

China's Dilemma Amid Economic Modernization: Retreats from Economic Modernization and Political Liberalization in the late 1990s?

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Abstract:

For over two decades following the Third Plenum of 1978, China has been at the forefront of implementing a series of economic and political reforms to boost economic growth. However, the trajectory of China's economic growth encountered unprecedented challenges from both domestic and exogenous variables. The acceleration of state-owned enterprise (SOE) reform, which began shortly after the Third Plenum and intensified as a central component of Prime Minister Zhu Rongji's reform package following the 15th Chinese Communist Party (CCP) Congress in September 1997, led to unprecedented layoffs among SOE workers. This, in turn, triggered social unrest and posed significant threats to the stability and legitimacy of CCP's leadership. On the external front, the post-Cold War unipolar international order and the Asian Financial Crisis of 1997 created a shifting landscape of foreign trade and more urgent national security concerns. This article examines two main questions: 1) How did the Chinese government respond to these unexpected challenges during the peak of the "opening-up and reform" period? 2) Did China's approach to dealing with internal and external crises slow down or cause a retreat from its economic modernization and political liberalization efforts? This article argues that these challenges compelled the Chinese government to modify its economic reform measures and political control over dissidents and protestors by resorting to trade protectionism and a shift of polity toward "soft authoritarianism" to navigate and mitigate both internal and external turmoil.

Keywords: China, State-Owned Enterprise reforms, The 1997 Asian Financial Crisis, Trade Protectionism, Political Liberalization

1. China at the Dawn of the Late 1990s

Within the field of international political economy studies, there is a solid argument that market economies consistently and aggregately outperform command economies, with trade liberalization being a critical part of a successful market economy (Greenaway et al., 2002). Unfortunately, China's path toward trade liberalization began from a position as one of the most closed economies in the world, and foreign economic policy was nearly autarkic. When Deng Xiaoping initiated the reform policy in 1978, China's trade volume was minimal, and its per capita GDP was approximately \$200, placing it among the poorest countries in Asia and around the tenth percentile globally (World Bank). The country was heavily entrenched in Mao's "self-reliance" (*zili gengsheng*) command economy, where major industries and commerce were state-owned and limited foreign trade was monopolized by the state.

Given China's vast size, the Communist leadership lacked a clear economic growth model to emulate and could not follow any specific theory of transition economics. Therefore, the guiding principle of the "reform and opening-up" policy became "crossing the river by feeling the stones under one's feet" (Wu, 1997). The revolutionary changes began with the Third Plenum of the Eleventh Central Committee of the Chinese Communist Party, where Deng Xiaoping consolidated his power and initiated the policies of "reform" and "opening." They encompassed a dual goal: implementing market-oriented economic reforms domestically and fostering broader engagement with the outside world.

Notably, Deng's economic pragmatism marked a stark departure from Maoist economic policy, epitomized by saying "It doesn't matter whether the cat is black or white; if it catches mice, it's a good cat." In line with this pragmatism, in the early decades of the reform, the government began to tolerate small-scale private entrepreneurs and grant greater autonomy to enterprises (DeLisle and Goldstein, 2019). Meanwhile, the protectionist policies of Mao's era allowed inefficient SOEs to dominate the market, absorbing funds while depriving the efficient private sector of resources for growth. Although SOEs accounted for around 77.6% of industrial output in 1978 and provided the bulk of employment – commonly referred to as the "iron rice bowl" (*tiefanwan*) – many of them were unprofitable and struggled to remain competitive in the market (Wu, 1997). This challenge became more pronounced with the influx of foreign direct investment (FDI) and foreign products, as China sought to revive its membership in the General Agreement on Tariffs and Trade (GATT) and join the World Trade Organization (WTO). More than

focusing on exposing SOEs to competition and introducing incentive schemes for workers and management in the 1980s, Deng's 1992 "Southern Tour" accelerated the pace of SOE reforms. This shift involved the corporatization of SOEs and the creation of shareholding companies, as earlier measures had failed to significantly improve SOE profitability.

