

## China's Hidden Obstacles to Socioeconomic Rebalancing

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# AsiaPacific

I S S U E S

**Analysis from the East-West Center  
No. 120  
October 2015**

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**S U M M A R Y** The global financial crisis of 2008–09 led to a policy consensus in China that its socioeconomic development model needed rebalancing. China's rapid development has been based on *extensive* growth reliant on exports, low wages, environmental exploitation, and the manufacturing of cheap products. China's current plans identify paths to economic rebalancing through *intensive* growth driven by rising investment in new technologies and manufacturing processes, improved wages and skills, and improved worker and environmental protections. Two industries, automotive and information technology, demonstrate the experience of and opportunities for rebalancing. Both offer improved employment conditions with better wages, but continue to incorporate large swaths of low-wage employment with little protection for workers' health and the environment. Economic rebalancing in China, therefore, has so far only appeared in pockets. Institutional safeguards for wages and labor standards remain constrained by powerful alliances among multinational corporations, Chinese state-owned/private enterprises, and the Chinese state.

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## Introduction

Following the 2008–09 global financial crisis a broad consensus emerged among Chinese and international policymakers and analysts: China’s development model needed substantial rebalancing. Overreliance on export-led growth, insufficient domestic demand (largely because of low wages), staggering income inequality, massive environmental pollution, and weak innovative capacities of indigenous firms were seen as key problems.

New priorities reflecting this consensus were laid out in China’s 12<sup>th</sup> Five-Year Plan (2011–15) and other documents. Policies focus on industrial upgrading, environmental sustainability, and further acceleration of urban development while “improving the Chinese people’s livelihood,” or social upgrading. At the core of economic rebalancing is a shift from *extensive* growth (with labor-intensive manufacturing of cheap products, low wages, and environmental exploitation) to *intensive* growth (with rising investment in new technologies and manufacturing processes, improved wages and skills, and improved worker and environmental protections).

Progress, however, has been slow on key issues. Important industries have developed technologically, while incomes have been rising. However, wages remain low for the majority of workers and income distribution is still highly uneven. Social conflicts, with recurring strikes in key industries, have been mounting as a result. And environmental pollution shows no signs of abating.

As China enters a “new normal” of slower economic growth, perceptions that the country’s socioeconomic development model needs substantial rebalancing are clearly on the increase. China’s domestic market will not likely absorb the recent massive build-up of industrial capacity. Rebalancing thus requires fundamental reorientations in industry growth models. Production-capacity expansion must be sustainable and incorporate new industry structures, innovation systems, and production regimes.

A lack of market competition and rule-of-law alone cannot explain the social and political forces that have impeded rebalancing so far. A more holistic view is necessary to recognize the changing power

relations among capital, state, and labor in China’s emerging model of capitalism.

Two of China’s largest, most advanced, and globally integrated manufacturing industries are automotive and information technology (IT).<sup>1</sup> Examining whether and how organizational, technological, and locational change have supported the shift from extensive growth (based on cheap labor, land, and resources) to intensive growth (with improved social, economic, and ecological sustainability) in these industries is instructive.

Powerful alliances among multinational corporations, Chinese state-owned/private enterprises, and the Chinese state have created pathways of development that are increasingly unsustainable in economic as well as in ecologic and social terms. A lack of institutional safeguards for wages, labor standards, and the collective representation of workers sustains low-wage strategies in core manufacturing industries. Economic rebalancing in China, therefore, exists only in pockets. Institutional safeguards for wages and labor standards have been created in a selective and highly segmented fashion, giving rise to fragmented industrial and social upgrading.

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## The Auto Industry: Refurbished State Capitalism Goes Global

China’s automotive industry has seen phenomenal growth since 2000. China is now the world’s largest producer of, and market for, cars. Development of capital-intensive growth followed the late 1990s downsizing of older state-owned carmakers and the loss of tens of thousands of jobs.<sup>2</sup> The industry is now dominated by joint ventures between state-owned Chinese and multinational carmakers. Growth in the industry, however, has been almost entirely driven by China’s domestic market while exports of finished cars remain insignificant.

