

## Challenges before China

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Even as the world still copes with Covid-19, many analysts have already declared that China has won World War III without firing a shot.<sup>1</sup> This is a gross exaggeration for various reasons, the most prominent being that while US-China relations may have indeed deteriorated over the past decade, we are unsure if even Cold War II has in fact commenced.<sup>2</sup> And it is too early to posit that China is in a similar position vis-à-vis the world that the USA was in August 1945 when World War II ended. It is also an equally mistaken notion that the Chinese economic miracle has ended with the plateauing of its growth, even though its economy shrank 6.8% in the first quarter of 2020. This contraction is the first economic shrinkage acknowledged in official statistics since 1976.<sup>3</sup> However, the Chinese economy is, to an extent, back on the rails and has already started working at 80% of its potential by mid-April.<sup>4</sup> This is a far quicker bounce back than what anybody could have predicted even in March. While the effects of Covid-19 on the global economy and geo-strategy would be more extensive than can be assessed at present, even without this global pandemic, China was facing some very serious challenges to its economic growth and the resultant political expansionist story that it was struggling to cope up with. These challenges have only grown since.

This essay takes a look at these challenges

faced by China while keeping in mind its historically unparalleled economic developments over the last four decades.<sup>5</sup> Though countries like Japan, South Korea and Taiwan had also witnessed an economic growth of 10%+ per annum for decades, the problem of economic endowment faced by these countries was relatively bearable, given the smaller sizes and lesser diversities of their populations. China, whose per capita income was less than India in the mid-1990s, is today almost five times richer with its GDP now second only to the US. The Chinese GDP in 2018 was USD 13.368 trillion while that of the USA was USD 21.427 trillion, in real exchange rate basis.<sup>6</sup> It has also come to be known as the world's factory, for China is not just the world's largest exporter but also the largest importer, which gives it a key position in the global supply chains. It, therefore, becomes necessary to recount some of these factors that drove China's growth, to analyse how they have served China well, and conclude with the challenges that China's development and changes in the external environment have thrown up.

### The Chinese Growth Story

The Chinese approach to economic growth is best captured in three statements of Deng Xiaoping. The most popularly known of these says that the colour of the cat does not matter as long as it catches the mouse. What the statement

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reflects is a pragmatic, non-ideological approach, quite antithetical to the stated creed of the Chinese Communist Party. This was later justified ideologically as ‘Socialism with Chinese characteristics’.<sup>7</sup> The second statement, in which Deng talks about crossing a river by feeling the stones,<sup>8</sup> is equally consequential as it states that China never did not enjoy the luxury of time to develop a master plan but had to plan as it went along. The third statement, about seeking truth from facts instead of dogmas,<sup>9</sup> is again one that must not be understated. These statements were not just slogans but had powerful resonance throughout the country—a fact which becomes clearer with the following narrative.

As an ambitious country, China is obsessed with GDP numbers, which results in all levels of the party and government hierarchy being conscious about achieving their targets. However, this obsession does lead to dodgy statistics e.g. if the central leadership announces that the GDP growth target for a particular year for the country as a whole is x%, every provincial secretary comes under pressure to deliver at least x%, technically pushing up the country’s GDP achievement to above x%. But the final aggregate figures more or less conform to the target laid down!

The point about statistics cannot be laboured beyond a point since even if GDP and other numbers may not be completely correct, other numbers like trade figures, foreign exchange reserves, consumption numbers etc. bear out the reality of the Chinese miracle. To come back to the importance of economic growth, this is the only metric by which party and government functionaries are judged. All speeches and public

statement by the party leadership, all publications, and even conversations, are dominated by this single theme.

It was in order to push up economic growth, release the potential of the people, and reduce poverty that market forces were allowed to make an appearance in an avowedly communist state that had abolished private property. Clearly, the colour of the cat, red or black, did not matter. This did lead to a degree of political opening, a natural consequence of increased participation of party cadres at different levels in public policy processes.

