will have a world class university within the next 20 years. (Shen and Wang, 2011) have identified that China has recognized that education is an important function of government which is closely associated with economic growth. Moreover, they describe that China has begun to apply marketing theories and concepts previously utilized in business to promote its’ educational system. The Chinese need to establish an environment to renew investment capital and attract highly educated influencers.

## **The Power of History: The Roots of a Legal Tradition Rather Than a System**

There is a tendency among those writing about the changes to China’s legal system to bypass China’s lengthy history and focus instead on developments since 1910 (Development of Separate Civil and Criminal Codes) or even 1978 (Restoration of the Legal System after the Cultural Revolution). While these events are significant signposts in the path of the ongoing development of Chinese law, they do not define the lengthy legal tradition which has shaped Chinese law.

Law and legal education were valued in China over three thousand years ago. (Hung, 2008). Law was a family enterprise with multiple generations teaching law. (Hung, 2008). The ruling class would often rely upon these informal teachings as a source of law. (Hung, 2008). However, the judicial process was controlled by laymen not specifically trained in the law. (He, 2005). The laymen were selected by completion of a civil service examination. (He, 2005). Often, the official’s secretaries would assist them in deciding cases, placing greater consideration on how the outcome would affect their master rather than relying upon the application of formal legal principles. (He, 2005).

The legal principles that guided the system were based upon the two competing fundamental Chinese philosophical concepts of *li* and *fa*. (LaKritz, 1997). *Li* is based upon a set of moral and societal customs that shaped social behavior. (LaKritz, 1997). *Li* recognizes the Confucian relationship of ruler/official among others. (LaKritz, 1997). Conflict resolution in this system was based upon compromise and harmony. (LaKritz, 1997). Thus one-half of the dual system relied upon relationships and knowing one’s place.

The other half of the system, *Fa* was a more formal, legalistic instrument of control. (LaKritz, 1997). For law to be effective it must be made known to all and all must be held responsible to it. (LaKritz, 1997). Utilizing a *Fa* approach was more authoritarian, but also more predictable.

Both of these approaches formed the basis for the Tang Code which was established in 618 A.D. (LaKritz, 1997). The Tang Code is essentially a penal or criminal code. In traditional China, there was no distinction between criminal and civil law as the sanctions were applied equally to situations which would today be considered civil. (HY Chen, 2007).

The roots of the Chinese legal system reflect a significant difference from the western and Japanese influences which would soon dominate and shape China’s legal development. Chinese law emphasized relationships and prized pragmatic resolutions to problems. In contrast, western law emphasized cases and codes. The absence of formal codes was not a sign that the law had no place in Chinese society; however, the role of law was secondary to spiritual and moral values. (He, 2008).

### **Pre-Communist Period: Introduction/Intrusion of Western Influence**

China's increasing contact with the west in the nineteenth century was based primarily on western interests in trade. (LaKritz, 1997). Both the west and Japan were dissatisfied with existing Chinese systems. (Hung, 2008). Early reforms were responsive to western desires. The first law school was formed in 1906. (Hung, 2008). Eventually, each province would establish its own law school. (Hung, 2008). The Qing Dynasty government formed a "Law Codification Committee" in 1903 to study and establish a code. (LaKritz, 1997). Although the formalistic legal system was more of a reflection of western economic, political and cultural influence than a reflection of Chinese social reality, it did provide a framework for resolving the increased disputes between the Chinese and the rapidly increasing foreign influx. (He, 2005). Interestingly, the foreign influx and trade battles which created the need for Chinese legal reform in the late nineteenth and early twentieth century have repeated themselves a hundred years later. The legal system continued to develop on this course until the invasion of China by Japan in the 1930's. (He, 2005). The invasion, followed by World War II and the subsequent civil war in China effectively eliminated the existing legal system which was replaced with a dramatically different system by Mao Zedong.