Production networks for China’s automotive industry mirror the globally dominant model known as “lean production.” Highly modern, but relatively small, factories and assembly for first-tier components (such as engines and brake systems) form the core; pyramids of second- and third-tier parts manufacturers are at the periphery.

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Such divisions are not specific to China but are representative of today's automotive industry. In China this separates the joint ventures of state-owned and multinational carmakers (including first-tier suppliers) from the scores of lower-end parts suppliers with labor-intensive and often-polluting production methods.

Most lower-tier companies are privately owned, many by overseas Chinese entrepreneurs from Taiwan and Hong Kong. Whereas automobile-assembly factories are typically located in large industrial cities such as Shanghai, Changchun, and Wuhan, lower-tier suppliers are often located in rural or semi-rural districts. Shanghai's "auto city" in Anting district, for example, hosts the core factories of Shanghai Automotive's joint ventures with Volkswagen and General Motors as well as global first-tier suppliers such as Johnson Controls and Delphi. Most mid- to lower-end suppliers are located in Kunshan and other low-wage areas in neighboring Jiangsu province.

Local governments attract labor-intensive manufacturing by offering cheap land, tax breaks, and "flexible interpretations" of labor and environmental laws. Such regimes may be called "market despotism." Firms in these regimes sit at the bottom of global value chains and face enormous competitive pressures and market gyrations. Management's repressive control of low-wage migrant workers, enabled by many local Chinese governments, guarantees at least marginally profitable conditions for cheap manufacturing, thus sustaining market despotism.

This split between the large state-capitalist core companies at the top and the market despotism of smaller suppliers at the lower levels of supply chains is particularly visible in the work practices and employment conditions of the Chinese automotive industry. In joint ventures incorporating many of the globe's leading suppliers, relatively high wages, stable employment, and extensive training prevail. Wages in some of the joint-ventures are among the best for industrial workers in China. Most of the workers live in urban areas.

At lower levels, meager wages and poor working conditions become common. Base wages hover near the legal minimum while overtime and bonuses frequently provide 50 percent or more of incomes. The majority of workers in these second- and third-tier

companies are migrants with rural backgrounds and low levels of education.<sup>3</sup>

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### **The IT Industry: Global Production Networks and Indigenous Innovation**

After the late 1990s China's IT industry also pursued capital-intensive growth. Global-production networks, led by transnational brand-names (e.g., Apple, Cisco, and Dell), used large contract manufacturers, with no recognizable brands of their own, for manufacturing.<sup>4</sup> Most companies in these networks are based in Taiwan or the United States. The largest contract manufacturer, Foxconn, has annual revenues of US\$135bn and is the world's largest employer of manufacturing workers—with more than one million employees in China alone.

IT contract manufacturers are infamous for harsh labor practices. Foxconn's giant manufacturing complex in Shenzhen, for example, recorded during 2010 a series of tragic suicides of young migrant workers. The production model of IT mega-suppliers rests on low wages, cheap land and infrastructure, and violations of labor and environmental laws tolerated by local Chinese governments. The manufacturing workforce consists almost entirely of migrant workers from rural areas living in large factory dormitories. Similar to the lower-tier automotive suppliers, wages are based on minimum local requirements. Workers need extensive overtime to achieve monthly wages of roughly 3000 RMB (about US\$500).<sup>5</sup>

The IT business model results in distinct separations. High-tech development companies are at the top of global value chains. These companies are mostly located in Silicon Valley (California) and other global tech-industry centers. Manufacturers employing low-wage workforces are largely located in China and other emerging economies. Manufacturing is physically and geographically separated from innovation and product development—and higher wages. In key sectors of the IT industry—computers, mobile phones and other hand-held devices, servers, and network equipment—capital-intensive high-tech manufacturing goes along with low wages.

This model has, somewhat surprisingly, still helped China and other emerging economies to rapidly

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climb the technology ladder. Global brands have shifted some engineering work to Chinese and other emerging high-tech locations to make use of skilled and competitive, yet relatively cheap, engineering workforces. This has driven the growth of significant clusters of software, chip, and system design in Beijing, Shanghai, and Shenzhen.

