

BUSINESS ENVIRONMENT IN CHINA: ECONOMIC, POLITICAL, AND CULTURAL FACTORS

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ABSTRACT

China is an emerging economy that offers lot of market opportunities for foreign investment. Although the country has a huge potential for economic growth offering access to a large market and considerable savings in labor costs, caution must be used due to differences in the political and cultural environment that create risk and pose uncertainty for foreign investors. This paper examines the economic, political, and cultural factors that influence business practices in China.

INTRODUCTION

After more than a quarter century of reform and opening to the outside world, by 2005 China's economy had become the second largest in the world after the United States when measured on a purchasing power parity (PPP) basis (World Bank, 2009). The Chinese government has a goal of quadrupling the gross domestic product (GDP) by 2020 and more than doubling the per capita GDP. A widespread market economy mechanisms and some reduction of government role has been evident since 1978. The government fosters a dual economic structure that has evolved from a socialist, centrally planned economy to a socialist market economic system, or a "market economy with socialist characteristics."

The rapid industrial development has been achieved by increasing technological advancements, huge foreign direct investment and productivity increases. People's communes were eliminated by 1984, after more than 25 years, and the system of township-collective-household production was introduced to the agricultural sector. Private ownership of production assets is now legal, although some non-agricultural and industrial facilities are still state-owned and centrally planned. Restraints on foreign trade were relaxed when China acceded to the World Trade

Organization in 2001. Joint ventures are encouraged, especially in the coastal special economic zones and open coastal cities. A sign of the affluence that the reformed economy has brought to China can be seen in the number of its millionaires (measured in US dollars), reported as 236,000 millionaires in 2004, an increase of 12 percent over two years earlier (Meredith, 2007).

Chinese officials note two major trends that have an effect on China's market economy and future development: world multi-polarization and regional integration (Balfour, 2004). In relation to these trends, Chinese officials foresee China and the United States' role in world affairs to be closely tied with one another and as one of high importance. Despite successes, China's leaders face a variety of challenges to the nation's future economic development. China must maintain a high growth rate, deal effectively with the rural workforce, improve the financial system, continue to reform the state-owned enterprises, foster the productive private sector, establish a social security system, improve scientific and educational development, promote better international cooperation, and change the role of the government in the economic system. China has recently become the world's third largest trading nation after the United States and Germany (World Bank, 2009).

ECONOMIC FACTORS

Foreign Direct Investment

China has remained a primary recipient of the world's destination of FDI in recent years. FDI accounts for 27% of the value added production, 4.1% of national tax revenue, and 58% of foreign trade. Over 190 countries from around the world invest in China, which includes 450 of the Worlds Fortune 500 companies. Member Priorities Survey, completed a survey that the majority of US companies invest in China to serve the Chinese domestic market, not export back to the United States.

According to UBS AG estimates, the total share of US, European, and Japanese multinational corporations (MNCs) in Chinese exports has been only 11% in 2009 (Library of Congress,

2009). Most exports are from Hong Kong, South Korea, and Taiwan firms. An estimated 75% of Western and Japanese MNCs are in China to sell to the domestic market. This year's drop in FDI may suggest that companies are losing interest in China. The top sources of FDI for China have remained the same over the years. Hong Kong continues to lead the list, followed by the British Virgin Islands, Japan, South Korea, and the US. Member Priorities Survey reported that 81% of firms in have operation on China are profitable (Foreign Investment in China, 2009).

In 2006, the Chinese National Development and Reform Commission (NDRC) had established a plan to better manage FDI investment in the economy. The plan addressed the relationship between national security investment and foreign investment. It instructs China to gradually relax restrictions on foreign holding of domestic enterprises. Foreign capital should be directed towards high-tech industries, modern service industries, high-end manufacturing, infrastructure development, and ecological/environmental protection. The NDRC is asking for MNC's to increase investment and setup production, assembly, and training institutions in China. The goal would be to enhance the independence of innovation for Chinese enterprises.