### **Communist Period: Party Domination of the Legal System**

The period of development following the establishment of the People's Republic of China was marked by the removal of the European-style codes established by the nationalists. (LaKritz, 1997). During the Cultural Revolution, a formal legal system was eliminated and replaced with a party and policy driven system. (He, 2005). Mao's plans to "modernize" China targeted the legal system. Judges were "re-socialized", schools were closed and no new laws were enacted. (LaKritz, 1997). The significance of the targeted removal of formal legal systems during the 1949-1979 time-period can be shown through the absence of both the contributors to a legal system, i.e. judges and lawyers as well as the by-products of a legal system, laws. The number of national laws implemented between the years 1949-1978 was 127. (Chen, 2007). In contrast, the number of national laws implemented in the twenty-six year period following 1978 ballooned to 762. (Chen, 2007). This rapid growth was mirrored in the development of laws at the administrative and local level. (Chen, 2007). 1979 also marked the beginning of the development of the judicial system including substantial growth in the number of courts and judges. (Chen, 2007). The number of lawyers increased from 300 practicing in approximately a dozen law firms to more than 118,000 working in almost 12,000 law firms. (Chen, 2007).

The economic, sociologic and cultural impacts of the Cultural Revolution are the subject of countless other articles. However, the stagnation and overall malaise that the Cultural Revolution produced in other areas of Chinese life also set the stage for reforms, including legal reforms. With the rapid development of the legal system, the stage has been set for dealing with the exponential growth of China's economy.

## **MARKETING AND EVOLUTION OF THE LAW**

The aim of this section is to provide some thoughts regarding marketing strategies and the evolution of the legal framework in China. First, the authors underline changes in core values that might relate to the marketing concept. Second, the authors emphasize some general operational principles that relate to marketing in the China transition. Finally, the authors provide some observations on specific marketing strategies.

## **The Marketing Concept and Some Core Value Changes**

As this research shows the evolution of the law has accompanied the rise of the Chinese economy. As with the economy, the emergence of the law has not been even and progressively linear. From a marketing perspective legal development has been bumpy and treacherous to navigate (interviews). But core values have changed. The rule of law has to some degree replaced arbitrary, personalized rule. At least in certain urban areas contracts are now protected as a consequence of the demands of the new consumer middle class (interviews).

Also, foreign business and investment clearly has an important and legally defined role in the new China. Profit and risk are encouraged and enshrined in the law (interviews). The rights of land owners in rural areas may be the next "legal revolution" (interviews). Nevertheless, corruption, complexity, and spotty legal development, plague the marketing effort.

## **General Marketing Issues and Imperatives**

There are several imperatives that the marketing manager needs to consider. First, the human resource question is paramount. One must find and employ individuals of uncommon skills. These characteristics include superb coordinating and communication skills based on either exceptional knowledge of the issues or the ability to rapidly learn (interviews). Additional necessary skills include uncommon creativity, flexibility, and initiative (interviews).

A second area of general need for China marketing is focus and constant communication. Over sixty percent of China joint ventures have failed in part because westerners assume that once a contract is signed parties will automatically carry out the assigned tasks. In fact Chinese often assume a contract is just one phase of a continuous process of negotiation (interviews). Constant feedback and learning are required.

A third general operational principle is "relationship marketing". Despite the increasing legitimacy of the rule of law, China is traditionally a high context culture. Relationships are hugely important. Thus to market successfully in China, one must patiently develop long term relationships (interviews).

A fourth general principle of operation is localization. This means finding and employing people who know the local market. This may involve expats who travel to the local markets or hiring locally (interviews).

## **Specific Market Strategies and Options**

First, an important option is marketing through Hong Kong. Even during the Mao era of a closed China, Hong Kong was by design a window to the West. In recent years, it has remained a financial center and a marketing resource for the mainland---a bridge to the mainland managed by people who understand China as well as the wider world (interviews).

A second strategy is to market in stages. First, one markets to upscale consumers. Then one markets to middle income consumers with partially localized products and services. Finally, one markets a completely localized product or service (interviews).

Finally, and above all, it is important to re-engineer one's organizational culture as a learning organization to continually gather necessary feedback for strategic marketing adjustments. (Senge, 1990).

## **TRANSITION AND REFORM: THE ECONOMY AS ENGINE FOR CHANGE**

China continues to power through the global financial crisis with a growth rate approaching 10 percent. The Chinese version of the stimulus continues to enable this success. At the same time, the leadership is concerned that this growth may not be sustainable and will create unacceptable inflation. In China, inflation can be a huge problem causing political and economic turmoil in a poor county. First, we will explain the nature of the economy. Second, the analysis outlines the unique current features of the Chinese stimulus. Finally the research shows the pitfalls ahead for the economy and the particular problems inherent in the Chinese approach to stimulus.