Innovative Chinese brand-name firms have emerged in the computer and mobile-communications industries. Companies with global reach, such as Lenovo and Huawei, and newer competitors, such as Xiaomi, are leading this change. In striking contrast to the automotive industry, Chinese IT companies (with important help from Taiwanese chipmakers and component suppliers) have developed significant indigenous innovation capacities and are now challenging global-market leaders.

Much as their global competitors, Chinese IT firms rely on mass production “without factories.” Chinese contract manufacturing makes world-class capabilities available to global Chinese companies taking full advantage of tight supply chains and cheap labor. This matches the hierarchy of the global IT industry. Domestic flagship companies employ mostly Taiwanese-owned factories capable of labor-intensive flexible manufacturing.

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**Refurbished State Capitalism...**

Analysts have described the massive stimulus used to jump-start the Chinese economy following the 2008–09 global financial crisis as the revival of state capitalism in China. As traditionally understood, state capitalism involves primarily state-directed economic development with private capital and markets playing a minimal role. Many observers believe that top-down, state-directed modes of governance have been further amplified in China after 2008.

The true picture, however, is not so simple. State capitalism in contemporary China differs from traditional conceptions of state capitalism.<sup>6</sup> It coexists with massive private entrepreneurship and global economic integration. As a dynamic force that is constantly remaking and renewing itself, it may be referred to as “refurbished state capitalism.” This form of state capitalism combines state-directed

development with development powered by global- and domestic-network capital as well as by gradually strengthening market forces.<sup>7</sup> Indeed, China’s refurbished state capitalism is both in symbiosis with and juxtaposed to market despotism and network capitalism.

This complex situation suggests that refurbished state capitalism is only one among several development modes in China. Since there are significant variations in how these modes of development interact, pronounced differences across industries and regions exist. Correspondingly, throughout the 2008–15 period, the pace of change in power relations within industries and in industry-government relations has varied.

In the automotive industry, the dominant joint-ventures between state-owned Chinese automotive holding companies and global carmakers form a globalized state-capitalist framework. Only China’s emerging independent carmakers, such as Geely, Cheery, and BYD, are under private or semi-private ownership. Similar to their state-owned counterparts, they have sought to enter alliances with global carmakers and investors. Nonetheless, when compared to the enormous capital invested in joint ventures, these independents remain on the fringes of China’s automotive industry.

Viewed simply in terms of production, following 2008 the globalized state-capitalist framework became even more dominant. Major state-owned groups reaped enormous profits from selling foreign-branded Chinese-made cars. These Chinese state firms, however, remain strategically restricted. They are holding companies with weak indigenous-innovation capacities, despite two decades of government policy envisioning Chinese state-owned carmakers developing competitive indigenous car brands. In contrast to the state firms, private Chinese carmakers and electric-vehicle makers have been innovative. Unfortunately, their efforts to develop Chinese-branded automobiles that meet the needs of Chinese consumers have been limited by the increased sale of foreign-branded cars. In fact, China has acted as a sort of safety valve for over-capacities in mature markets, primarily Europe, since the early 2000s. Global brands developed Chinese markets to absorb their

overproduction, generating intense competitive pressures on indigenous carmakers.

Despite their weak innovation, Chinese state-owned carmakers took financial advantage of the 2008–09 crisis. They emerged as shareholders and sometimes rescuers of well-known European and US car brands. Beijing Automotive became a major shareholder in Daimler-Benz while state-owned Dongfeng Motor Corporation invested three billion euros in PSA Peugeot Citroën, France's leading carmaker. State-owned carmakers thus became strategic partners of foreign multinationals seeking to expand into developing Asian markets.

These state-capitalist alliances, intermingling Chinese state capital with global automakers, continue to dominate China's automotive industry. China's state-coordinated automotive capitalism is refurbishing itself, globalizing and marketing, while maintaining its leadership.<sup>8</sup>

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### **..Versus Network Capitalism**

China's IT industry is different. State-owned enterprises play only minor roles. Hybrid companies with mixes of domestic private, institutional, state, and private overseas capital (much from Taiwan and Hong Kong) lead in this sector. Innovation is embedded in this global industry of network-based mass production for which China is now the dominant location. Global IT production networks are directed by three groups: mostly US-based brands (e.g., Apple and Cisco); large-scale contract manufacturers and first-tier component suppliers, most of them from Taiwan (e.g., Foxconn and Quanta); and emerging Chinese multinationals with hybrid ownerships (e.g., Huawei and Lenovo).