This is best reflected in the various experiments carried by cadres in different parts of China, involving new, localised, economic models like the household responsibility system that effectively did away with village communes, and the township and village enterprises, whose growth and success encouraged the hiving away of the best parts of state-owned enterprises and tying up with investors in Hong Kong and Taiwan, eventually laying the ground for major FDI flows.<sup>10</sup> China’s isolation post-Tiananmen, forced the Chinese leadership to allow the creation of Special Economic Zones, beginning with Shenzhen, that ultimately led China into becoming the factory of the world.<sup>11</sup> Deng’s famous southern tour to kick-start the economy and push the bitterness of the Tiananmen into the background was captured in his slogan ‘to get rich is glorious’.<sup>12</sup>

For the same reasons, China was quick to adopt policy advice from the World Bank, IMF and other international institutions. It also kept inviting foreign scholars from Milton Friedman (on the right) to Joseph Stiglitz (on the left) and exposed Chinese decision-makers and academia to them,

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the idea behind such steps being that such interaction would encourage experimentation. Professor Daokui Li of Tsinghua University calls it the ‘just do it’ attitude to reform for he explains that the party leaders were encouraged to go ahead and experiment, rather than getting bogged down in debate. This attitude is also reflected in the Chinese saying, ‘let experience teach you, not arguments’.

However, the Chinese story is only partially understood by observers who conclude that China abandoned socialism in order to grow. The reality is that China abandoned only the economic aspects of socialism, retaining the political monopoly of the Communist Party of China (CPC), a monopoly which includes controlling the most successful private enterprises. The CPC never abandoned the essential Marxist-Leninist core of politics being in control, and of a form of democratic centralism.<sup>13</sup> The latter allowed local party cadres and later individual entrepreneurs to experiment and adopt a capitalist approach to the economy, allowing market forces reasonable freedom, but always within the ambit of the overall CPC umbrella, whose monopoly of power could not be questioned.

China’s ability to experiment would have been limited if not for the decision of the Chinese authorities to send its students to foreign countries for studies. China made clear its determination to learn from anywhere, be it the US, Europe, Japan or South Korea. It helped that many senior communist party leaders like Zhou Enlai and Deng Xiaoping studied abroad. In fact, from the early days of Chinese modernisations, leaders like Sun Yat Sen, Liang Qichao etc. had studied and worked abroad.<sup>14</sup> This openness to the outside world, even

at the risk of losing their best students who might not return, helped China emerge as a science and technology superpower, in addition to brick and mortar infrastructure and manufacturing for which they are well known. In fact, currently, the US and other western powers accuse China of theft of intellectual property since many Chinese nationals have worked with cutting edge companies and institutions, taking their knowledge and actual designs back to China. It is estimated that at any time, over half a million Chinese students are studying outside China.<sup>15</sup> Spread over a quarter of a century, the number of Chinese exposed to advanced educational institutions and economies becomes enormous.

China’s approach to foreign capital has also been very pragmatic. In the first few decades of its economic reforms, China was capital scarce and needed considerable foreign direct investment to initiate and sustain high rates of growth. Initially, the transfer of advanced equipment and machinery was often a proxy for actual capital inflows.<sup>16</sup> Subsequently, foreign direct investment (FDI) from Japan, Taiwan and Hong Kong came in a large way, mainly because these economies were moving up the value chain and shedding more capital-intensive and low-technology manufacturing to China.

There were two primary factors which made FDI acceptable to the Chinese leadership: one, the knowledge that though the owners of the capital may be foreigners, the assets were physically located in China, and two, the realisation that much as China needed FDI, the owners of the capital were often mesmerised by the prospect of selling in the Chinese markets. General Motors (GM)

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continued to lose money in China for over two decades but hung on. And just when it started making money, it realised that its prize design, the Chevy Spark, had been copied by a Chinese company openly, which sold it as QiQi. Yet, GM did not take the matter to court as it wanted to stay on in China and had been in receipt of a ‘secret’ bailout from the Chinese government.<sup>17</sup> Such policies and attitude gave the Chinese leadership the confidence to dictate terms to foreign investors. Recently, in the context of theft of intellectual property, it has come to light that China forces foreign investors to share their technologies either directly or by taking on a local partner.<sup>18</sup>

### **Challenges before China**

Even before the Covid-19 pandemic, China had been facing considerable economic, political, social and strategic challenges. The pandemic has only exacerbated them, both domestically and externally, and with so much of the China Story dependent on the external factors, any deterioration in the latter would have a considerable impact domestically. De-coupling is not an easy option in the best of circumstances, and when foreign trade is such an important driver of economic growth, then the room for the Chinese, or the US, government to manoeuvre, becomes quite limited.<sup>19</sup>

