the WHARTON ASIA ECONOMIC REVIEW

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MICHAEL SIMEONE

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DR. AVERY GOLDSTEIN

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Needed Economic Reforms in China and the Role of the Exchange Rate

Liberalizing the exchange rate of the Renminbi will lead to benefits for China's monetary policy, its financial sector and macroeconomic imbalances, outweighing the costs of transitioning to a flexible exchange rate.

Michael Simeone

INTRODUCTION

The entire world, developed and undeveloped alike, looks at China with a sense of wonder. In recent years, scholars have rushed to explain China's growth in terms of neo-liberal economics and modernization theories. China is unique not in what reform measures it has undertaken, but in how these reforms have been implemented. Since Deng Xiaoping began economic reforms in the late 1970s, reform has taken on a uniquely incremental character (Naughton 2007). Slow liberalization of trade and investment began in isolated Special Economic Zones (SEZs), before expanding to other areas of China (Naughton 2007). Similarly, true market incentives were first introduced in rural areas, operating as a second "track" of China's economy through the 1980s (Naughton 2007). Eventually, township and village enterprises (TVEs) were allowed to compete with state-owned enterprises (SOEs), and China's "dual track" economic system converged on market orientation with prices determined by the forces of supply and demand (Naughton 2007). China's accession to the World Trade Organization in 2001 signified further acceptance of the developed world's liberal economic agenda. China agreed to lower tariffs and liberalize its service sector, among other concessions (Lardy 2002). Thus, while China's ascent to a position of global power has been meteoric, its strategy regarding specific reforms has been more gradual.

China's newfound global importance has thrust its domestic policies into the international spotlight. On issues of labor rights, human rights, trade openness, and environmental protection, the Chinese Communist Party (CCP) has seen its policies face constant scrutiny from abroad. This is inevitable; in an increasingly interconnected global economy, policies are more salient and their repercussions are felt more strongly worldwide than ever before. China is not alone in facing scrutiny, but has been uniquely reluctant to acquiesce to foreign wishes. This is especially true regarding matters seen by the CCP as related to economic growth. The CCP regards continued economic growth as the means by which social stability can be maintained; this is perhaps most evident in its policies toward SOEs during the 1990s (Naughton 1995). By allowing for large losses of employment, or even a stifled growth in the creation of new job opportunities, the CCP leaves itself vulnerable to the erosion of its power by creating social discontent. For this reason, among others, China has been slow to respond to pressures for policy change; the pragmatic, growth-oriented CCP tends to resist reforms that it sees as potentially detrimental to the domestic economy.

This strategy manifests itself in China's exchange rate management. Since early 2009, China has pegged the Renminbi (RMB) to the United States dollar at a rate of roughly 6.83 Yuan per dollar (International Monetary Fund 2010)[1]. A currency peg refers to a policy in which a country maintains a constant value of its currency against a specific foreign currency or a basket (collection) of foreign currencies. This value is maintained through massive purchases and sales of the involved currencies on the foreign exchange market (Hubbard and O'Brien 2010). Technically, the RMB is pegged to a collection of currencies, including the US Dollar and the Euro; empirically, the US Dollar is seen to be the most heavily weighted currency in the basket (Frankel 2010). A vast plurality of economists contends that this policy results in an undervalued RMB, meaning that Chinese exports are artificially inexpensive relative to other countries' (Goldstein and Lardy 2008). The CCP appears to regard export competitiveness as imperative to its continued economic, and therefore political success. This is consistent with the characterization of the CCP discussed above; steady economic growth is seen to be a guarantor of social stability. An exchange rate regime that promotes Chinese exports is, unsurprisingly, a cornerstone of CCP policy.

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[1] Note: This paper will refer to the general currency as Renminbi and specific values as Yuan.

There is wide debate about China's exchange rate. Some scholars contend that a fixed exchange rate is appropriate and that its effects on trade imbalances have been overstated. David D. Hale and Lyric Hughes Hale, for example, argue that revaluation of the RMB is unimportant when compared to the challenge of fully integrating China into the global economy. (Hale and Hale 2008) China's exchange rate regime is not without detractors. Critics contend that China's exchange rate policy amounts to nothing more than a subsidy for its exports at the expense of producers and employment prospects abroad (Krugman 2010).

A public showdown has emerged in the past few months as the United States has taken the lead in criticizing China's exchange rate regime. China's leadership, through Prime Minister Wen Jiabao, has been characteristically stubborn, publicly rebuking the United States: "I understand some economies want to increase their exports, but what I don't understand is the practice of depreciating one's own currency and attempting to force other countries to appreciate their own currencies, just for the purpose of increasing their own exports." (New York Times 14 March 2010, A2) The issue has reached somewhat of an impasse, with Treasury Secretary Timothy Geithner announcing that the Treasury will delay a decision on whether to declare China a "currency manipulator". (New York Times 2 April 2010, A10) Still, with the United States in a feeble recovery from its worst recession in decades, the debate over exchange rate policy will inevitably return to the headlines.