Both employment and profitability in the non-state sector increased dramatically from 1989 to 1998 (Fewsmith, 2001). However, the optimism surrounding the growth of the non-state economy was overshadowed by the changing economic and social context by 1998. As the number of bankrupt SOEs rose and mass layoffs intensified, widespread protests and demonstrations compelled the Communist Party's leadership to adjust its reform measures, seeking a balance between addressing SOE issues and shaping its trade policy (Takeuchi, 2013). Moreover, in 1998 and 1999, the Asian Financial Crisis, which tarnished the East Asian model of economic development, reignited debates about how open China's economy should be and the pace at which it should expose its market to foreign competition (Goldstein, 1999; So, 1999). As a result, in the late 1990s, China developed a unique pattern of trade protectionism prior to its entry into the WTO, despite its leaders repeatedly acknowledging that trade barriers severely hindered the rationalization of production and trade.

On the political front, in contrast to China's impressive economic growth, political reforms were largely put on hold and lacked the same incentives as economic reforms. Social unrest, fueled by frustrations over uneven economic development and disparities in opportunities, posed urgent challenges to the regime's legitimacy. Understanding China's struggle to balance economic and political liberalization is crucial in grasping its efforts to maintain stability as a paramount goal for an authoritarian regime. CCP's leadership feared that massive unemployment resulting from SOE reforms would lead to the erosion of the social safety net and trigger social instability; and President Jiang Zemin remarked in 1998 that the SOE issue was "not only a major economic issue but also a political one" (Takeuchi, 2013). Meanwhile, the CCP's leadership responded to the ongoing Asian Financial Crisis by slowing down economic reforms to mitigate the political risks of a short-term contraction (So, 1999). Since 1998, the Chinese government has adopted a new political approach, "soft authoritarianism," to address labor unrest and manage political activists, aiming to maintain stability while balancing reform efforts.

2. Literature Review

The creation of trade barriers would undeniably appear paradoxical for an economy transitioning toward a free market system, which was seemingly a significant turnaround. As shown in Figure 1, although imports and exports increased overall within the decade, China's trade liberalization presented that exports increased much faster than imports, with particularly imports plateauing between 1995 and 1998. What might account for the stagnation of imports in the late 1990s and how do the implications of SOE reforms and the Asian Financial Crisis relate to this stagnation and variations of trade protectionism behind that? In what ways did these events contribute to the slowdown or retreat of China's political and economic reforms?

Takeuchi (2013) examined the political economy of China's trade protectionism in the 1990s, testing both economic and political hypotheses. His work explored whether the Stolper-Samuelson theorem on factor endowments and the water-cooler theory on the geographic concentration of industries receiving protection could explain China's protectionist measures during this period.¹

¹ The Stolper-Samuelson theorem, derived from the Hecksher-Ohlin model, posits that the owners of scarcely endowed productive factors should prefer protectionism and owners of abundant factors will benefit from free trade. The water-cooler theory suggests that physical proximity among group members increases the likelihood of collective action. Takeuchi (2013) applies this concept to examine the relationship between trade barriers and the geographic concentration of industries.

Through statistical models, he concluded that the primary incentives driving the Chinese government's trade protectionism were political, involving factors of the SOE reform and the potential for workers' protests. Regarding China's trade policy in the late 1990s, So (1999) investigated the effects of the Asian Financial Crisis of 1997 and the escalating issues related to SOE reform on its domestic economic and political conditions. He argued that the Asian crisis prompted the CCP's leadership to adjust its reform strategies by slowing down SOE reforms and increasing bank lending to the state sector to mitigate political risks. Similarly, Zweig (2001), who extensively studied Zhu Rongji's reform package from 1998 to 2001, noted that the fifth wave of reforms was stalled due to the plight of unemployed workers and the financial burdens on SOEs.