Outbound FDI has also been increasing as China's economy continues to grow and prosper. Xinhua News Agency reported that China's outbound direct investment reached \$73.3 billion by the end of 2006. The majority of Chinese outbound direct investment came from overseas acquisitions. Hong Kong and tax havens, such as the Cayman Islands and the British Virgin Islands received 81% of the total outbound investment.

The top sources of outbound FDI from China are costal and border provinces. Fujian, Guangdong, Heilongjiang, Jiangsu, Shandong, Shanghai, and Zhejiang account for 62.5% of China's outbound FDI. The service sector received 50% of the Chinese FDI, 23% targeted manufacturing, 22% covered wholesale and retail, and 17% was invested in the mining industry (Foreign Investment in China, 2009). Table 1 presents the Top 10 origins of FDI in China in the period of 2005 and 2006.

Country/Region of Origin	Amount Invested 2005 (\$ billion)	Amount Invested 2006 (\$ billion)	Year-on-Year Growth (%)
Hong Kong	\$17.95	\$20.23	13
British Virgin Islands	\$9.02	\$11.25	25
Japan	\$6.53	\$4.60	-30
South Korea	\$5.17	\$3.89	-25
United States	\$3.06	\$2.87	-6
Taiwan	\$2.15	\$2.14	-1
Singapore	\$2.20	\$2.26	3
Cayman Islands	\$1.95	\$2.1	8
Germany	\$1.53	\$1.98	29
Western Samoa	\$1.36	\$1.54	13

Foreign Exchange Reserve

China's foreign exchange reserves were minimal in 1978, but it was enough to cover requirements with a very small import. In the 1980s, export contributed to the rise in reserves to \$17.4 billion. The economic slowdown in the early 1990s created a sharp fall in imports, while exports continued to rise. This created a merchandise trade surplus reached \$9.2 billion. The surplus was eventually eroded when imports rose faster than exports. In 1993, the trade and current accounts created a deficit, but the acceleration in inward foreign direct investment (FDI) kept foreign exchange reserves increasing.

China joined the World Trade Organization (WTO) in 2001 and contributed to a rapid growth in imports, expanded exports, and FDI inflows surpassed \$60 billion annually in 2006. In October 2006, foreign exchange reserves exceeded \$1 trillion for the first time. In September 2008, the

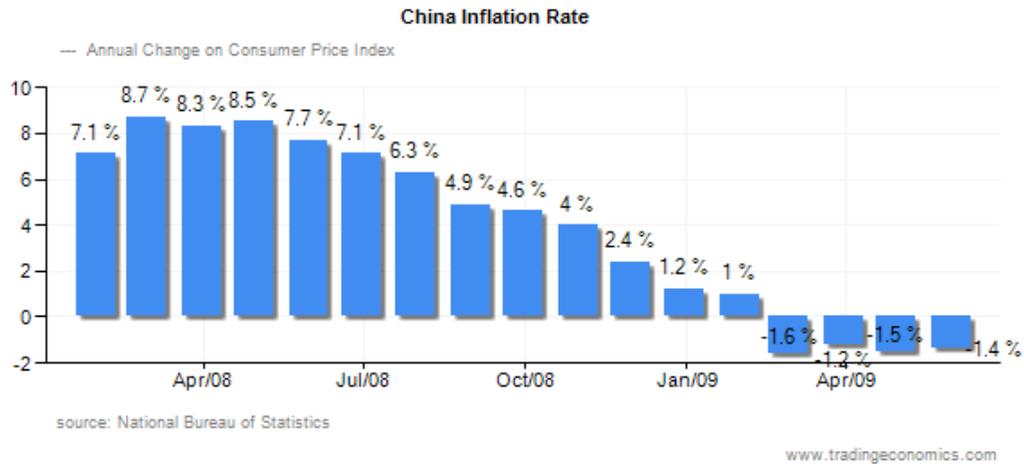
reserves totaled \$1.9 trillion. It remained at this level until the end of 2008 when trade growth slowed and FDI inflows declined (China Foreign Exchange Reserves, 2009).

