Economic Development in China and Its Implications for Japan

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I Introduction

Since the Four Modernizations undertaken in the late 1970s China has emerged as another rapidly growing, newly industrializing economy in Asia. In the decade following the reform China’s real GNP grew at an annual average rate of 10 percent, up from an annual rate of 6.5 percent during the 1970s. Although its economy slowed down in the late 1980s due to the government’s anti-inflationary measures, it regained the growth momentum in the early 1990s, achieving a 13.4 percent rate of growth in 1993 and then a somewhat lower rate in subsequent years (Table 1).

One of the key elements of China’s economic reform was the opening of its economy, which has transformed it into a major trading country—the 10th largest in the world in 1997—and has had a positive effect on its economic growth. The opening also has brought about

[Table 1 here]

a rapid expansion in economic interactions between China and Japan. China is now Japan’s fifth largest export market and second largest supplier of imports and, in terms of the total value of trade (imports and exports combined), it is Japan’s second largest trading partner after the United States, accounting for 8 percent of Japan’s total trade.

China is also currently the world’s second largest recipient of foreign direct investment (FDI) although the inflow has decreased since 1993 when 83,437 cases worth US $111 billion were registered. As of 1996 Hong Kong, the United States, Singapore, Taiwan, and Japan (in a
descending order) were the five largest investors in China in terms of the amount invested.

[Table 2 here]

The above discussion makes it clear that China has emerged as Japan’s major economic partner in trade and investment since the reforms of the late 1970s. How this relationship will evolve as we enter the 21st century is an issue that has serious policy implications for Japan. It is possible that, given its size and growing economy, China may become Japan’s major export market, invigorating its manufacturing industries. It is, however, also possible that, with its ambition to rapidly catch up with the advanced economies of the world, China may soon challenge Japan’s supremacy in technology and know-how and become a rival instead of a partner.

In attempting to answer some of these questions we assume that China will continue with its market-oriented reforms and thus maintain the momentum of economic growth albeit at a lower rate than in the past (Naughton 1997). ¹ We then argue that the pattern of economic development in China will be similar to the historical process that Japan has experienced in catching up with the West and the one that the newly industrializing economies in Asia have been going through in more recent years. In this catching-up process, as happened in Japan (Akamatsu 1962), a technologically lagging economy such as China first imports crude, labor-

¹According to Singh and Singh (1996), by 2010 China’s real GDP and per-capital GDP (in 1990 US$) will reach $2.3 trillion and $1,635, respectively, while its nominal merchandise exports and imports will amount to $953.2 billion and $966.4 billion, respectively.
intensive consumer products, undertakes their domestic production, and then finally exports them to the rest of the world. The country repeats this process—the cycle of import, domestic production, and export—as it moves up the ladder of technological sophistication until it finally catches up with the industrially advanced economies of the world.

We also argue that, although the economic interaction that we now observe between China and Japan (and the West) appears to be following this catching-up pattern of industrial development, China is unlikely to become a fully advanced economy by the early part of the 21st century. What is more likely is that even though China will, by then, succeed in developing a number of technologically advanced industries that will seriously challenge their counterparts in Japan and the West, a majority of its industrial activities will remain in the unskilled labor-intensive manufacturing sector. The reason is, as pointed out by Garnaut and Huang (1995), obvious: Given China’s large population and its generally low level of education it will take several more decades of rapid economic growth and human and physical capital accumulation for it to become an advanced industrial economy.

In the following section, we briefly examine the economic relationship between China and Japan in the early part of the 20th century as we believe that certain aspects of the relationship between the two countries have remained basically the same since then.\(^2\) The first is that China is, in a geographical and cultural sense, a close neighbor of Japan with a potentially

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\(^2\)The years from 1937 when Japan began its military invasion into China until 1978 when economic reform in China began are not a period during which a “normal” trade and investment relationship between the two independent countries existed. For our purpose that period should be regarded as an interregnum in the economic relationship between the two countries.
vast market for Japanese products. The second is that for the foreseeable future China will lag behind Japan in technological development. Given these constants an examination of the economic relationship between the two countries in the early 20th century should shed light on what may lie ahead early in the 21st century. Section III discusses economic changes in the post-reform China and section IV looks into future economic development in China and its implications for Japan. Section V concludes the paper.