Relationships among emerging Chinese multinationals resemble the decentralized cooperation which emerged in the 1990s in high-tech centers such as Silicon Valley. The Chinese form of network capitalism, however, depends on extensive relationships with all levels of the Chinese government.

Chinese high-tech companies and their multinational partners are heavily involved in national-level politics of technology development, regulation, and standardization. The IT field is also increasingly

relevant to national defense and cyber security. Additionally, as major markets for equipment and software, giant state-owned telecommunications companies such as China Telecom and China Mobile are key players in IT. At the local level, the growth of large clusters of software, component, and chip-development companies is promoted by activist city governments.

To a much larger extent than in the automotive industry, however, low-wage assembly continues to form the backbone of industry-wide supply chains. With large contract manufacturers such as Foxconn, capital-intensive high-tech manufacturing is combined with low wages and extremely flexible employment conditions. At the lower end, similar to the second- and third-tier auto-parts suppliers, countless firms produce such IT components as connectors, cables, and metal parts. These suppliers typically cluster where local governments are not proactive in upgrading their local industrial base. Rather, these governments offer lax oversight and "flexible interpretations" of laws and regulations to attract investors, facilitating regimes of labor-intensive low-wage production.<sup>9</sup>

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### **Drivers of Change:**

#### **Environmental Crises and Labor Unrest**

Time for Chinese policymakers to strategize and maneuver seems to be running out. Looming environmental crises and increasing labor unrest are already driving changes with myriad consequences.

Extreme air pollution is forcing major cities to curb the use of private cars through black-out days for certain car numbers and by limiting license plates for combustion-driven cars. At the same time, government agencies are promoting new-energy vehicles with tax breaks, increasing battery-charging stations, and issuing unlimited license plates for electric vehicles. Such policies damage the vested economic interests of national and local governments as shareholders of major state-owned auto companies. Conflicts of interest are evident where cities such as Beijing, Shanghai, and Guangzhou must limit combustion-driven cars on their streets to control pollution yet own parts of major traditional automakers.

Labor unrest is another issue. Historically, labor conflicts in the automotive industry have mostly

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*Countering this institutional sclerosis is the increasing enforcement of competition and transparency rules*

occurred in manufacturing sites along the eastern coast, e.g., the month-long strikes in 2010 in the automotive-supply industries of the Pearl River Delta. These highly publicized labor conflicts triggered significant wage increases, better enforcement of minimum wages, and a tepid start for collective bargaining in a number of regional auto-parts factories. However, huge differences in working conditions between low-wage auto-parts suppliers and large joint-venture automobile-assembly factories remain.

Labor unrest is also significant in the IT industry. In older locations of IT manufacturing, such as the Pearl River Delta, a wave of plant relocations sparked numerous strikes in 2011 and 2012. Labor unrest is even more obvious in the hastily set up mega-factories of central and western China. Foxconn's new plants in Zhengzhou, Wuhan, and Taiyuan (each with more than 100,000 workers) saw riot-like confrontations between workers and supervisors over issues of factory discipline in 2013 and 2014. In Chongqing, where workers staged a series of strikes in early 2014, reports emerged that six workers at a Foxconn plant committed suicide that year.

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**From "Rule of Law" to Institutional Reform?**

Public protests over pollution and worker unrest express the enormous pressures faced by Chinese policymakers as the country enters a period of slower economic growth. Current anti-corruption and "rule of law" campaigns demonstrate how socioeconomic regulations have atrophied under attacks from industry and government interests fostering corruption and weak governance.

Countering this institutional sclerosis is the increasing enforcement of competition and transparency rules. The National Development and Reform Commission (NDRC) and other national government agencies, for instance, have assumed new roles as industry watchdogs. This step could help separate market, product, and environmental regulation from the influence of corporate and state economic interests.