Inflation Rates

Inflation rate is the general rise in prices measured against a standard level of purchasing power. In April 2009, prices dropped 1.5% from last year, after steady falling at the beginning of 2009. Falling prices lower the costs on goods and encourage consumers to spend. This helps the Chinese economy recover its diminishing exports. Inflation was at 8.5% which caused the price of pork to increase because of the shortage on meat. Food fell 1.3% from a year earlier which represents the biggest part of the index. Non-food prices fell 1.5%, garments fell 2.5%, service costs dropped 1.4%, and utilities fell 2.2%. Producer prices decreased on lower raw-material and energy costs. Crude oil fell 53.6% which is a significant drop from historical numbers (The Economist, April 7, 2009).

The Chinese Central Bank took caution to the risk, expecting prices to decrease further, and delayed purchases to diminish demand and stifle economic growth. The government has countered the risk by raising state controlled prices of resources and purchasing farmers products to stabilize prices. The investment of cash reserves into the economy of \$586 billion makes protracted pricing declines less probable. This insertion of funds into the financial system may fuel inflation as the Chinese economy turns around (China Inflation Rate, 2009). Table 2 presents data on the annual change of Consumer Price Index (CPI) of China from April 2008 to April 2009 (National Bureau of Statistics, China Report, 2009).

Table 2



Trade

China joined the WTO to become competitive in the global market. The main industrial exports for China are manufactured goods, textiles, garments, and electronics. The leading export materials in China are tungsten, antimony, tin, magnesium, molybdenum, mercury, manganese, barite, and salt. China is the world's largest producer of aluminum (China Trade, 2008).

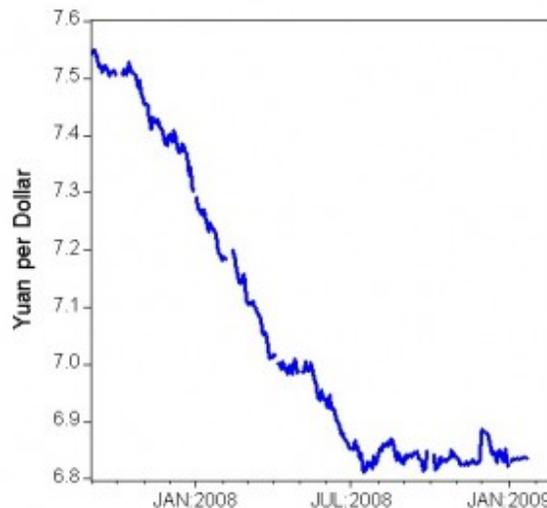
Infrastructure

The liberal economic policies in the 1980s have strengthened China's economy. However, the country still suffers from inadequate transportation, communication, and energy resources. Since the 1980s China has undertaken a major highway construction program and is working in building a world class infrastructure. The human development index (HDI) in China is 0.777 (ranks 81st out of 177), and shows the disparity between urban China and the rural hinterlands. China receives criticism from human rights campaigners for executing hundreds of people every year for failing to stop torture. Other problems include government corruption, the growing rate of HIV infections, and the deterioration of the environment (People's Republic of China Infrastructure, 2009).

Currency & Exchange Rate

China has been manipulating the holdings of its currency at an artificially low level. The currency appreciated 21% against the dollar through July 2008 and then went flat as Chinese authorities were concerned about slipping exports. China's continued currency manipulation is hurting its own economy. The Treasury Secretary noted the appreciation of the Yuan could be a win-win situation for the world's economy. The Obama administration wants to strengthen the International Monetary Fund to improve currency practices. Graph 1 illustrates the Yuan per dollar rates and how China's currency has moved from January 2008 to January 2009.