II China and Japan in the Early 20th Century

In the early 20th century Japan was the first country in Asia on the way to becoming a modern industrial economy. Even though it still had a large traditional sector it also had an emerging modern manufacturing sector that accounted for 17.4 to 23.4 percent of its GDP. The manufacturing industries, which relied on imported machinery and technology, were still backward relative to those in the West, but they were advanced enough in 1900-19 to carry out primary export substitution—the substitution of light manufactured goods for agricultural products as exports (Ohkawa and Kohama 1989). What facilitated this primary export substitution in spite of the relative backwardness of these industries was the availability of Chinese markets for their products.

In terms of value, the United States was the most important destination of Japanese exports during 1913-24 but they were mostly raw silk and silk products, i.e., the products of Japan’s traditional sector. Although China (including Hong Kong and the Kwangtung Leased

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3 Japanese exports to the West (the United States, Europe, and the British Dominions) were
Territory) was second to the United States as a market for Japanese exports, its importance for Japan’s industrialization lay in that Chinese imports from Japan were mostly manufactured goods such as cotton piece goods, matches, paper, and machinery. In fact, China accounted for three-quarters of Japan’s total manufacturing exports (Uyehara 1926, pp. 76-77).

Prior to the First World War, cotton yarn was Japan’s most important export to China, followed by cotton piece goods, refined sugar, copper, coal, matches, marine products, timber, hosiery goods, and paper. In 1923, however, cotton piece goods replaced cotton yarn as Japan’s most important export to China while refined sugar, copper, matches and hosiery decreased greatly in both value and quantity. Paper, machinery, metal manufactures and marine products also increased (Uyehara 1926, p.80). This change in Japanese exports to China is a sign of the increasing technological sophistication that Japan was making in its manufacturing industries in the early 20th century. What made this advance in Japan’s technological capability possible?

For Japan, as observed by Lockwood (p. 320), international trade was a “highway of learning” with the imports of Western products and technology having “catalytic effects” on its economy. Obviously, a catalytic effect is not sufficient for an economy to sustain the process of economic development, and in the case of Japan this development process was facilitated by its “social capability” to learn and develop indigenous industries. 4 It must be added, however, that

mainly materials and manufactured goods produced by relatively simple processes in which hand labor was the chief element of cost. Beside raw silk and silk textiles, they included such things as tableware, toys, perilla and rapeseed oil, tea, canned fish, and wood and straw products (Lockwood 1968, p.370).

4According to Ohkawa and Kohama (1989, p. 22), social capability is a concept that cannot be directly quantified by statistical measurements, and improving it is a gradual continuous process
for indigenous industries to grow and prosper there had to be markets for their products. In the case of Japan they were provided by the growing demand at home and in China.

In other words, Japan’s trade performed a dual function in promoting Japan’s industrialization in the early 20th century. Its trade with the West was a conduit for machinery and technology from a more technologically advanced part of the world—a highway of learning—as put by Lockwood, while its trade with China, a country less technologically advanced than Japan, was an outlet for the products of the budding Japanese manufacturing industries. Its trade with China thus made possible the effective utilization of machinery and technology imported from the West and learning-by-doing by its indigenous industries.

This relationship between the two neighboring countries was interrupted when Japan went to war, first with China in 1937 and then with the United States and its Western Allies in 1941. The end of the war in 1945 did not, however, bring back the pre-war relationship as China soon became a socialist economy closed to the West. It is only with the reforms starting in 1978 that China began the process of opening its economy and thus restoring its “natural” economic relationship with Japan—a complementary relationship between an economy with advanced technology and abundant capital and an economy with an abundant supply of labor and potentially immense domestic markets.

III Economic Changes in the Post-Reform China

One striking achievement that China has achieved since its reform in the late 1970s is that it is based on education, training, and learning by doing.
now a major trading nation in the world. Its international trade grew at the average annual rate of 14.5 percent during the 1990-97 period (with the exception of 1996), and its trade dependence ratio increased from 29.9 percent in 1990 to 36 percent in 1997. In 1997, its exports and imports reached $182.7 billion and $142.4 billion, respectively.