Political reforms waxed and waned in response to shifting domestic and international landscapes. Over the first two decades following the Third Plenum, Shambaugh (2016) observed that China's political trajectory displayed a distinct oscillating pattern of opening and tightening, and from 1998 to 2008, China entered a phase of "soft authoritarianism." So (1999) also emphasized that in 1998, at the height of the Asian Financial Crisis, the Chinese leadership adopted "soft authoritarianism" as a strategy to address social issues and preserve political stability.

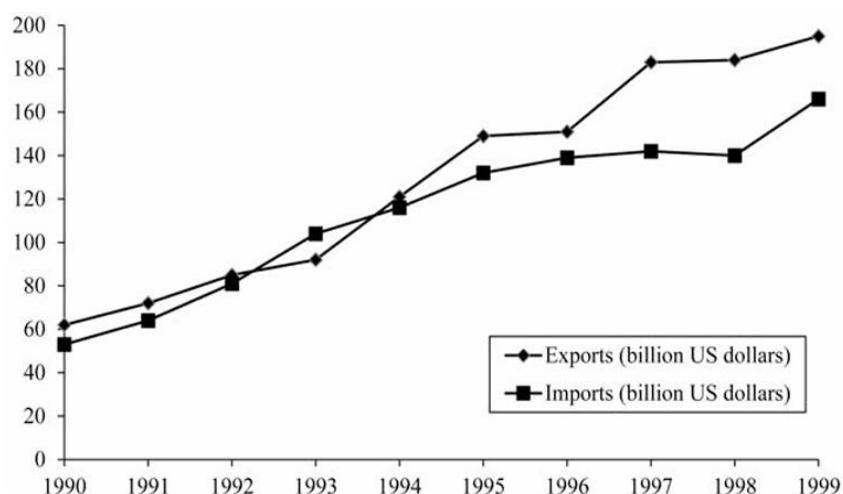


Figure 1 China's exports and imports during the 1990s. *Source:* <http://irps.ucsd.edu/faculty/faculty-publications/chinese-economy/chapter-by-chapter-data--supplementary-materials/chapter-16.htm> (4 April 2011).

Figure 1

3. Implications of the SOE Reform and the Asian Financial Crisis

Since the Third Plenum, SOE reform has been a central element of China's economic transformation, a process characterized by a reduction in the scope of the SOE sector in the economy. The absence of market-based incentives and limited autonomy resulted in low efficiency and poor output in SOEs during the Mao era. The transformation of SOEs focused on granting them greater autonomy and exposing them to market competition. Facing increased product market pressures and reduced access to government bank funding, SOEs were pushed toward significant restructuring and downsizing (Naughton, 2007). Meanwhile, the government gradually promoted the development of nonstate enterprises and ownership transformation (*gaizhi*), fostering private sector growth.

It was true the Chinese government did not adopt the

rapid and widespread privatization of SOEs seen in former socialist countries in Europe (Naughton, 2007). Unfortunately, after the mid-1980s, with increasing market competition, SOEs experienced worsening financial performance, and a growing number of SOEs bankrupted or experienced *gaizhi* (Song, 2018). Figure 2 illustrates the declining share of SOEs in China's total gross industrial output, and more critically, highlights dramatically declined unemployment, reflecting the widespread layoffs of SOE workers during the 1990s. As retirement pensions and unemployment insurance for employees were very weak, more than the disruptive and violent natures of worker protests, unemployed workers illegally established organizations for their movements (Wu, 1997). Reminiscent of the Tiananmen student movement in 1989, the Chinese government viewed these organized protests by unemployed workers as a significant threat to its legitimacy.