China has been conscious of the need to find other drivers of economic growth. For example, the Chinese economy is investment-driven, a luxury that it can afford because the domestic saving rate is around 45% of GDP, which was earlier in excess of 50%.<sup>20</sup> By contrast, the savings rate in India is less than 25% of GDP. Further, the Chinese authorities had adopted, quite early on, financial

repression as a matter of policy in order to make available funds for investment at low costs. Hence, Chinese savers face negative interest rates on their deposits in order for China to ensure that investment as a percentage of GDP remains around 45%.<sup>21</sup> This has enabled China to build up a massive stock of infrastructure and manufacturing facilities. However, now with the plateauing of exports due to headwinds in the global economy over the medium term, with China moving up the value chain into higher-end manufacturing & services, and the glut of economically unviable infrastructure projects, the extant Chinese model is running out of steam. The effect of these factors, including the much larger size of the Chinese economy, is that exports as a share of GDP have been continuously falling from 32.6% of the GDP in 2008 to 19.5% in 2018.<sup>22</sup>

China, however, is attempting to break out of this, by moving aggressively into the technologies of the future, e.g. 5G, AI, nanotechnology etc, where it has emerged as a world leader. This is paying off to an extent and China is no more seen as only a provider of consumer goods, or even of standard capital goods like power generation equipment, earthmovers, cranes etc. But while China has developed its human capacity to emerge as one of the leading nations in what is called fourth industrial revolution, its progress is limited to what the world can absorb and its own ability to generate intellectual property. Clearly, these new generation industries would not be able to absorb the millions of workers who are being released as low wage manufacturing shifts to countries like Vietnam and Bangladesh.

The other policy initiative that China has

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adopted in order to ensure that the external sector remains an important engine of economic growth is the Belt & Road Initiative (BRI).<sup>23</sup> BRI provides China a way out of its surplus capacities in manufacturing, which is plagued with industrial obsolescence, and in creating infrastructure. With BRI, it can ‘export’ entire factories and power plants, create massive projects for its infrastructure economies and find markets for its standard capital goods. The funding of BRI projects is interesting in that it entails little costs to China’s own finances, with recourse to long and guaranteed return on Chinese equity, a win-win situation for China strategically and economically.

However, both moves, into cutting-edge technologies and into BRI, would need a benign external environment. The world economy must see robust growth and China must be trusted. Unfortunately, both these imperatives are under pressure. The world economy, particularly of most of the developed world, has not fully recovered from the crisis of 2008-09, and private sector growth, the most important driver of the economy, is unable to sustain itself without substantial public sector push even after a decade of the crisis. This phenomenon, which economists have called secular stagnation, shows no sign of ending soon.<sup>24</sup> Business as usual, in these circumstances, will only yield diminishing returns.

China has been trying to deal with this issue in another manner by trying to shift its focus away from exports to domestic consumption; the latter drives growth in the US, most of the developed world and even India. The latest value of consumption as a percentage of GDP for China, from 2018 is 38.68 percent. For comparison, the

world average in 2018 based on 152 countries is 63.64 percent’.<sup>25</sup> China has been trying to make this transition too, but it is not easy since it would involve increasing wages, shedding low-wage employment, cutting back on investment and other steps, all of which would be tremendously destabilising in the short-run. There is also no guarantee that such a transition would be successful or that there is a specific time period within which it could be reasonably assumed to be completed.

Politically, there is a concerted pushback against China on account of privacy concerns and the misuse of personal data that accompanies the use of Chinese technologies and its companies. These fears have multiplied with reports of the use of facial recognition technologies, tracking of individual social media accounts, and other obtrusive methods that China has used in Xinjiang and in the roll-out of its social credit system. That China has shared such technologies with other authoritarian regimes has further raised concerns all around, and not just within the human rights community. China’s use of its diaspora to influence the politics of other countries is also increasingly being challenged, with Australia having had to change its domestic laws to restrict foreign influence.<sup>26</sup>

The Covid-19 pandemic has only made the situation worse for the Chinese. The desperate attempt to score brownie points, which has led many to believe that China has come out looking as if it has won WW III, is fast running out of steam. China’s culpability in suppressing information and in denying that human-to-human transmission had started and its cynical

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manipulation of the WHO, cannot be easily washed off.<sup>27</sup> Reports that China cornered the global supplies of Personal Protection Equipment (PPE) and medicines in a period when news of the virus was kept under wraps, even if exaggerated, has hit its image hard. It would, therefore, be difficult for the country to emerge out of this pickle looking as the global saviour, despite the US's clumsy and ineffective handling of the crisis.