*Pari passu* the rapid growth of China’s international trade, economic interdependence between China and Japan has also increased. Japan has become one of China’s major trading partners, accounting for 17.4 percent and 21.0 percent of China’s exports and imports, respectively, in 1997, and in terms of total value of trade Japan is China’s largest trading partner. (In 1997, Hong Kong and the United States accounted for 24 percent and 17.9 percent of China’s exports, respectively. Taiwan accounted for 11.7 percent, the United States 11.6 percent, Korea 9.0 percent, and Hong Kong 5.6 percent of China’s imports.)

China has also become Japan’s important trade partner, albeit not a major one yet. In 1997, when Japan’s exports and imports amounted to $422.9 billion and $340.4 billion, respectively, China accounted for 5.2 percent and 12.4 percent of Japan’s total exports and imports, respectively. The United States is still the largest trade partner for Japan, accounting for 27.8 percent of Japan’s exports and 22.3 percent of its imports.

Japan’s imports from China include food items (12.0 %), raw materials (3.5%), and mineral fuel (5.6%), but its largest imports are labor-intensive manufactured products such as textile and apparel (29.6%), machinery and equipment (20.9%) and metal products (4.5%). The largest of Japan’s export items to China is general machinery (23.9%), followed by electronic equipment (22.3%), textiles and apparel (11.7%), and metal products (11.2%).
The inflow of FDI to China has also increased at an astonishing speed since the late 1970s, especially in 1992 and 1993, and in 1994 it was four times as large as that for ASEAN-4 (Indonesia, Malaysia, the Philippines and Thailand). Japan is an important source of FDI for China, especially during 1990-94, which attracted much of the Japanese investment with its abundant supply of cheap labor and its potentially large domestic markets (Seki 1999). It is thus concentrated in industries such as food, textile, garments, chemical products, metal products, general machinery, electric machinery, home electronics, electronic equipment, and precision machinery. Textile-related industries have also attracted much investment by Japanese firms.

The pattern of Japanese FDI in China and the pattern of China’s subsequent export expansion are closely correlated, and this seeming linkage between Japanese FDI and Chinese exports resembles the linkage between Japanese FDI and manufacturing exports from ASEAN. Although long time-series data and detailed FDI data are necessary to obtain conclusive evidence on this linkage, there is already enough empirical evidence to support the hypothesis that Japanese FDI has contributed to the growth of the latter’s exports (e.g., Kreinin, Plummer, and Abe 1998).

Along with the expansion in China’s overall trade there have occurred significant changes in the commodity composition of trade, particularly in manufacturing exports. Exports increased rapidly in labor-intensive manufactures such as textiles, apparel, footwear, and toys and sporting goods, their share of China’s total exports growing from 29.6 percent in 1985 to 40.2 percent in 1990. Equally significant was a surge in exports of electrical equipment—mostly black and white televisions, radio receivers, telephone equipment, and domestic electrical
equipment, its share expanding from 2 percent in 1985 to 11 percent in 1990.

To demonstrate more clearly the changes in China’s trade pattern we calculated the revealed comparative advantage index (RCA) for forty-seven sectors for China and ASEAN for three different years (Table 3).  

[Table 3 here]

These calculations show that between 1987 and 1996 China made a significant gain in the number of industries in which it has a comparative advantage. What is more remarkable is that this increase was not limited to labor-intensive industries: China has also become internationally competitive in a number of capital-intensive industries.

A comparison with the ASEAN economies sheds light on the speed at which China’s trade structure has been changing. First of all, China’s RCA in all the labor-intensive industries has been increasing while ASEAN’s RCA in the same industries has been decreasing. China, for instance, increased its RCA in apparel from 4.77 in 1990 to 5.34 in 1996 while ASEAN found its RCA decreasing from 2.34 to 1.81 in the same period. Second, China has been increasing its RCA in a larger number of capital-intensive industries than ASEAN has been. Thus, in 1996, China had RCA greater than one in twenty-five sectors while ASEAN-4 had in only thirteen

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5 An RCA value for a product greater than one is taken to mean that the country has a comparative advantage in that product. Since it is calculated using the actual trade values which may be “distorted” by tariffs and non-tariffs, it may not be a true measure of a country’s comparative advantage. However, if we can assume that the level of trade barriers has not changed over the period that we consider, then changes in RCA can be taken to indicate changes in comparative advantage.
sectors. In other words, China now has a more diversified trade structure than ASEAN-4.