Share of SOEs in Industrial Production and Employment

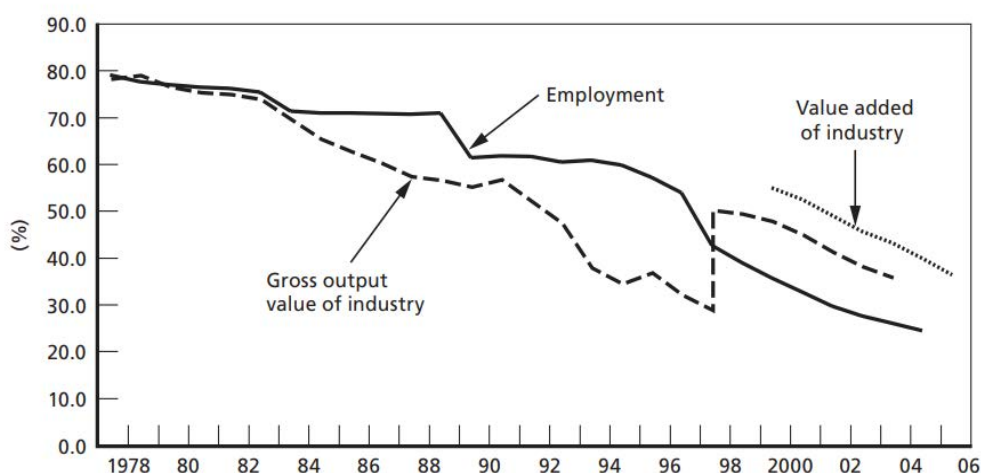


Figure 2

SOURCE: Banking system reform in China, Okazaki, K., 2007, p. 8.

Notes: 1. "Gross output value of industry" and "Value added industry" is the percentage of state-owned and state-holding industrial enterprises to all industrial enterprises.

2. The data for "Gross output value of industry" was broken in 1998, when the data source was changed from "all industrial enterprises" to "all enterprises with an annual sales income over RMB 5 million."

3. "Employment" is the percentage of employees of state-owned entities in an urban area.

At the outbreak of the Asian Financial Crisis in 1997, China was on a path of rapid economic growth and liberalization, with expectations that this explosive expansion

would continue for many years. The crisis spread from Thailand to South Korea, Hong Kong, Indonesia, and other East Asian economies, triggering a sharp depreciation in currencies, plummeting real estate prices, failing banks, widespread layoffs, and civil unrest. One critical impact of the crisis was the sharp decline in exports, which dropped from 60 percent in 1997 to 40 percent in 1998. The Chinese had counted on export growth to create new jobs and absorb redundancies from the SOE reform, but with the steep fall in exports, job creation became increasingly questionable (So, 1999). Additionally, since foreign direct investment (FDI) from neighboring countries like Japan, Indonesia, Hong Kong, and Taiwan had constituted a significant portion of FDI in China's economy during its reform period, the crisis severely disrupted these traditional

sources of FDI. More importantly, as the financial crisis was compounded by investments from Western multinational corporations, the Chinese government became increasingly cautious with FDI and trade relations with Western countries. The following sections will explore how the Chinese government responded to both domestic and external crises and to what extent these responses contributed to the slowdown of economic and political liberalization in China.

4. The Slowdown of Reforms

The basis for analyzing China's responses to both crises lie in the fact that its economic growth rate was visibly slowing down, as illustrated in Figure 3, during the second half of the 1990s. This article does not aim to explore the detailed macroeconomic reasons behind the slowdown in gross domestic product (GDP) growth, although this was a critical consequence of the two crises discussed. Instead, it focuses on explaining why and how the Chinese government responded to these challenges by slowing economic and political liberalization. Specifically, the government adopted a pattern of trade protectionism leading up to China's accession to the WTO in 2001 and shifted toward "soft authoritarianism."

