

CHAPTER II

CHINA'S ECONOMIC SYSTEM

The economic system is a system that is used by a country to allocate its resources both natural resources and human resources. The economic system is the fundamental understanding to run the economic activities since all of the economic activity is done based on the system that is adopted. In the context of China, its economic system has experienced the changes from the centrally planned economy or socialist economy into market economic system. The centrally planned economy happened in the era of Mao while the market economy happened in the era of Deng. In the chapter II, the writer would like to explain more about the China's economic system in the pre-reform period and reform period. In addition, the writer also would like to explain the China's economy in Xi Jin-ping era as the current president of China.

A. The Origin of China Economic System

1. Pre-reform Period, 1949

China, officially People's Republic of China (PRC), is a new emerging power with a great economic growth nowadays. Its economy is inseparable from the

struggle of the leaders to have an enhancement. Mao Zedong was the leader of China since its establishment who believed in communism with the communist party as the dominant party at the time. Since its establishment in 1949, the China's economic system was a socialist economy or called as the centrally planned economy. It is an economic system in which the entire of economic activities are planned, controlled and implemented by the central government. There is no room for personal and private sectors to run the economic activity. The socialist economic system is different from the capitalist system which gives fully the economy to the market mechanism. In the socialist economic system, the market mechanism is under the control of central government. Therefore, the state becomes the absolute actor in regulating the economy activities within the country.

The China's centrally planned economic system was closely patterned on the Soviet kind of economic system. It happened because the realization of the socialist economic system in China was not run well until 1957 with the adoption of the Five Year Plan (Krueger, 2007). During that time, China practiced centrally planned economy under the direction of the State Planning Commission (Chow, 2011). The function of planning, according to Chow (2011), was to establish the state-owned enterprises that can create major production. At that time, the agriculture sector was collectivized and Mao was establishing the large state-owned industrial enterprises (Krueger, 2007). The output of the economic activity within the country was "controlled and directed by the state, which set the

production goals, controlled prices, and allocated resources throughout the economy" (Morrison, 2012, p. 2). In addition, the private ownership abolished and therefore the competition was non-existent. The foreign trade was limited meanwhile the foreign investment and foreign aid was not exist at all in China (Roy, 1998). The relations between China and Soviet Union itself began after the founding of the Republic in 1949. China was much dependent to the Soviet Union from 1950 to 1959 (Roy, 1998). It happened because China at that time was suffered from the international isolation and only relied on the Soviet Union. However, the relation between China and Soviet Union was going worse. Instead of building the socialist world economy, Soviet Union was joining the capitalist world economy. China thought that Soviet Union was the role model for China's centrally planned economy and the socialist system could not be alive without the Soviet Union. Seeing this condition, China decided to go on its own style of the economic development which called as "Maoist" (Krueger, 2007). The Maoist means that China will run the economic development based on the China's style through the self-reliance (Roy, 1998). The self-reliance policy became the important principle of the Communist Party at that time. It indicates that China did not depend on other countries but not completely isolated from the world outside. Through the self-reliance, China can develop the existing resources within the country without relying on other industrial countries. The strategy in this stage was to build China's economy by exploiting the internal resources, particularly the effort and willingness of the Chinese people to work (Roy, 1998).

The self-reliance policy led to the emergence of the Great Leap Forward in 1958. The Great Leap Forward was Mao's effort to modernize China's economy so that it would be able to rival the United States' economy (Allen & Qian, 2014). This Great Leap Forward plan was written in the second Five Year Plan that launched for 1958-1963. The plan was basically to develop the agriculture and the industry. The China's Communist Party believed that industry was the effective way to speed up the modernization process in China. While the development requires much capital, China's economy was so poor at that time. The economy of China, from long time ago, was based primarily on agriculture and thus the agriculture sector was being collectivized. It became a means to support the development in China, particularly the economic modernization. Therefore, China's government created so called as commune. Commune was the type of large rural organization controlled by the government (O'Leary & Watson, 1982). People in commune gave up the ownership of the tools so that commune can own it. The communes were strictly controlled the life of the people in which the farmers were prohibited for engaging in nonfarm activities. People were forced to work hard in order to achieve the target. However, things were going wrong. The Great Leap Forward which was expected to be the way to modernize China's economy, became a boomerang for China itself. Instead modernizing the China's economy, the Great Leap Forward became a toxic that damaged its people. It was not only failed to raise the gross domestic product but also had such disruptive effects on the agricultural sector. The desire of Mao who wanted to modernize the