China has accomplished this diversification more quickly than its southern neighbors. Between 1987 and 1996 China increased the number of sectors in which it has RCA greater than one from 16 to 25 while ASEAN-4 increased the number from 5 to 13 between 1980 and 1996. In other words, it took only 9 years for China to gain 9 more sectors in which it has a comparative advantage whereas it took 16 years for ASEAN-4 to gain 8 more sectors. The relative rapidity with which China has been increasing the number of industries in which it has a comparative advantage may be an indication of the speed with which the Chinese economy is becoming industrialized and is replacing ASEAN-4 in the world markets for labor-intensive manufactured products.

The manner in which a group of the Asian economies have developed since the end of World War II has been described as the flying-geese pattern of development with Japan leading the Asian NIEs, which in turn were followed by ASEAN-4. The whole flock has made economic progress while each member has made successive shifts in comparative advantage by acquiring increasingly sophisticated technology from the more advanced economies of the world including Japan. In the late 1970s, China joined the flock at its tail end and since then has been catching up fast with other members of the group.

What is remarkable about China’s RCA changes is that China has become a major exporter of labor-intensive products in general as well as some capital-intensive products. This is consistent with the wild-geese-flying pattern of industrial development, according to which a developing country first exports crude and consumer goods and then exports refined and capital
goods. What is, however, different about China’s experience is that it seems to be gaining a comparative advantage in capital-intensive industries at a rapid speed and even before it begins to lose its comparative advantage in labor-intensive industries. A plausible explanation for that is that China is a dualistic economy with both a large pool of low-cost labor and an adequate pool of skilled labor capable of producing capital-intensive products. In other words, although China as a whole is still at an early stage of economic development it has a number of sectors such as electric and electronic products that are capable of and, in fact, are catching up rapidly with more advanced economies in the region.

IV Future Economic Development in China and Its Implications for Japan

Even though it is difficult to predict what the Chinese economy will be like as it enters the 21st century, the prospects for its continuing on a high-growth path are good as China appears to continue with its effort to introduce a rule-based society characterized by markets, private ownership, and pluralistic political institutions (Jefferson 1997). It is likely that China will continue to have relative stability, a high saving rate, a strong record of pragmatic reforms, a disciplined and literate labor force, a supportive Chinese Diaspora, and a growing administrative capacity—the strengths that have driven its economic growth for the last two decades of the 20th century (World Bank 1997).6

6According to The Economist (October 24-30, 1998, pp23-26) China’s economy is entering a period of sluggish economic growth (3-4 percent per annum). Such economic slowdown, plus an insolvent banking system and a sharp divide between the relatively wealthy parts of the country and the poor regions, could threaten China’s stability. Furthermore, unless it is reformed in a radical manner China’s ailing financial system will bring about a decrease in the rate of
If China’s saving rate is maintained at 35 percent (for 1978-95 its saving rate was 37 percent of GDP although more conservative estimates place it at 33-34 percent) and if its total factor productivity growth is maintained at 1.5 percent per year, which is deemed to be a reasonable estimate for China, its GDP growth will be 8.4 percent a year between 1996 and 2000 and will average 6.6 percent over the twenty-five years until 2020 (World Bank 1997).

What effect will such economic growth in China and the increasing diversification of its economic structure have on the Japanese economy? According to the World Bank report (1997), there will be high growth in demand for capital- and knowledge-intensive products growing at 8 percent per year accompanied with rapid growth in China’s exports of labor-intensive manufactured products. If that happens, Japan, being a major exporter of the first group of products, will gain from an improvement in its terms of trade. In fact, it is estimated that Japan would gain as much as 6.5 percent in its cumulative terms of trade by 2020 (4.0 percent for North America and 1.4 percent for Western Europe). China’s export growth in the second group of products--labor-intensive manufactured products--can possibly have an adverse effect on the jobs and income of unskilled workers in Japan, but this effect will be negligible for Japan since it long ago lost its comparative advantage in those industries and has successfully made the necessary structural changes.