The current profile of the Chinese economy might be described as being two economies. They are clearly in major transition. The first economy is export manufacturing. This has been the basis of China's recent historical success, attracting over 600 billion dollars of foreign direct investment in the six years running up to the global financial crisis (interviews). The GDP of China has been growing over 10 percent annually since Deng's market reforms began in 1978 with some growth rates as high as 40 percent in places like the Pearl River Delta (interviews). When this export manufacturing sector began to crash in the financial crisis, some 20 million workers in Guangdong province alone lost their jobs (interviews). The Chinese 565 billion stimulus package was meant to counter this problem and to date it has worked effectively to move laborers into infrastructure projects (interviews). Moreover, the export economy, according to most recent reports, has begun to pick up again. (interviews).

The second Chinese economy is the economy of internal demand and consumption, which is the new focus. The leadership believes that this is necessary for sustainability and to improve the value chain (interviews). Moreover, internal demand and consumption is now approaching 44 percent of GDP (interviews). There are two principal obstacles to turning the economy toward consumption. The first problem is cultural. The Chinese are traditional frugal savers. They save as much as 30 percent of their incomes (interviews). The second issue is a clear matter of rational personal finance. Chinese society does not provide social safety nets, thus requiring individuals to personally save (interviews).

The nature of the Chinese stimulus is unique. First, it has seamlessly transferred millions of manual workers out of export manufacturing into infrastructure projects all over China with a certain amount of pressure to move population according to the goals of the "go west" government development policy (interviews).

The second and perhaps most important characteristic of the Chinese stimulus program is that, in great part, it is not a traditional stimulus program at all. It is essentially a massive bank lending program commanded by central authority. This lending by the instruments and agents of the command economy has created massive tensions in the Chinese government (interviews). This tension can be explained in the following way. The general policy management of the entire Chinese economy is carried out by the central government in Beijing. More specifically, this means overall economic policy is set by the State Council. The State Council seeks to further expansion and growth and high employment particularly in light of the global financial crisis, which slowed the economy from a growth rate of 12% to 7.5%. At the same time, the leaders of the central bank and the banking system generally seek to restrain the economy by tightening loan policy with traditional monetary restraints to prevent inflation that appears to have increased to 3.6% (interviews). From the perception of the Chinese banking leadership, inflation in the Chinese system can have a devastating political and economic impact substantially out of

proportion to other countries. China has raised more than 300 million people out of "one dollar per day" poverty, but many people, particularly in rural China, continue to live in extreme poverty. Any inflationary increases will directly impact their circumstances. Moreover, the political repercussions can be dramatic. The banking and political leadership perceive that the greatest fear of the Chinese people is political and economic chaos, particularly after the turmoil of the last 200 years (interviews). Thus there is a continual tension in the policy-making machinery between the banking leadership and State Council (interviews).

Stimulus "Chinese style" has several problems going forward. (Geib and Pfaff, 2010). These problems include how to stimulate internal demand and consumption in a sustainable way, how to prevent the resurgence of a huge percentage of non-operational loans, and how to balance the right amount of government control with the need for separation between government and economy. A similar need for balance between a state-run and a truly "open" legal system has resulted in significant progress towards creating a system that recognizes the value of the rule of law.

The post-cultural revolution period in China did not necessarily provide a "blank slate" for the creation of a formal legal system; however, the essentially state run, highly centralized system created a vacuum which was filled with what can be termed an emerging or transitional system. Considering the history, population and size of China, this provided an unparalleled opportunity to build a new system at all levels.

The Organic Law of the Courts was implemented in 1980 and helped to shape the development of the current legal system in China. (Song, 2007). The court system has four levels, The Supreme Court of China, the higher provincial courts, the intermediate courts and the local courts. (Song, 2007). There are other specialty courts, such as military courts.