China's increasingly protective trade policies in the late 1990s relied on two primary means: 1) the use of non-tariff barriers (NTBs) to protect key non-heavy industries, particularly those concentrated in geographic regions like the Northeast, and 2) reducing trade reliance on Western countries following the Asian Financial Crisis, especially the United States, while selectively lifting protective barriers in service sectors. Takeuchi's statistical study revealed that, in the 1990s, the Chinese government implemented a significantly higher level of trade protection through NTBs compared to tariffs. The average tariff rate was just 2.6%, whereas the tariff equivalent of NTBs reached 12.5% (Takeuchi, 2013). NTBs encompass a variety of restrictive regulations or policies - such as quotas, import licenses, and technical standards - that governments use to control imports without directly imposing tariffs. NTBs are typically a preferred means for protecting domestic industries due to their transparency, offering governments a means to circumvent direct accountability and scrutiny, particularly in democracies. This "optimal obfuscation" allows policymakers to covertly protect domestic markets while upholding a "veneer of liberalization" (Kono, 2006). Despite being an authoritarian regime, the Chinese government had clear incentives to protect industries through less transparent mechanisms when China was seeking to integrate into the global economy and negotiate its membership in WTO.

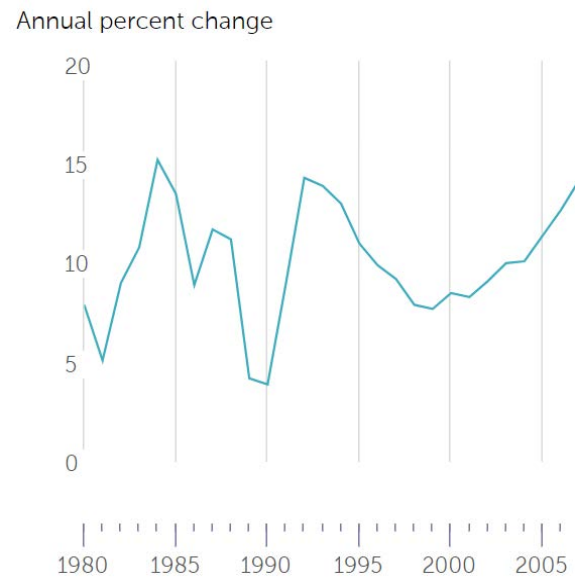


Figure 3

Source: International Monetary Fund, https://www.imf.org/external/datamapper/NGDP_RPCH@WEO/CHN?zoom=CHN&highlight=CHN

At the fifteenth CCP Congress in September 1997, the Chinese leaders adopted the policy of "holding onto big and let go of the small" SOEs, which underlined state control over critical sectors, particularly public utilities and heavy industries. During Mao's era, heavy industries in China wielded considerable political clout, being closely tied to vested interest groups within the CCP leadership; therefore, it afforded them greater trade protection and preferential treatment compared to other sectors (Shirk, 1985). However, the pattern of China's trade protectionism in the 1990s suggests that the NTBs of heavy industries were 5.4 percentage points lower than those of non-heavy industries in the 1990s (Takeuchi, 2013). One of the key reasons for this protection was that heavy industries such as electric machinery, metal products, and transportation equipment in China were competitive and export-oriented in international markets. Although the majority of worker protests were not directly aimed at China's trade policies or liberalization efforts, industries geographically concentrated in certain regions like the Northeast - where laid-off workers could more easily mobilize and engage in collective actions - tended to receive more protectionist relief to quell unrest. Despite the intensification of SOE reforms and trade liberalization efforts, large-scale industries with substantial state ownership continued to receive protection (Takeuchi, 2013). It underscored the Chinese government's commitment to addressing the dissatisfaction and social unrest of laid-off workers. Even though these workers did not directly criticize trade policies, the government responded by increasing trade barriers and

employing non-tariff barriers (NTBs) to protect non-heavy industries that were geographically concentrated and had significant state involvement.