Given its present stage of development and its large population it may be years before China joins the ranks of fully developed economies. According to the World Bank study cited

saving, which in turn will deprive China of the resources necessary to address its long-term environmental and other challenges (Lardy 1998).
earlier, for the foreseeable future the Chinese people will on average remain less well-educated than, say, the Indonesians or the South Koreans. It projects that by 2020 the number of years in secondary education per person in China will be 5.94 years whereas the number of years in tertiary education will be only 0.36 years per person. These figures do not compare favorably with 6.2 years and 1.59 years, respectively, for Indonesia and 6.44 and 6.75 years, respectively, for South Korea.

Given its large, currently not well educated population and given the huge human resource requirement for developing its own scientific and technological foundation China will thus remain for the foreseeable future a country with a comparative advantage mainly in the production of unskilled labor-intensive manufactured goods. But, that does not mean that China will for long be unable to develop in a select number of areas a sufficiently large pool of well-trained people to be able to exploit scale as well as agglomeration economies in research and development and thus develop technologically more sophisticated industries capable of international competition. In fact, China is already a country with “no shortage” of well-trained scientists, engineers, mathematicians, or other technical experts, and as its older researchers retire and are replaced by younger, Western-educated researchers China’s ability to absorb, assimilate, and innovate new technologies will grow (Yoshitomi 1996, Bureau of Export Promotion 1999).

To improve its technological capabilities China has also used industrial policies aimed at developing pillar industries such as automobiles, electronics, machinery, construction materials, and petrochemicals (Morrrison and Hardt 1996). These policies include numerous
provisions and mandates that require foreign investors to transfer technology as a condition for investment in China, and many high-tech foreign firms have in fact complied with the requirement by establishing a training or R&D center, institute, or lab with China’s premier universities or research institutes (Bureau of Export Promotion 1999).

There is another reason why China may soon succeed in moving up the specialization ladder, albeit in a limited number of areas, and that is what some call AGreater China. which includes individuals from the People’s Republic of China, Taiwan, Hong Kong, Singapore and the overseas Chinese in Southeast Asia and throughout the world (Lilley and Hart 1996). In fact, China has already benefited from being a part of Greater China as the foreign investors largely responsible for its present economic success are overseas Chinese. It is quite conceivable that with right incentives they can be induced to invest in the development of high-tech industries in China.

Nelson and Wright (1994) point out that in the period since the 1950s the economic and technological gaps among the major industrial powers has been dramatically closed, largely ending the leadership position held by the U.S. nearly for a century. They offer basically two reasons for this convergence--globalization of markets and the advent of science-based technologies. First, because of the decrease in transportation costs and drop in trade barriers the advantages of having large national markets and the access to cheap raw materials have been eroded. Consequently, even those firms that are located in a small, resource-poor economy can exploit the economies of scale and acquire raw materials at globally competitive prices.

Second, the advent of science-based technologies has significantly increased the extent to
which generic technological understanding is possessed by scientists and engineers. Many of such technologies are codified and thus more easily transferable across national boundaries and more generally accessible to those, wherever they may be located, with the requisite skills and willing to make the required investments.

Given these changes in market conditions and the nature of technology, a country which is willing and able to train at least a portion of its labor force and devote a sufficient proportion of its GNP to research and development will be able to import and utilize technologies from abroad as well as create new technologies. As a case in point, Nelson and Gavin cite the rapid speed with which the Japanese, the Koreans, and the Taiwanese learned to command American-made technologies during the 1970s and 1980s. Given what they have done, we see no reason why China will not be able to replicate, if not surpass, the record achieved by the newly industrializing economies in East Asia.

In fact, the World Bank study cited earlier projects that, by 2020, China will gain 8 percent in transport equipment and other machinery and 4 percent in highly capital-intensive heavy manufactured goods (chemicals, rubber, plastics, paper, iron and steel, nonferrous metal) while gaining 10 percent market share in light manufactured goods (leather, fabricated metal products, and miscellaneous manufactured products). If this projection is correct, China’s technological advance will present serious challenges to the Asian NIEs and ASEAN-4, the second- or third-tier countries in terms of technological development.