Graph 1. Value of Yuan Relative to the US Dollar



POLITICAL FACTORS

Political System

According to the Chinese Constitution, "The People's Republic of China is a socialist state under the people's democratic dictatorship led by the working class and based on the alliance of workers and peasants." The government is comprised of the system of people's congresses and the political party system that accords with it is that of multi-party cooperation and political consultation under the leadership of the Communist Party of China (CPC). The systems of people's congresses, multi-party cooperation, regional ethnic autonomy, and self-governance at

the primary level of society together constitute the kernel and fundamental framework of China's political system. As one of China's fundamental political system, the multi-party cooperation system identifies the status and functions of the CPC and the eight other political parties in the political life of the state, and the relations between the parties (Background Note: China, 2009)

Government

The Chinese government consists of a system of multi-party cooperation and political consultation under the leadership of the CPC. The system ensures that the CPC is the only party in power in the People's Republic of China. Under the precondition of accepting the leadership of the CPC, the eight other political parties participate in the discussion and management of state affairs, in cooperation with the CPC. Political consultation means that under the leadership of the CPC, all parties, mass organizations and representatives from all walks of life take part in consultations of the country's basic policies and important issues in political, economic, cultural and social affairs before a decision is adopted and in the discussion of major issues in the implementation of the decisions. Political consultation takes the organizational form of the Chinese People's Political Consultative Conference. Political consultation is the most important political and organization form of the multi-party and political consultation system. Cooperative relations between the CPC and other political parties are based on the principle of "long-term coexistence and mutual supervision, treating each other with full sincerity and sharing weal or woe" (Background Note: China, 2009)

Human Rights

The China country reports in the State Department's 2007 Human Rights Practices and International Religious Freedom Reports noted China's well-documented and continuing abuses of human rights in violation of internationally recognized norms, stemming both from the authorities' intolerance of dissent and the inadequacy of legal safeguards for basic freedoms. Reported abuses have included arbitrary and lengthy incommunicado detention, forced confessions, torture, and mistreatment of prisoners as well as severe restrictions on freedom of speech, the press, assembly, association, religion, privacy, worker rights, and coercive birth

limitation. In 2006, China continued the monitoring, harassment, intimidation, and arrest of journalists, Internet writers, defense lawyers, religious activists, and political dissidents. The activities of non-governmental organizations (NGOs), especially those relating to the rule of law and expansion of judicial review, continue to be restricted (Background Note: China, 2009).

Political Risk

China is particularly hazardous with respect to political risk. The possibility of nationalization of industries needs to be considered. In fact this has already occurred in China (in 1949). Similarly, there are the risks of confiscation, expropriation, currency inconvertibility and contract repudiation. Currency devaluation and rampant inflation are possible scenarios in many countries, wreaking havoc on the adequacy of insurance limits, as one of many potential problems. There is also risk to company employees of personal harm or kidnapping, and risk to the firm of extortion attempts. A unique form of political risk occurs in China, and this is the constant battle between the country's central government and the provincial and local governments over applicable law, and observance or non-observance of it. This makes it difficult for companies operating in China to know exactly what the rules are (China Political Risk Management, 2009).

Political Stability

The level of foreign business activity in China after the Tiananmen Square massacre has fallen off dramatically in many areas, including tourism and foreign investment. While companies not already involved in China are wary of committing investment to China, countries already involved in investment activities seemingly are waiting for a quiet period in which economic progress will begin again and believe that China will not expel foreign investors in the meantime. There is not much likelihood that extant joint ventures and foreign manufacturing plants will be closed under the present regime, but political stability is still a big question to foreign investors.

At the same time, China's economic growth and reform since 1978 has improved dramatically the lives of hundreds of millions of Chinese, increased social mobility, and expanded the scope

of personal freedom. This has meant substantially greater freedom of travel, employment opportunity, educational and cultural pursuits, job and housing choices, and access to information. In recent years, China has also passed new criminal and civil laws that provide additional safeguards to citizens. Village elections have been carried out in over 90% of China's one million villages.