China also faces considerable domestic challenges. These include rising inequality and outbreaks of social tension. In fact, according to recent public opinion surveys, 'Chinese citizens have frequently ranked corruption, pollution, and social tension as their top concerns'.<sup>28</sup> These issues of corruption and party highhandedness are closely related to social unrest which often expresses itself in matters of forced appropriation of land at low compensation and in the failure to enforce environmental laws. According to one survey—part of an ongoing study over the past two decades—'land conflicts are the source of 65 percent of the more than 180,000 protests China experiences annually'.<sup>29</sup> The mishandling of environmental issues has frequently seen Chinese citizens file cases and take the issue to the social media, for example, the famous case of the waste-to-energy plant in Wuhan.<sup>30</sup>

The legitimacy of the CPC rests on its ability to generate economic growth and be seen as delivering on quality of life. The slowing of economic growth, the rising inequality and social tensions arising out of land and pollution issues are challenges that the party would have to contend with. These are unlikely to bring down the regime or even lead to a Tiananmen-like situation. But

these do chip away at its credibility and, increasingly, on its legitimacy. The party has tried to counter this with its policy of co-opting economic and social elites on the one hand and taking up rigorous anti-corruption measures on the other. To detail the latter, Xi Jinping, since coming to power, targeted corruption within the party and has, in fact, made this issue his top priority. The arrest and downfall of Bo Xilai, seen as a rival, led many to believe that Xi's campaign was mostly to strengthen his position and to centralise power. While true, this explanation is inadequate. Deng's reforms which encouraged local experimentation led to wide-spread corruption in the leadership and ranks of the party. It was hard to not see the linkage between corruption in the party and rising inequality and social unrest, which were collectively undermining the party's position. Xi put his trusted lieutenant, Wang Qishan, in charge of the 'tigers and flies' campaign. Wang reported in 2015 that in less than three years, 282,000 persons had been punished for 'discipline violation', of whom 82,000 received serious punishment.<sup>31</sup> The scholar Minxin Pei stated that Xi essentially wanted 'to generate popular support, and fighting corruption is a sure-fire way of giving him enormous public support.' In fact, Pei clarified that in 'terms of tigers—these are officials with the rank of vice-minister or vice governor and above—as of today, the number is about 150. That averages to 50 a year, and that's a lot, for it is double the number of officials arrested in any given year before the anti-corruption campaign'.<sup>32</sup> Without forming any conclusion about whether such campaigns can reduce corruption adequately to bolster the party's support and help facilitate economic growth, the fact that Xi had to

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make anti-corruption the centre point of his efforts speaks to the magnitude of the domestic challenge faced by the CPC.

The Chinese Communist Party was always known for its cliques, with purges of dissidents a normal way of dealing with it. However, after the dismissal of Zhao Zhiyang for failing to deal with the Tiananmen demonstrators, the CPC had managed to avoid public bickering that hurt its image. The different factions settled their differences through compromises and deals, and this saw smooth transitions for almost a quarter of a century. The Bo Xilai episode was the first episode where arrest and imprisonment were used against a top party leader, who posed a challenge to Xi's accession of power. Wang's virtual demotion as Vice President, after being seen as a strong instrument of Xi's efforts to control and cleanse the party, was an indication that Xi was feeling insecure despite the removal of term limits, which were so painstakingly put in place by Deng to avoid the emergence of a single leader and ensure rule by consensus. Lately, Xi's position has been challenged by Ren Zhiqiang, a princeling, realty tycoon, and part of the party's leadership. Ren has been a public critic of Xi since 2016, and in the aftermath of Xi's handling of the Wuhan crisis, called the latter 'the clown who insists on wearing the emperor's new clothes', likening him to the character in Hans Christian Andersen's fairy tale.<sup>33</sup> In the absence of open information, and the fact that Ren and Wang were classmates, rumours and speculations, lead people to insinuate that the former is speaking up for the latter; for the time being Ren is in prison with no chances of his release any time soon.