Reform began by implementation of codes designed to organize the legal system. The 1982 Constitution raised the Supreme People's Court and the Supreme People's Procuratorate to a higher status. (May et. al, 2006). Other laws soon followed:

Over the last two decades, the People's Congress has enacted basic, foundational legislation to enable economic development, including a Company Act that permits some forms of private ownership and enterprise; a Contract Act that offers a framework for business transactions more familiar to foreign interests; a Civil Law Process Act to provide, at least theoretically, a structure for enforcement of rights and obligations; a Criminal Code; and an Intellectual Property/Patent Act. Taken as a whole, these laws reflect a careful move from a planned economy to some participation in a market economy. (Hanson, 2001).

The changes in the legal system were paralleled with changes to the professionals participating in the system. There were only two law schools in all of China in 1979; this has increased dramatically to over three hundred law schools today. (McPherson, 2008). The number of lawyers has mushroomed to over 120,000 from 3,000 in under thirty years. (McPherson, 2008). However, China's lawyer population, as is the case in many other countries, pales in comparison to the number of lawyers in the United States. The United States has one lawyer for every 300 people, whereas China has one lawyer for every 8,000 people. (McPherson, 2008).

The judicial system changed as well. Following the cultural revolution, the judiciary was comprised of retired military officers with no particular legal training. (McPherson, 2008). China's inclusion into the World Trade Organization has placed additional pressure to improve

the judiciary. (Hung, 2008). Formal education is now required by the Judges Law, adopted in 1995 and revised in 2001. (Song, 2007). Judges are now also required to pass the National Judicial Examination, which is clearly rigorous, with a pass rate of only 7%. (Song, 2007).

Another reflection of the overall changes in China's legal system involves the development and growth of law firms. Law firms were state-owned organizations. (Hanson, 2001). Now some of the firms are organized as "cooperatives" which more closely resemble western firms. (Hanson, 2001).

The rapid growth of the building blocks of the Chinese legal system: formal codes, law-schools, judges and lawyers, is remarkable. Most western legal systems developed over centuries, not decades. Because the system in China is still in its infancy, it is difficult to gain an overall perspective of the efficacy of the changes. However, the growth is not without "growing pains" and barriers remain to achieving a fully developed and efficient system for handling disputes. The relationship between the growth of China's economy and the development of the Chinese legal system has resulted in impressive progress in both systems.

## **MOVING TOWARDS A MATURE LEGAL SYSTEM: THE RULE OF LAW**

China seeks ultimately to be a rules-based society as evidenced by its long time goal to join the World Trade Organization, which it accomplished in 2001. China's drive to become a rules-based society has become hugely complicated as a consequence of culture, the speed of the transition, lack of transparency, the legacy of decision-making by the party, and lack of a system-wide ethical framework. We are talking here about a sea change in attitude and values.

The lack of a universally accepted code of ethics and law is complicated by the legacy of fragmented party decision-making. This stems from the rapid transition of the last thirty years that has furthered decentralization and substantial fragmentation. Courts support the politics of provincial township structure. But final judgments will be finally passed by a justice minister who is a communist party official. Thus, there is always the danger of political interference. But there is a more fundamental problem. Because of the importance of *guanxi* and the party legacy of arbitrarily personalizing power, people do not use courts to sort out their issues. They use informal networks. The party does not oppose this because turning to the courts might undermine party power.

Corruption and the lack of a permeating ethical system is a significant problem. It has been estimated that 12 percent of the GDP is tied up in corruption. Certain sectors of the economy, such as intellectual property, may still be experiencing significantly more. The 1990's may have seen some stabilization in the problem; moreover, there is now legal protection for the property of urban consumers. The Party has begun to deal with individuals first and then the state system. Fifty thousand corruption cases have been tried in the last three to four years. Fifty percent have resulted in sentences of five years or more. Some have resulted in the death sentence. Thus if one is caught, the punishment is quite severe. The whole area of crime and punishment is quite mysterious. For example, there are 31 provinces and special regions, 19 of which have been dubbed corrupt in the area of highways.

### **The Red Codes and Beyond**

Interviews with joint-venture managers and government officials underline changing values regarding the public-private distinctions. The so-called "Red Codes" do not clearly distinguish between the public-private creations. As the economic reforms progressed between 1979-1989,

there has been a great deal of debate regarding this distinction, culminating in the legal protections for middle class property rights in urban areas as of three years ago. Almost 50 percent of the economy is now private and begging for more legal protection. It is clear that more of the economy will be in private hands in the future. The Red Codes are ambiguous nevertheless. In some cases they still do not effectively determine who may do what to whom under what kinds of circumstances. Therefore individuals may unconsciously (or consciously) use public sector privileges such as preferential tax treatment to function in the private sector. This can easily lead to corruption which is one of our major reform concerns. It has contributed to the crisis of legitimacy.