The United States has conducted 12 rounds of human rights dialogue with China since Tiananmen. During 2003 and 2004, no progress was made on the commitments China made at the 2002 dialogue, and we declined to schedule another round at that time. In February 2008, the United States and China agreed to resume our formal human rights dialogue, with the understanding that the discussions need to be constructive. Outside the formal human rights dialogue, the U.S. Government regularly raises human rights concerns with Chinese officials at all levels of government. In his September 2007 meeting with President Hu and in subsequent discussions, President Bush has emphasized U.S. interest in human rights and religious freedom in China (Foreign Business in China responds to Political Instability, 1990).

CULTURAL FACTORS

China has the largest population of any country: 1,133,682,501 people were counted during the census taken in 1990. This population had grown rapidly in recent times, expanding by approximately 15 million each year, an increase equal to the total population of Australia. Between 1964 and 1982 China added 313 million to its population, more people than lived in the Soviet Union during that time. This rapid growth has occurred because the death rate has dropped sharply. The birthrate has also fallen, but the total population is enormous, and there are many young people. Thus, without extreme means of population control, the outlook is for continued rapid increase.

The problem of providing an acceptable quality of life for a society this large - and growing ever larger - is a major concern in China. In an effort to reduce the rate of population growth, the Chinese government since 1978 has promoted the one-child family among the Han. Married couples are urged to have only one child. Rewards such as better opportunities for one child are

offered. Family-planning advice and birth-control techniques are easily available and commonly used.

Ethnic & Language Groups

The concept of being Chinese is not based on race. Rather, it is a cultural concept. To speak and behave like a Chinese--in short, to accept the Chinese system of cultural values--is to be Chinese. The Chinese refer to themselves as Han or sons of Han (as in Han Dynasty, a period of great historical significance). Throughout history, small ethnic groups that came into contact with the Han Chinese have adopted Chinese culture and have been absorbed into the mainstream. This process continues, though there are legal guarantees designed to protect the rights and culture of minority nationalities.

Traditionally, the definition of a minority nationality in China is a group of people who speak a common language, occupy a common area, and share a common sense of social values. Although the minority nationalities represent a comparatively small proportion of the total population (approximately 67 million people, or 6.7 percent of China's population), they have an importance in Chinese society beyond their numbers because of the strategic territories they occupy. Most minority nationalities live along China's sparsely populated frontiers and have cultural relationships with minority groups in neighboring countries, such as Kazakhstan, Kyrgyzstan, Russia, North Korea, Mongolia, Thailand, and Myanmar (formerly called Burma). If these groups became hostile toward the central government it could affect China's national security.

Guarantees protecting the minority nationalities are expressed in the structure of China's administrative system. In addition to the 22 provinces, there are five autonomous regions, based on the location of five of the larger and more important minority nationalities. In addition, smaller units such as autonomous prefectures, leagues, and banners (equivalent to British counties) are based on their occupancy by even smaller minority groupings. This administrative system is designed to give the minorities' political equality with the Han people and to help them maintain their distinctive identities. At the same time, Putonghua (based on the Mandarin dialect

spoken in the Beijing area) is being promoted as the official spoken language of the country. All minority peoples are urged to learn it. Generally, all minorities live harmoniously with the Han. The government has adopted measures to promote economic development among minorities to enable them to catch up with the Han.

Cultural Values

Chinese culture is highly complex but scholars across the world agree that despite the diversity of Chinese communities many shared characteristics persist. These derive largely from the pervasive influence of Confucian philosophy of the Chinese culture and they are at very core of Chinese identity. Indeed, since Confucian thought has dominated the Chinese way of life for 2,000 years, it is unlikely to cease its influence, even after two or three generations of participation in British society.