But Ren is not the only Xi critic in jail. Xu Zhangrun, a law professor at the prestigious Tsinghua University is also under detention for publishing an essay severely critical of the handling of the Wuhan crisis. Both Ren's letter and Xu's essay have been taken off the net, and their social media accounts closed.<sup>34</sup> Xu, in fact, was investigated earlier when he published his essay criticising Xi's removal of term limits. Since 2016, there has been a spate of anti-Xi letters and articles, including by another Tsinghua University professor, Lu Xia, which had angered the party and led to disciplinary action.<sup>35</sup>

China's ability to control its runaway population growth hailed for a generation as a major achievement and something that other countries were encouraged to emulate, has come back to haunt it in a big way. According to Yi Fuxian, an expert of Chinese demography, 2018 was a crucial tipping point as China's population started to shrink. According to the Global Times, the media outlet of the People's Liberation Army, there were fewer than 15 million births in 2018 or two million lesser than in 2017. When the one-child policy was given up in 2016, and couples were encouraged to have more children, there was a surge in births, but that trend soon reversed itself very sharply.<sup>36</sup> According to Yi, China's 'total fertility rate, or births per woman, dropped from 4.54 in 1973 to 2.29 in 1989, then to 1.22 in 2000 and 1.05 (then the lowest in the world) in 2015'.<sup>37</sup> Total fertility rate of 2.1 is considered to be replacement level, so if this trend continues, China's population in 2100 would be 480 million, or less than the projected population of China. This would have major implications for the Chinese economy as its workforce would shrink

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and the number of old age pensioners would go up. There is a real fear of China ageing before it becomes rich, as reflected in the fact that its demographic profile of 2018 was similar to Japan in 1992.<sup>38</sup> Specifically, China's working-age population (people aged 15 to 64) is 'estimated to fall by 9% from 2015 to 2035, and by 20% in 2050. That's a loss of 200 million people. Japan has experienced a similar decline over the past two decades: Its working population fell 13.4% from 1997 to 2017'.<sup>39</sup>

The last challenge, post-COVID-19, that China faces is hubris or premature declaration of victory. Prof Zhang Weiwei explained that when TV anchor Fareed Zakaria asked him why China did not adopt democracy as other Asian countries had done, he replied that the Chinese had shown that democracy, or western political system, was unnecessary since it had performed better than all the other Asian countries combined over the past four decades. China had started at the level of Malawi and at present has a middle class larger than the population of the US, with more homeowners.<sup>40</sup> Similarly, HR McMaster, who as the National Security Advisor had accompanied President Trump to Beijing, described that at their meeting with Chinese Prime Minister Li Keqiang, the latter stated that 'China, having already developed its industrial and technological base, no longer needed the United States. He dismissed U.S. concerns over unfair trade and economic practices, indicating that the U.S. role in the future global economy would merely be to provide China with raw materials, agricultural products, and energy to fuel its production of the world's cutting-edge industrial and consumer products'.<sup>41</sup> This,

notwithstanding the fact that China's per capita income in 2018 was USD 9,580 whilst that of the USA was USD 65,456.<sup>42</sup>

## Conclusion

The post-COVID-19 world would see many of these chasms widening since the pandemic has exposed a number of vulnerabilities within and across countries. China's reputation, despite Evo Morales and others, has taken a big hit since its acts of omission have had a very deleterious effect on public health all over the world, in particular, the US and Western Europe, and consequently on their economic well-being. This has resulted in a proliferation of conspiracy theories about China using the coronavirus as a tool of biological war, though there is little evidence to support this. Much worse, the Chinese lockdown disrupted global supply chains and raised questions about the implications of relying on one economy to be the factory of the world. Countries have responded to this in different ways. Japan's latest budget has a provision of USD 2.2 billion, as assistance to Japanese companies to move their production facilities out of China, primarily to Japan and also to other destinations.<sup>43</sup> This is unlikely to be an isolated example.<sup>44</sup> In fact, the on-going US-China trade dispute had already prompted companies to re-think their investments in China.<sup>45</sup> There are also concerns about China's investment in strategic industries in other countries that has led to calls for imposing checks on such acquisition. India's recent move to check FDI from neighbouring countries is primarily directed at China, a move that has not gone unnoticed in Beijing.<sup>46</sup> This would only gather steam.