As the Chinese legal system emerges from the post-Cultural Revolution period of transition, a number of problems need to be addressed before the system will be fully functional. These barriers include: a clear set of codes or law which are applied equally, an independent judiciary, and an emphasis on quality rather than quantity in the education and implementation of legal professionals.

The very method of creating law differs in China. Both the legislative body, the National People's Congress and the executive branch, the State Council have the authority to draft laws. (Jianhua, Z & Guanghua, Y, 2004). This is further complicated by granting the ability to interpret laws to the legislative body, the executive branch and the Chinese Supreme Court. (Jianjua, Z & Guanghua, Y, 2004). "The consequence of this fragmentary power to make and interpret the law is widespread inconsistency both in enacted law and the interpretation of law." (Jianjua, Z & Guanghua, Y, 2004, p.437). The result is that the conflicting rules and interpretations are hard to apply and create the opportunity for arbitrary application of the law. (Jianjua, Z & Guanghua, Y, 2004).

Another concern is the manner in which laws are drafted. Chinese laws tend to be drafted in very general terms. (Jianjua, Z & Guanghua, Y, 2004). "Standard drafting techniques include the use of general principles, undefined terms, broadly worded discretion, omissions and general catch-all phrases." (Lubman, 2000, p.391 n.27). Such vague and unclear legislation further promotes unequal and arbitrary application of law.

One of the most widely criticized problems with the Chinese system is the interference with the judiciary at all levels. This interference is complex and systemic. First of all, the one party system places control of the courts with the party. This leads to direct interference through the appointment and removal of judges. (Lubman, 2000) . Indirect interference can occur in many ways, such as the prevention of the transfer of a case out of a local jurisdiction. (Hung, V., 2004).

A more subtle form of interference occurs through the presence of *guanxi* ("connections"). The custom of relying upon relationships rather than the application of the law affects the confidence of the participants in the system. In other words, a strong case may become a loser if a party doesn't use *guanxi*, and a weak case will almost certainly become a loser if *quanxi* is not relied upon. (Hung, V., 2004).

Chinese judges also practice *qingshi*, which involves lower court judges consulting higher judges for advice. (Hung, 2008). This form of review can result in an appellate judge "reviewing" a lower case prior to appeal. This practice is utilized in part because Chinese judges are subject to discipline for issuing a politically unpopular ("erroneous") ruling. (Mizner, 2009).

Clearly, judicial independence is hampered by judges' inferior position in the structure of Chinese government. They face direct influence from the party and, other superior judges and must be cognizant of their obligations under both *quanxi* and *qinshi*. Most are not in a position to create law nor may they interpret the law. Although the training and education of judges has

improved, it will take time for the better educated judges to fill the ranks of their less educated former military peers. These “non-legal” pressures impair the trust and predictability which are routinely accorded western judges without such influences.

The Chinese government responded to the concern over judicial qualifications with a Five Year Program for Judicial Reform in 1999. (Song, 2007). The 1999 program sought to increase fairness and efficiency of trial proceedings, improve judicial resources and address the problem of judicial interference. (Song, 2007). A second Five-Year Judicial Reform Program was implemented in 2005. (Song, 2007). This program sought to further increase the independence of the judiciary. (Song, 2007).

The massive growth in the number of lawyers has resulted in an overall reduction in the quality of legal education. (Hung, 2008). Again, the government has responded with policies to curb further growth. (Hung, 2008). As with the judges, it will take time for the new group of attorneys to insinuate themselves into the current system and hopefully, enhance the quality of the profession.