The most important values of Chinese culture include the: importance of the family, hierarchical structure of social life, cultivation of morality and self-restraint, and the emphasis on hard work and achievement. Chinese culture and society can be defined as 'collectivist'. In many ways the family unit takes precedence over its individual members. Children must learn not to answer back to their parents or other elders. It is assumed that the family as a whole will thrive and prosper if harmony prevails at home. In other words – the basic rules of obedience, moderation and self-restraint amongst family members should be observed. Expectations related to family life account for many of the difficulties faced by Chinese immigrants. The second generation finds it hard to cope with the demands of their parents. They want to fulfill their own potential - like opting out of the catering business. And, stripped of their traditional position, deprived of respect, abandoned and isolated, the first generation feels unable to shape their children's way of life. Guilt on the children's part and shame on the parents' may result (Background Note, 2009).

Religion

The Chinese Government recognizes five official religions which are Buddhism, Islam, Taoism, Catholicism, and Protestantism. China seeks to regulate religious groups and worship. Religious

believers who seek to practice their faith outside of state-controlled religious venues and unregistered religious groups and spiritual movements are subject to intimidation, harassment, and detention. In 2006, the Secretary of State again designated China as a "Country of Particular Concern" under the International Religious Freedom Act for particularly severe violations of religious freedom (Background Note: China, 2009).

Chinese religious beliefs are wide-ranging and eclectic, deriving from several religious traditions (Chinese folk religion, Confucianism, Taoism and Buddhism). But several religious concepts are characteristic of general Chinese religious thought. Chinese religion is generally dualistic, emphasizing the two opposed and complimentary principles of the universe: yin and yang. But the yin and yang are the double manifestation of the single, eternal cosmic principal: the Tao. Also important is the concept of heaven (T'ien), which is sometimes described in terms of an impersonal power or fate, other times as a personal deity, and can also be equated with the Tao.

Cultural Dimensions

Geert Hofstede's cultural factors measured on five dimensions: power distance, individualism versus collectivism, masculinity versus femininity, uncertainty avoidance, and long-term orientation, are widely used for comparing cultural differences among nations.

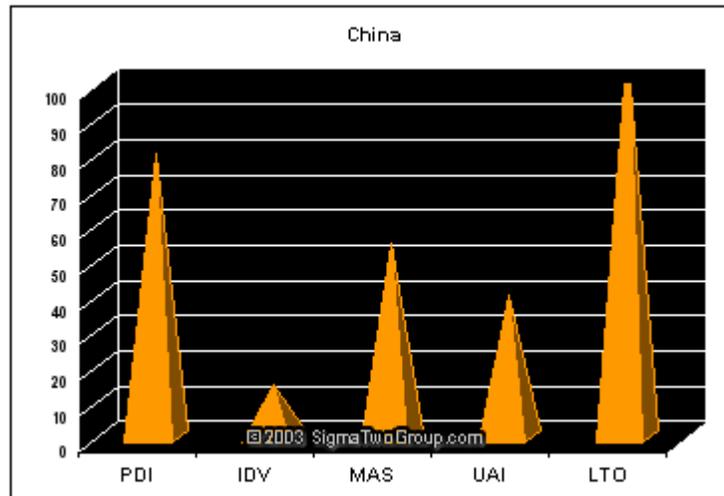
Power Distance Index (PDI) refers to the extent to which the less powerful members of organizations and institutions (like the family) accept and expect that power is distributed unequally. It suggests that a society's level of inequality is endorsed by the followers as much as by the leaders. Individualism (IDV) and collectivism relates to the degree to which individuals are integrated into groups. On the individualist side, societies include loose ties between individuals: everyone is expected to look after him/herself and his/her immediate family. On the collectivist side, we find societies in which people from birth onwards are integrated into strong, cohesive in-groups, often extended families (with uncles, aunts and grandparents) which continue protecting them in exchange for unquestioning loyalty. The word 'collectivism' in this sense has no political meaning rather it refers to the group, not to the state.