Despite operating under an authoritarian one-party system, the Chinese leadership acknowledged the sustained stagnation of East Asian economies and the challenges faced by Newly Industrializing Economies (NIEs), including China, which could suffer similarly from the financial crisis. China's ability to avoid the worst-case scenarios was partly due to its "backward advantages" – specifically, its relative insulation from the international economy and currency exchanges owing to its lower dependence on foreign trade and the Western economies (Goldstein, 1999). A crucible posed by the financial crisis in 1997, the CCP leadership should be concerned about the extent to which China should engage with the West and integrate into the international trade system in an attempt to create buffer zones and mitigate the negative effects of the global economy in a timely manner.

During the period of "strategic partnerships" between the U.S. and China and ongoing WTO accession negotiations, the Chinese government unexpectedly increased trade barriers against the U.S. in 1998 and revived apprehensions about multilateralism, which was central to Bill Clinton's foreign policy. On the one hand, China acknowledged the benefits of multilateral institutions led by the U.S. and the drawbacks of economic and political isolationism. On the other hand, China's hostility stemmed from the perception that these multilateral institutions were driven by U.S. interests, which could exert unfavorable pressure on China (Goldstein, 1999). In response to the turmoil of the 1997 crisis, the Chinese government became more cautious regarding its economic relations with the U.S. In 1998, China raised barriers to U.S. imports, imposed currency control, and enacted price controls to counter deflation. They restricted foreign control in retail, insurance, and telecom sectors and increased value-added taxes for key exports to the U.S. (So, 1999). The unforeseen ramifications of the Asian Financial Crisis and SOE reforms influenced China's trade liberalization to an evident extent, effectively manifesting as a strategic deceleration of economic reforms.

5. The Phase to Soft Authoritarianism

The social unrest caused by SOE layoffs and heightened concerns over national security and social stability during the Asian Financial Crisis can be seen as efforts to under-

mine the CCP's legitimacy, which in turn compelled the government to adopt new policies. Known as the *fang-shou cycle* (放收周期), China's political orientation since the Third Plenum has lacked consistency, instead displaying a discernible oscillation between periods of political tightening and opening. According to Ian Bremmer's "J-Curve" concept depicted in Figure 4, the relationship between economic openness and state stability has evolved in a certain way. Bremmer argued that China was situated on the left side of the J-Curve from the 1980s through the 2000s (Bremmer, 2006). This indicated that during the two crises discussed in the article, China was in a phase where increased economic openness was likely to lead to heightened instability. The central question addressed in this section is how the Chinese government responded to the dilemma on the left side of the J-Curve, specifically the choice between pursuing economic reforms and maintaining state stability.

China arguably emerged from the shadows of the 1989 Tiananmen Movement during Deng's "Southern Tour" of 1992, pivoting its focus on economic growth rather than adhering to the post-Tiananmen hardline authoritarian agenda. However, within the one-party authoritarian system, the fear of internal overthrow was a crucial context for understanding the CCP leadership's political strategies (Shambaugh, 2016). This fear of internal opposition also played a central role in balancing economic reforms with state stability.

In the context of the late 1990s, while labor protestors focused mostly on economic demands without challenging CCP rule, political dissidents such as the China Democratic Party politicized the workers' grievances. The CCP responded firmly by cracking down on the Party, arresting its organizers, and sentencing its leaders to prison. This parallels the argument that while the CCP could make compromises on economic issues, protests that challenge the state's role are less amenable to such concessions (Huang, 2012). Even under consistent pressure from the United Nations Human Rights Commission and Western countries, China adopted a strategy of arresting and then releasing political activists. Unlike the post-Tiananmen era of "hard authoritarianism" between 1989 and 1992, the Chinese government adopted a "soft" stance toward political dissidents (So, 1999; Shambaugh, 2016). The level of free expression, including on political topics, was relatively higher in the history of the People's Republic of China, as long as the discourse did not directly challenge the CCP's legitimacy.