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The challenge of post-Corona recovery is yet to be fully assessed. Projections across the board point to a contraction of the global economy, which would be particularly concentrated on the USA and Western Europe, with India and China barely escaping a recession.<sup>47</sup> The resultant fall in global demand, especially in countries which are a huge market for Chinese exports, means that exports are unlikely to help China regain its growth momentum. It is probably for this reason that China, unlike the US, Western Europe and India, ‘has so far avoided unfurling a huge spending package. Its economy has become too big and complex to easily restart like it did in 2008, when it unveiled a plan to spend more than half a trillion dollars. Years of easy lending have also left local governments and state-run companies mired in debt’.<sup>48</sup> Incidentally, China’s stock of debt is not so much an issue as it is mostly denominated in the local currency and as a proportion of the GDP is less than debt in Japan, but the pace at which it has grown in the past few years seems unsustainable.

Can domestic demand then compensate for the expected loss of export markets? China faces a peculiar problem in that while consumption as a share of GDP is still on the lower side for an economy of its size and complexity, its best and largest companies—State Grid Corporation of China, China Petrochemical Corporation, China National Petroleum Corporation, Alibaba and Tencent—are largely dependent on the domestic market, with Huawei and Lenovo being exceptions. This makes them very vulnerable to ‘a major slowdown in the domestic market’.<sup>49</sup> Official Chinese statistics for the first quarter of 2020

indicated that while manufacture shrunk by only (-) 1.1% in the quarter, retail sales fell by (-) 15.8% and investment by (-)16.1%.<sup>50</sup>

It’s not all gloom and doom for China though. The fact that even as its population is shrinking, and migration from villages to cities has slowed to a crawl, the economy has kept up its momentum. While economic growth will slow down to a lower ‘normal’, China’s transition out of low-wage employment to a more high technology economy is underway. Its manufacturing employs less than half the numbers it did in 1992, but the total quantity produced has grown in magnitude. Can it break out of the productivity trap that Japan has found itself in since the late 1990s? The past record suggests that it would be unwise to underestimate the ability of the Chinese State to make major leaps of faith, as it has in the past. While this may be possible without political democracy, experience elsewhere suggests that in order to facilitate experimentations, as it had achieved previously, China must create much greater space for a diversity of opinions and decentralised decision-making, for what it has chosen to try and achieve in decades, others have taken centuries. Despite efforts at decoupling to make the global economy less dependent on China, and a shift in manufacturing out of China would happen, the country is so closely enmeshed in the global supply chains that such efforts would have limited impact in the short-term. Perhaps, convincing others that it would play as per the laid down rules, and not be a revisionist power, would help China make the transition to an upper-income country in the next few decades.

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The final word belongs to McMaster:

*The party's leaders believe they have a narrow window of strategic opportunity to strengthen their rule and revise the international order in their favour—before China's economy sours before the population grows old before other countries realize that the party is pursuing national rejuvenation at their expense and before unanticipated events such as the coronavirus pandemic expose the vulnerabilities the party created in the race to surpass the United States and realize the China dream.*<sup>51</sup>

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- 5 *I have gained a lot from listening to the lectures of Prof Daokui Li, delivered to the Schwarzman Scholars and available online. He is a Professor of Economics at the School of Economics and Management at Tsinghua University. He is also the Dean of the Schwarzman Scholars programme. The lectures present a conceptual explanation to the Chinese growth story and its challenges.*
- 6 *<https://countryeconomy.com/countries/compare/china/usa>*
- 7 *This slogan was adopted at the 12th Congress of the Communist Party of China in 1982. Xi Jinping has revived this slogan as part of his 'China Dream'. See 'China Focus: Socialism with Chinese characteristics: 10 ideas to share with world', by Li Zhihui, Wang Aihua and Tian Zijun, Xinhuanet, October 8, 2017, can be accessed at [http://www.xinhuanet.com/english/2017-10/08/c\\_136665156.htm](http://www.xinhuanet.com/english/2017-10/08/c_136665156.htm)*
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