economy through the Great Leap Forward program led to the crisis in China. People were suffering from the starvation due to the scarcity of food. The scarcity of food was due to the crop failure in agricultural sector (Ramzy, 2016). Ramzy (20106) then adds that there were more than 45 million dead because of the starvation. This crisis triggered the decrease of the Chinese living standards. In the end, the Great Leap Forward turned to be the Great Leap Famine in 1959-1961 (Zhu, 2012). The failure of the Great Leap Forward made Mao resign from the position as the China's leader. It was left to three moderates which were Liu Shaoqi, Zhou Enlai and Deng Xiaoping (Ramzy, 2016).

The failure of the Great Leap Forward has not only given the impact towards the economic field but also towards the China's politics. Mao perceived that the current China's Communist party perceived has moved into more revisionists through emphasizing the expertise instead ignore the purity of its ideology (History, 2009). Therefore, in 1966, Mao launched what so called as Cultural Revolution in order to return his power in central government, this done through gathering the youth against the party hierarchy (Asia News, 2006). In this event, it emerged what became known as Gang of Four that consisted of radical political leaders including Mao's wife. This revolution was known as the greatest revolution that lasted for a decade. The end of the Cultural Revolution was considered to be Mao's dead in 1976.

In summary, the socialist economy or the centrally planned economy of China in the era of Chairman Mao led to the stagnant and inefficient economy. Mao's

attempts to modernize China's economy by putting more emphasize on the agriculture sector and the industry was failed and inefficient. The attempt to make the regional self-reliance in productivity farmers turned to be the inefficient way. It created the misallocation of resource that failed to increase gross domestic product, creating the great famine, declining the productivity, creating the crisis and failed to increase the living standard of China's people. The annual growth of China's economy was only reached 6 percent a year (Hu & Khan, 1997). In the end, China fell behind the developed countries.

2. Reform Period, 1978

The end of the Cultural Revolution became the beginning of the reform period to Deng Xiaoping in 1978 (Wong, 2017). Deng Xiaoping emerged as the leader to rule China and known as the father of the reformation. Deng was expected to be able to create better economic modernization and increase the standard of living in China after the great famine. Therefore, Deng launched the economic reform from socialist economy system into more market economy. Deng believed that the market economy became an effective way to modernize China's economy. Socialist market economy is the economy system in combining the socialist system and the market economy. It is characterized by the state-owned enterprises that go along with the private sectors as the economic wheel to modernize the economy. In terms of modernizing China's economy, the first two leaders which were Mao and Deng had different point of view even though both of them came

from the same party which is Communist Party. While Mao was much upholding the purity of socialism in each aspect to every strata of society, Deng reversed even tougher the achievement of Mao had done and called it as socialism.

China, in the era of Deng, launched policies that were different from the previous leader. Deng proposed the policy of *Gaige Kaifang* or called as reform and opening (Zhu, 2012). The reform policy was conducted in four phases which were agriculture, industrial, technology and military (Liu & Yoon, 2000). Implementing the economy reform through agriculture sector was the important aspect to be done firstly to generate surplus to support the modernization process. The economic reform started with the rural reform in 1978, which “raised the long-depressed state procurement prices for agricultural products, provided the land lease to individual farmers, and abolished eventually the mandatory state production plans in agriculture” (Liu & Yoon, 2000, pp. 25-26). In addition, the government increased prices for agricultural goods and shift the collective farming system into household-responsibility system (Zhu, 2012). The farmers were given the opportunity to sell the agricultural products to the government with the prices that had been determined by the government, in addition, they can also sell to the market with their own prices. In other word, there were two ways in selling the agricultural products which are to the government with the determined prices and to the market with the prices determined by the farmers. The main strategy in succeeding the agricultural reform was the incentives policy and private ownership right. The incentives policy in the agricultural sector aims