In the automotive industry, carmakers not complying with CO<sub>2</sub> emission standards have been named and cited. Competition has been supported by investigations into price fixing by major carmakers. Senior

Chinese managers of leading joint ventures, including those with Audi and BMW, have been charged with corruption. Xu Jianyi, chairman of state-owned First Automobile Works, was removed from his position and is under investigation for corruption.<sup>10</sup>

The IT industry has seen similar crackdowns on price fixing and consumer fraud by such global brands as Apple and US chipmaker Qualcomm. Rising stars within the Chinese high-tech industry, including Alibaba, have recently been investigated. Less visibly, the national government has also cracked down on government subsidies encouraging electronics manufacturers to relocate to central- and western-China. The State Council ordered the governments of Chengdu and Chongqing to end subsidies and tax incentives for relocated plants of Foxconn, Quanta, and other IT mega-suppliers.<sup>11</sup>

The "rule of law" campaign has led to better enforcement of labor laws. Following an explosion at an auto-supply factory in Kunshan, Jiangsu province, the national government took charge and began a major investigation. As a result, the party chairman and the mayor of Kunshan were removed from their offices while the Taiwanese owner of the company was taken into custody.

In the IT industry, the head of the legal department of the All China Federation of Trade Unions publicly criticized Foxconn for its ongoing violations of overtime and working-condition rules.<sup>12</sup> This is the first open criticism Foxconn has faced from China's official trade union.

Enforcement of existing laws alone will not end reliance on cheap labor. Exploitation of low-wage workers has become central to the production systems relied upon by the world's most technologically advanced manufacturers. This exploitation is core to China's manufacturing economy and a practice that will prove difficult to end.

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**Conclusion**

The financial crisis of 2008-2009 triggered a massive state-guided stimulus that rapidly reinvigorated the Chinese economy. Its longer-term consequences, however, have been less positive. Negative results include industrial overcapacity, a real-estate glut, and missed

***Middle-class concerns with environmental pollution and worker unrest have triggered limited reforms***

opportunities for addressing long-standing problems including insufficient domestic demand, large social inequalities, environmental pollution, and limited innovation from indigenous firms. The “new normal” of slower growth has highlighted how little progress has been made since 2008.

Strategies of major industries, successful since the late 1990s, are now proving difficult to displace and modernize. Despite technological upgrading, the growth of manufacturing industries remains characterized by volume manufacturing outsourced to networks of subcontractors. These networks utilize highly segmented assembly work with flexible and mostly low-wage employment conditions.

Industry alliances controlling these suppliers are politically influential. Joint ventures of global car-makers and Chinese state firms are deeply embedded in party-state politics. Similarly, de facto alliances of multinational brand-name firms, Taiwanese contract manufacturers, and new Chinese multinationals now dominate in the IT industry. While these alliances involve mostly private- or hybrid-owned Chinese firms (e.g., Huawei, Xiaomi, and Alibaba), they still exert considerable influence over government decisions and now rival the influence of major Chinese state-owned conglomerates in more traditional industries.

True institutional reform driving industrial and social advances requires controlling these alliances of vested interests with their dependence on low wages and lax environmental protection. While China is rapidly improving technology and productivity, industry pyramids in both automotive and IT manufacturing continue to depend on extensive growth. Reliance on plentiful, docile, and cheap labor; weak environmental controls; and limited social safety nets remain the hallmarks of Chinese industry, including within some of its most advanced sectors.

Despite the continuing dominance of industry alliances, their development is coming under increasing pressure from slower growth. Middle-class concerns with environmental pollution and worker unrest have triggered limited reforms. In 2014, Guangdong province, hosting the largest number of migrant workers in low-wage industries within China, enacted new guidelines supporting collective bargaining. Guidelines now define collective bargaining between trade

unions elected by workers and factory management as the norm. While this regulation fails to establish any right to strike, strikes in contemporary Guangdong are accepted as facts of life. Such changes are recognized as legacies of the 2010 auto-supplier strikes, the first time an industry-wide workers’ movement confronted companies and governments.

Nonetheless, piecemeal reforms are unlikely to drive industrial upgrading to sustain social upgrading. Sustained social improvements require far-reaching reforms of labor laws, labor markets, and migration regulations. Reforms of worker-training systems and transforming trade unions into organizations genuinely representing employee interests could create the basis for fundamental reforms. Collective representation and negotiations on key social and distributive issues would speed the end of low-wage manufacturing and modernize labor-intensive industries by leveling the playing field between first-tier brands and lower-end suppliers.