The growing technological capability of China and its abundant supply of cheap labor will make China an attractive host country for Japanese overseas direct investment. An
empirical study of Japanese FDI shows that the decline in the rate of return on capital as labor costs increase at home is a driving force for Japanese overseas investment in textile, chemicals, basic metal, machinery, electrical machinery, and transport equipment industries (Ogawa and Lee 1996). In other words, Japanese FDI is a channel through which its industries extend the economic life of vintage capital that becomes obsolete as new technology and products are developed in Japan. It is obvious then that, provided that China becomes a genuinely open economy, it will be an attractive location for Japanese investors who are seeking well-trained, low-cost labor. A detailed study of Japanese electronics investment in China also shows that although initially China attracted Japanese investment with its potentially huge domestic market for a wide range of electronics products it now has become an export platform production base for low-end assembly and simple components manufacturing, competing with Indonesia, India, Malaysia, South Korea, Thailand and Vietnam for Japanese investment (Ernst 1997).

V Concluding Remarks

Even though China has achieved spectacular economic development since its modernization that started in the late 1970s and continues to grow at a relatively high rate, it is not likely to become a fully developed economy by year 2020. Japan will still lead China and other Asian countries in technology and in capital goods, but with its sheer size and a potential for further economic growth China will play an increasingly important role in the region’s economic prosperity. It is likely that in place of the Japan-led flying-geese pattern of development of the second half of the 20th century there will emerge a new multi-polar East Asia with Japan and China as its major
China’s emerging as a major economy in East Asia will certainly have many positive effects on the region’s economic prosperity but it will also create problems of structural adjustment in its neighboring economies that are currently ahead of China in economic and technological development. It is highly unlikely that China will take over Japan as the leading economy in East Asia by 2020 although some of its leading industries may be able compete with their Japanese counterparts in the global markets. For the Asian NIEs and ASEAN-4, however, catching-up by China in the area in which they now have a comparative advantage is a strong possibility, and these economies will be faced with the serious and painful problems of adjustment and structural change. Obviously, structural adjustment will be easier and less costly if China opens up its economy, creating demand for exports from these economies. This is one very important reason why China should become a genuinely open economy and become an engine of economic growth and integration for the region. China’s ascension to WTO will only facilitate this process!

Another reason for China to open up its economy is that Asia needs China as well as Japan to be the region’s engine of growth. Japan is a country with a rapidly aging population with the possibility of becoming the most aged society in the world by 2020. This increase in the dependency ratio is expected to have a serious negative effect on the country’s saving rate. In fact, some studies on Japanese saving predict that by 2010 Japan’s net private saving will become negative (Mason and Ogawa in this volume). In comparison, China will be a young country in terms of its demographic distribution and can thus play a more dynamic role in the
region. Perhaps Japan may be surpassed by China as the leading economy in East Asia at some point in the distant future, but in the meantime an open and growing economy of China will revitalize the Japanese economy with its expanding markets for Japan’s sophisticated capital equipment and technologies.

Entering the 21st century, we thus have the possibility of having two engines of growth working together for the region’s economic prosperity. Obviously, for the two engines to move in a harmonious way a number of economic policies will have to be coordinated between China and Japan. Clearly, whether such policy coordination can exist between the two will depend on their political relations.

Up to 1992, Japan’s China policy was to support China’s modernization programs, its economic development, and its domestic stability. Since then, however, a series of developments have led to changes in Japan’s perception of China, and many in Japan now see China as being overbearing toward the region and, worse, as having territorial ambitions beyond the confines accepted during the Cold War (Soeya 1998). If this perception persists in Japan and if China begins to believe, as observed by Pryzustup (1996), that its economic success should restore it to its rightful place in Asia as the Middle Kingdom, the two engines of growth will be at loggerheads instead of working together. Thus what the 21st century will bring to the region will depend very much on how the region’s two major powers relate to each other politically. If, as remarked by Alaggapa (1998), a hierarchical order with a single center of power and authority is no longer tenable in East Asia, then China and Japan will have to come to terms with each other and learn to coexist, although historically unprecedented, as great powers in the region.
Only then we have the hope that with two locomotives together leading the other economies in the region the 21st century will turn out to be an age of prosperity for East Asia.
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