The barriers to a fully integrated legal system that is trusted from both inside and outside China are many. However, there is a dramatic difference between the near absence of any functioning legal system during the Cultural Revolution and the current system. China’s willingness to adapt its economic and social structures to respond to exponential economic growth provides hope that such changes will be made to support a fully developed legal system. Outside pressures such as the WTO as well as internal demand from a growing middle class should provide the impetus for China to make the ongoing and necessary changes. Although the legal system is still subservient to the party, many changes have already been made to improve the laws, the judiciary and the environment for lawyers. China’s national pride and desire to “be the best” should provide an additional catalyst to develop a legal system worthy of respect and to foster stable economic reform.

## **ECONOMIC INDEPENDENCE FROM GOVERNMENT INTRUSION**

The first problem facing China is transitioning the Chinese economy to a sustainable internal demand based on consumption. The problem is that much of the growth of the Chinese economy has been based on export manufacturing, attracting at its peak between 65 to 85 billion dollars per year for years before the depths of the financial crisis (interviews). At its roots this is about changing cultural values and attitudes. Unlike India, for example, where internal consumption drives 65% of the economy, the Chinese people have been traditional savers and not traditionally oriented to personal consumption (interviews). This may be changing with young urban professionals. Also the Chinese leadership has been “jawboning” the value of private consumption. In addition, government incentives have occurred on a variety of levels. Politically, the regime has included representatives of the emerging bourgeois entrepreneurial class within the party. Encouraging such private wealth formation is a great departure from the past.

The Chinese government is also leveraging the auto industry. Demand in some cities like Shanghai was increasing 80% per year until the financial crisis. The Chinese auto market is now the largest in the world. The government supports this market by building highways, other infrastructure, and protecting private property like automobiles. Another important strategy for creating a new attitude toward private wealth formation is legal. The key policy has been to sponsor the development of a new legal framework for the protection of private property contracts in urban areas (interviews). This means that for the first time, there is serious legal

protection for the purchase of such items as cars, refrigerators, and real estate, seriously reducing past ambiguities. This has been done rather quietly after years of discussion as it runs counter to Communist ideals. Moreover, there has been great political pressure for the Communist Party to support the rising urban middle class which has become politically powerful (interviews).

Another major problem of the stimulus package Chinese-style, is the problem of non-operational loans. Before the privatization began in 1978, China's banks were running 80% nonoperational loans. Under the old regime the role of the banks was simply to channel money from the government to state-owned enterprises (interviews). Too frequently money was forwarded on the basis of arbitrary political decisions and personal relationships, a system that certainly preceded Communism as "guangxi" (interviews). The condition of the banks has been a continuing problem for China. But before the financial crisis, the Chinese leadership had made substantial progress in reducing the number of non-operational loans (interviews). They have probably been reduced to below 15%. The problem that arose was part of the unique nature of the Chinese stimulus package. With the impact of the financial crisis, the state council instructed the banks to flood the system with liquidity. This they rapidly did, making risk assessment for good loans impossible. Thus, the problem will once again be a plethora of non-operational loans (interviews), which may take years to unravel.

### **Balance Between Government and the Economy**

The issue for China is how to keep the right balance between the government and the economy. Before the financial crisis, China was successfully privatizing its economy. When the crisis hit, the government moved strongly to stimulate the economy and provide liquidity for the banks. China is now again seeking an appropriate balance between the public sector and private sector economy.

In case of China, how unique is the current period of history and the entrepreneurial link between government and business: Mao's last revolution was the Cultural Revolution. But nobody knew what he wanted. It was as if people were vaguely working toward the Chairman. The government issued unclear statements; Mao's officials would drive what they thought Mao wanted, then move back and punish those who guessed wrong. No one knew what Mao wanted. They now seem to be working towards the Chinese notion of entrepreneurship. Is it sustainable? Economic and legal progress must deliver social progress. Ultimately, there must be a focus on responsible economic policy combined with a sincere desire to develop a legal system governed by the rule of law to maintain stable long-term growth.

### **CONCLUSION**

Only through the lens of time will a true assessment of China's efforts to reform its economic and legal system be possible. Given China's history of closing off such inquiries, assessment has been difficult until recently. The creation of an independent and transparent legal system in China would likely have seemed impossible in 1978, however, it would also have appeared very unlikely at that time that China would become the world's third largest economy. Perhaps this will occur because of, rather than in spite of, the development of a sustainable "new" economy and a legitimate legal system. The resulting "transparency" of the legal system will spur economic growth and enhance both internal and external marketing opportunities in China.

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