As current policies of the Chinese leadership still lack strategies to integrate industrial upgrading with enhanced social and environmental protections, time for effective rebalancing could be running out. Alliances between multinational corporations, Chinese state-owned/private enterprises, and the Chinese state are continuing to foster overinvestment in production capacities. This unsustainable growth is driving deflationary pressures that could potentially trigger industrial bankruptcies and concomitant debt problems.

Without doubt, the joint-ventures of state-owned Chinese and global-brand-name corporations along with the technology-intensive indigenous IT corporations have created a substantial “labor aristocracy” with high pay and decent working conditions. This fortunate group coexists, however, with the lower-wage workers powering manufacturing suppliers. As a consequence of this segmentation, higher paid groups of workers are constantly threatened by outsourcing to production manufacturers employing lower-wage workers particularly as such businesses tend to skirt environmental and labor safeguards.

China’s efforts at economic rebalancing have so far merely created pockets of intensive growth. Institutional safeguards for wage incomes and labor standards are present in a highly segmented and selective

fashion, giving rise to a fragmented picture of industrial and social upgrading. Regimes of refurbished state capitalism and large-scale global capital at the top of production chains coexist with market despotism at the lower ends. While pressures are mounting to

find new ways of intensive, resource-light, “innovation-driven development,” broader policy efforts to foster regulation in key industries, to create better workplace regimes, and to fashion environmentally sustainable growth patterns remain at best a work in progress.

## Notes

<sup>1</sup> Both sectors have been extensively researched since 2010 in a joint project of the East-West Center and the Frankfurt Institute for Social Research, as well as in previous projects of these two partners. The current project is *Rebalancing China's Emergent Capitalism: Socio-Economic Regulation in the Wake of the Global Economic Crisis* and it is funded by the German Research Foundation (DFG) under grant no. LU 509-7/1. Unless otherwise referenced, this article is based on field data from this project (which included more than 100 interviews with industry, government, and trade-union experts).

<sup>2</sup> For detailed analysis see Boy Lüthje and Miao Tian: “China’s Automotive Industry: Structural Impediments to Socio-Economic Rebalancing,” *International Journal of Automotive Management and Technology* 10, no. 3, vol 15, 2015.

<sup>3</sup> For a systematic analysis see Boy Lüthje, Siqi Luo, Hao Zhang, *Beyond the Iron Rice Bowl: Regimes of Production and Industrial Relations in China* (Frankfurt/New York: Campus Publishers, 2013).

<sup>4</sup> For an extended analysis see Boy Lüthje, Stefanie Hürtgen, Peter Pawlicki, and Martina Sproll, *From Silicon Valley to Shenzhen: Global Production and Work in the IT Industry* (Lanham, MD: Rowman & Littlefield, 2013).

<sup>5</sup> Ibid.

<sup>6</sup> For a theoretically expansive treatment of the concept of state capitalism and its contemporary applications see Christopher A. McNally, “The Challenge of Refurbished State Capitalism: Implications for the Global Political Economic Order,” *Der Moderne Staat (The Modern State)* 6, no. 1 (June 2013): 33–48.

<sup>7</sup> The essence of this form of capitalism—Sino-capitalism—is the dialectical interplay of top-down state-led capital accumulation juxtaposed with bottom-up networked and globalized modes of accumulation exposed to intense market pressures. See Christopher A. McNally, “Sino-Capitalism: China’s Reemergence and the International Political Economy,” *World Politics* 64, no. 4 (October 2012): 741–76.

<sup>8</sup> Christopher A. McNally, “Refurbishing State Capitalism: A Policy Analysis of Efforts to Rebalance China’s Political Economy,” *Journal of Contemporary Chinese Affairs*, no. 4 (December 2013): 45–71.

<sup>9</sup> *Beyond the Iron Rice Bowl*.

<sup>10</sup> *Automotive News China*, March 16, 2015.

<sup>11</sup> *Digitimes*, December 23, 2014.

<sup>12</sup> *South China Morning Post*, February 3, 2015.

## About this Publication

The AsiaPacific Issues series reports on topics of regional concern.

**Series Editor: Elisa W. Johnston**

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ISSN: 1522-0966

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