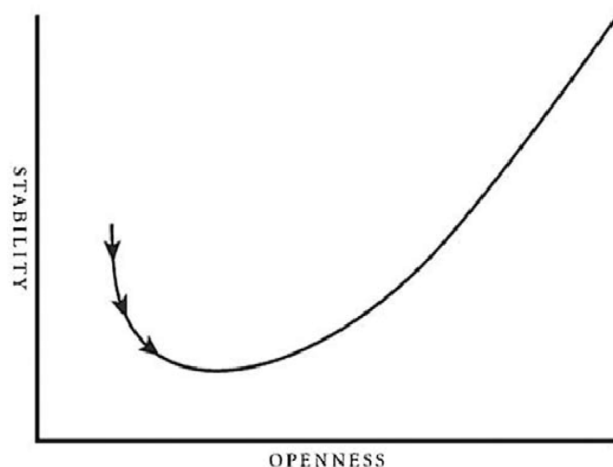


Figure 4

Source: https://www.researchgate.net/figure/Bremmers-J-Curve-2006_fig2_269760099

I argue that this shift to soft authoritarianism was not necessarily a retreat from political liberalization; rather, it highlighted two persistent dilemmas in post-Mao China. First, within the CCP leadership, there were two cohorts: reformers and hardliners. Reformers favored managing political openings from above and advancing economic modernization, while hardliners resisted political reforms due to their fear of being overthrown by internal and external opposition, akin to the fate of former socialist countries in Eastern Europe. Second, as shown in Figure 4, the dynamic balance between stability and openness disrupted and obscured reform measures following the Third Plenum. The government remained highly alert to the development of civil society and political dissent while simultaneously striving to grow the economy and integrate into the international system.

6. Conclusion

The 1990s are often viewed as the decade of the most rapid growth in economic and political openness, paving the path to milestones such as the granting of Permanent Normal Trade Relations (PNTR) with China, China's accession to the WTO, and the early 2000s. Even at the forefront of economic modernization, this article acknowledges several critical economic and political challenges posed by the SOE reforms and the 1997 Asian Financial Crisis, and it explores the ways in which China responded to these challenges. Given the issues of massive unemployment and unprofitable SOEs, China deliberately adjusted its trade policies to protect non-heavy industries that were not competitive in exports through non-tariff barriers (NTBs). Simultaneously, non-heavy industries in geographically concentrated regions, where workers could

collectively exert influence, received higher levels of protection. In sacrificing rapid economic growth, China not only altered its trade policy but also adjusted its measures for SOE reforms. As the Chinese government became more cautious about foreign investments, trade relations with the West, and the multilateralism championed by the Clinton administration, China raised trade barriers specifically targeting the U.S. Politically, the government adopted a soft authoritarianism approach, taking a more lenient stance on dissidents from civil society while remaining vigilant against any internal subversion. More importantly, China's responses to both internal and external crises reflected the long-standing and inherent challenge of authoritarianism: balancing economic reforms with political stability.

The article also raises two research questions that might be worthy of further research. The first question concerns China's negotiation and accession to the WTO. The article examines China's pattern of trade protectionism and rising trade barriers toward the U.S. in the late 1990s. However, in the first half of 1999, U.S. and Chinese representatives successfully negotiated a final deal on China's WTO accession, leading to China's successful entry into the WTO in 2001. In this sense, it is worthwhile to explore how China and the U.S. reached the final agreement, as well as why and how China altered its trade policy to meet the requirements of bilateral negotiations with other WTO members and to get WTO membership eventually. It will be intriguing to examine how this article's findings corroborate or contract the subsequent WTO-induced economic reforms. Second, although domestic politics within the CCP's leadership is not the focus of this article, the elite leadership under Jiang Zemin's administration, particularly Zhu Rongji, played a holistic role in addressing the crises discussed in the article. With profound changes in SOEs, the financial and banking systems, and China's accession to the WTO, Zhu Rongji's reform package in the late 1990s was considered crucial to China's economic and political reform trajectory. However, these reforms also sparked significant criticism and debate within the Party leadership. It is intriguing to analyze the polarization over public policy between reformers and hardliners, and how this divide manifested in Chinese politics in the future.

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