to improve the competitiveness among farmers so that the farmers are willing to work hard. The reform in the agricultural sector was successfully implemented and thus, as a result, the productivity gain in agricultural sector increased 5.62 percent per year (Zhu, 2012). Besides, Deng was also implementing the strategy of Township and Village Enterprises (TVEs) which aims to reinstate the private ownership. The Township and Village Enterprises was the strategy in which “the farmers are allowed to lease the land from the collective and allowed to keep any residual earnings they possessed after payments” (Krueger, 2007, p. 217). This means that the farmers who running the enterprises were given the responsibility for the profit and losses of their own enterprises. This strategy was effective to motivate the farmers to work hard since it generated the profit for the farmer itself. Seeing the good improvement on the competitiveness of the farmer, Deng gradually reduced the quota for the farmer to sell the products to the government. The farmer can sell the agricultural products in the market based on their own prices instead. This decision to reduce the quotas led to the increase of the non-state actors in China.

Besides the reform on the agricultural sector, Deng also implemented the *open door* policy in 1979 (Wei, 1995). This means that the China would open its trading and join the international trade. Thus the existence of China would be considered by the country outside. The opening policy aimed to decentralize the economy in China that firstly started in the countryside and then moved to the cities (Vogel, 2011). The open door foreign economic policy portrays the basic

changes in the strategy of China's development in which there are two basic approaches which are: extensive development and intensive development. According to Roy (1998), the extensive development is increasing the production or inputs aspects such as allocating the capital and workforce to the desired products, built more factories, worker work longer hours, etc. Meanwhile, the intensive development is boosting the productivity through increasing the efficiency. In the context of China, China in the beginning was use the extensive development through capital accumulation from the Soviet aid and low consumption policy during self-reliance. After that, China moved towards the strategy of the intensives development which need much supplies for advanced technology and management methods. China has experience variety of ways to modernize its economy.

During the open door policy, the China's government has taken the main effort such as decentralizing the decision making regarding the export and import into the regional foreign trade corporation and the local government, imposing the tariff, quotas and licensee, and loosening the control on foreign exchange particularly for the foreign-invested managed firms (Wei, 1995). As a result of the China's *open door* policy, China, that initially ranked in the thirty-second of the world export in 1978, became the world's thirteenth largest export in 1989 (Wei, 1995, p. 74). Wei (1995) adds that during that period, the average of the annual rate of trade expansion was above 15 percent. These numbers were quite big number in China economic considering that trade and investment in pre-reform

period had almost non-exist. The trade in the pre-reform period was highlighted by monopolization by the central government, the domestic prices were not influenced by the world outside, and foreign exchange was strictly controlled by state. In the era of Deng, such condition was gradually decreased. The process of modernizing China's economy became more complex with the implementation of Special Economic Zone as the measurement of the open door policy. The special economic zone consisted of cities which are Shenzhen, Zhuhai, and Xiamen (Roy, 1998). Year-by-year, the list of city that joined the special economic zones was added. Through the inception of the special economic zone, the law of the economy activity differ each region which aim to make it more business-friendly to the investors. Under this new system, "the special tax concessions and less restrictive regulations on foreign exchange and land use are adopted in order to attract foreign investment" (Wei, 1995, p. 84). The emergence of the special economic zones was the way of China to attract the foreign direct investment and export. Through the foreign direct investment, China can absorb the technology and knowledge from developed countries. The China's government believed that in order to speed up the economy growth, it needed to be supported by the foreign direct investment. It would help to boost the industrialization in China.

The open door policy in Deng era was welcomed by the countries outside such as United States. The China's government began to have the bilateral relations with the United States. In order to get the access towards the United States economic, the China's government has improved its relation with United

States. China's efforts were paid off. The United States proposed the Open Door Notes as a follow up to the China's open door policy. In the Open Door Notes, the United States, represented by John Hay as a secretary of state, proposed "free and open market and equal trading opportunity for merchants of all nationalities operating in China, based in part on the most favored nation clauses already established in the Treaties of Wangxia and Tianjin" (United States Department of State, 2013). The opening of relations with United States had become a good start for the China's economy. Besides United States, China also opened up the economic cooperation to improve its political relations with other countries such as the Soviet Union, Japan, and South Korea. Therefore, this practice is termed as the economic diplomacy (Wei, 1995). Besides creating the special economic zone, the next step to liberalize its economy was through integrating themselves into the international regime which is called World Trade Organization. China started officially join the World Trade Organization in 2001. The entry of China into the World Trade Organization encouraged China to open its economy with all the rules of global trade.