Masculinity (MAS) versus femininity refers to the distribution of roles between genders. Hofstede's study revealed that (a) women's values differ less among societies than men's values; (b) men's values from one country to another contain a dimension from very assertive and competitive and maximally different from women's values on the one side, to modest and caring and similar to women's values on the other. The assertive role is called 'masculine' and the modest, caring role is called 'feminine'. The women in feminine countries have the same modest, caring values as the men; in the masculine countries they are somewhat assertive and competitive, but not as much as the men, so that these countries show a gap between men's values and women's values.

Uncertainty Avoidance Index (UAI) denote a society's tolerance for uncertainty and ambiguity. It indicates the extent to which a culture programs its members to feel either uncomfortable or comfortable in unstructured situations. Unstructured situations are novel, unknown, surprising, and different from usual. Uncertainty avoiding cultures try to minimize the possibility of such situations by strict laws and rules, safety and security measures, and on the philosophical and religious level by a belief in absolute Truth. People in uncertainty avoiding countries are more emotional, and motivated by inner nervous energy. The opposite type, uncertainty accepting cultures, are more tolerant of opinions different from what they are used to; they try to have as few rules as possible, and on the philosophical and religious level they are relativist and allow many currents to flow side by side. People within these cultures are more phlegmatic and contemplative, and not expected by their environment to express emotions.

Long-Term Orientation (LTO) versus short-term orientation relates to the virtues of thrift and perseverance. Values associated with Short Term Orientation are respect for tradition, fulfilling social obligations, and protecting one's 'face'. Both the positively and the negatively rated values of this dimension are found in the teachings of Confucius, the most influential Chinese philosopher who lived around 500 B.C.; however, the dimension also applies to countries without a Confucian heritage. Graph 2 shows the rankings of Hofstede's five dimensions of the Chinese culture.

Graph 2. Hofstede's Cultural Dimensions in China



Geert Hofstede cultural factors in China indicate a significantly high (80) Power Distance ranking compared to the world average of 55. This is indicative of a high level of inequality of power and wealth within the society. This condition is not necessarily forced upon the population, but rather accepted by the society as their cultural heritage. Another factor in the Chinese culture is the high (118) Long-term Orientation (LTO). This indicates the society's time perspective and an attitude of persevering; that is, overcoming obstacles with time, if not with will and strength. The Chinese rank low (10) in the Individualism (IDV) ranking. This may be attributed, in part, to the high level of emphasis on the collectivist society imposed by the communist rule compared to the values of individualism.

The low individualism ranking also manifests a close and committed 'group' orientation, be that the family, extended family, or extended relationships. Loyalty in a collectivist culture is paramount. The society fosters strong relationships where everyone takes responsibility for fellow members of their group.

IMPLICATIONS

Conducting business in China can be difficult due to the many uncertainties and differences in the economic, political, and cultural environment. The Chinese prefer doing business with

companies they know, so working through an intermediary is crucial in China. Business relationships are built formally. It is important to be patient as it takes a considerable amount of time to build business relationship which is also bound with enormous government bureaucracy.

The Chinese see foreigners as representatives of their company rather than as individuals. Rank is extremely important in business relationships and you must keep rank differences in mind when communicating. The Chinese prefer face-to-face meetings rather than written or telephone communication. Meals and social events are not the place for business discussions but social etiquette is important to follow. There is a demarcation between business and socializing in China, so it is important not to intertwine the two.

Some of the cultural values that govern business practices relate to setting up appointments one-to-two months in advance and preferably in writing. The Chinese view punctuality as a virtue. Arriving late is an insult and could negatively affect your relationship. It is important to pay attention to the agenda as each Chinese participant has his or her own agenda that they will attempt to introduce. You are also advised to send an agenda before the meeting so your Chinese colleagues have the opportunity to meet with any technical experts prior to the meeting.

CONCLUSION

China has a growing market infused with rapid industrial development and economic growth. As the world's third largest trading nation after the United States and Germany, China will continue to be an important business partner of the United States. US business people and organizations must understand the differences in the economic, political, and cultural environment of the country as these can be difficult to manage and may hinder business development. Especially important is to learn about cultural and political differences and their impact on business practices and business conduct.

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