In summary, the China's economy in Deng's era experienced better improvement than the pre-reform period. The reason behind the better improvement on the economy was the productivity gain which increased due to the increased of the non-state actors. "In the early 1990s, productivity's share of output growth exceeded 50 percent" (Hu & Khan, 1997). Through the economic

reform, the China's economy began to recover and had successfully been critical in creating this productivity boom.

B. China Economic Development in Xi Jin-ping Era

The China's economic reform that happened in the 1970s century was known as the driving force of the China's economic development in the twenty-first century. In the twenty-first century, Xi Jin-ping emerged as one of the successors of the economic reform of China. Since March 14, 2013, Xi was elected to be the president who would serve for five years term of office (VOA, 2012). China in Xi era was not much different from the previous period of President. This was because Xi still continue the good partnership with the state-partner countries so that there would be no significant changes in the political and economic system. After being elected as the General Secretary of Chinese Communist Party, Xi launched what so called as “the Chinese dream (*Zhongguo Meng*) which meant that in the name of people’s welfare and the power of the state, party and nation, the economic reform remains to be developed” (Dahana, 2015). Xi found that the Chinese Dream will not be achieved without fixing the problem that exists in the body of government. Unlike the previous leaders, Xi acted more concretely towards the economic reforms.

The market economic system that was launched in the era of Deng was used as the guidance for Xi to make it more mature and modern. At the Industry Leader Summit and APEC Trade, Xi asserted that China would maintain the

policy of reform and openness that had been carried before (CRI, 2013). The China's economy, in Xi's era, will "enhance the economy reform system, encourage administrative system reform, establish systems engineering and innovation, enhance security system and public service system, and improve the preservation of the ecological environment. In other hand, Xi also said that China would actively implement the strategy of transparency, promote balanced development of foreign trade, and increase the level of cooperation in the investment" (CRI, 2013).

In the new era of economic modernization, the China's government began to focus more on the environment as it becomes the huge deal for the rise of China's economy. The sustainable development becomes reason for China to consider the environment. Instead of raising the China's economy unlimitedly, China government decided to generate the sustainable development. The key point on sustainable economic development is "the collaboration of its populations, economy, society, environment, and resources" (Itoh, 1997). In the twenty-first century, China has expanded concentrations of reform towards a green economy. Basically, China has prioritized the green economy since the 11th Five Year Plan in its economy sector such as energy, transportation and forestry (Pan, Ma, & Zhang, 2011). Through the green economy, China can expand the employment in industries and that can help reduce the environment impact.

Besides, Xi also maintains its relations with the other countries so it will help China to be considered in international world. To promote China's relations with other countries, China will maintain the economy diplomacy as a means of the relationship. China will eliminate trade barriers to foreign investment and improve the protection towards the intellectual property (Portland Press Herald, 2015). It aims to gain the credibility from the foreign investors so that the investors will comfortable to invest in China. As a follow up of the efforts to promote openness policy, the China's state council announce the Notice on Several Measures on Increasing of Openness to Foreign Investment and Active Use of Foreign Investment (Guo Fa [2017] No. 5)" (Ross & Zhao, 2017). The Notice is intended to expand China's openness towards the foreign investment that comes to China. The effort to promote the foreign investment is because the foreign investment is one of the factors that drive the economic development, thus, China's government believe that the more investors coming to China, the faster China's economic development will be. The China's great economic growth is always followed by the need to increase its military power. Economic and military powers are the fundamental power in political world. Therefore, these two aspects will always be related to each other. The increase on two aspects triggered China to play more in the international relations through expanding its influence towards other countries, such as Asian countries as its neighbors, Africa, United States, Europe, and Middle East and others (CRI,

2014). Thus, “the Chinese economic growth got translated into greater military spending even military modernization” (Jash, 2015).

In summary, the China’s economy in Xi era, did not change drastically but he would continue the economic reforms that have been implemented before. The difference is that he is more conservative in economic terms in China. Xi makes it more modern and mature. Xi aggressively promotes foreign investment so that foreign investment is easy to enter China. This is realized by launching the Notice on Several Measures on Increasing of Openness to Foreign Investment and Active Use of Foreign Investment.