This paper will begin with an overview of China's exchange rate policies since 2005. It will proceed to place China's exchange rate regime in the context of a broader domestic macroeconomic picture. An analysis of Japan's experience with exchange rate pressures in the 1980s will be examined, and policy conclusions will be applied to China's present situation. This paper will end with a discussion of China's need for further economic reforms, arguing that it may actually be in China's best economic interest to liberalize its exchange rate regime, regardless of outside pressure to do so.

EXCHANGE RATE POLICY SINCE 2005

By 2005, China had pegged the value of the Renminbi to the United States Dollar at a value of 8.27 Yuan per US Dollar for over a decade (IMF 2010). A currency peg is often used by developing countries for a number of reasons. First, a fixed exchange rate imposes discipline on a country's central bank; the bank will not be able to print excessive amounts of money, reducing the risk of extreme inflation. Second, a fixed exchange rate reduces costs and uncertainty in international transactions. (Sachs and Larrain 1999, 81-82) For China, the latter is a more convincing benefit; China's growth is led by exports, and a high premium is placed on stability and low cost of exchange in order to facilitate easy exports. Of course, an added caveat in China's case must be that it enables the Chinese leadership to maintain an undervalued currency.

China's currency policy changed significantly with a July 21, 2005 announcement by the People's Bank of China of a new stance on exchange rate valuation. The new regime would include an immediate 2.1 percent appreciation of the RMB and allow for greater exchange rate flexibility by transitioning to a "managed float" (Ito 2008). The new policy diverged from its predecessor in that, rather than peg the RMB exclusively to the US Dollar, the RMB would float against a basket of currencies, each with a different assigned weight based on importance (Ito 2008). Under a managed float, the RMB was allowed to appreciate or depreciate by 0.3 percent each day, based on market forces. The closing exchange rate for one day would be the central parity for the next, around which the currency would be allowed to move by +/- 0.3 percent (Ito 2008). The effect of this policy was a 17 percent appreciation of the RMB against the US Dollar from 2005 to 2008. In mid-2008, however, China abandoned its managed float, reverting to a pegged exchange rate regime (Schott 2010). This policy change was not announced, but was gradually introduced by assigning progressively more weight to the US Dollar in the basket (Schott 2010). The basket of currencies used to value the RMB includes the US Dollar, the Euro, the Japanese Yen, and the Korean Won. By mid-2008, however, it became apparent that nearly all of the weight in the basket was assigned to the US Dollar (Ito 2008). Since then, the bilateral exchange rate between China and the United States has been roughly 6.83 Yuan per US Dollar (IMF 2010).

While much of the media's attention has focused on bilateral exchange rate tensions between the United States and China, currency valuation is truly a multilateral issue. A metric for evaluating a currency's value relative to the world's other major currencies is the Real Effective Exchange Rate (REER). The REER is the weighted value of a currency relative to other major currencies, adjusted for inflation. During the period of 2005 to 2009, China's REER depreciated by about 23 percent (IMF 2010). For the most part, this reflects a weakening Dollar over the same period because its value was followed closely by the RMB. Nonetheless, the REER of the Renminbi reveals that China's exports have grown increasingly competitive with those of other nations, even excluding the United States. While the bilateral relationship between the RMB and US Dollar has reduced China's export competitiveness vis-à-vis the United States since 2005, a declining US Dollar has preserved China's international competitiveness, as shown by the REER.

CHINA: A MACROECONOMIC PICTURE

Growth

Put simply, gross domestic product (GDP) growth rates in China have been astounding. Since 1995, GDP growth rates in China have averaged about 9.6 percent (World Bank 2010). This is especially impressive when one considers the context in which this growth was achieved; the Asian Financial Crisis crippled many East Asian economies in 1997 and 1998. The United States, an important importer of Chinese goods, faced a recession in 2001. Furthermore, Chinese economic growth has continued through the present worldwide financial crisis. For the purposes of this paper, it is important to consider the composition of Chinese GDP growth. Included in GDP calculations are household consumption, investment, government expenditure, and net exports (Hubbard and O'Brien 2010).

> "These low interest rates encourage enterprises to reinvest profits in production or asset speculation, potentially leading to problems of industrial overcapacity or asset bubbles"

Investment, as measured by Gross Fixed Capital Formation, has increased from 34 to 42 percent of GDP since 1995 (World Bank 2010). In the same period, foreign investment averaged around 4 percent of GDP (Naughton 2007). This implies that private savings finances the vast majority of investment in the Chinese economy. Indeed, by 1995 private savings accounted for 70 percent of total savings in the economy, and was trending upwards (Naughton 2007). With this information in hand, it is possible to conclude that investment contributes significantly to GDP growth in China, and that it is largely funded by private savings. The vehicles for savings will be discussed below.

High rates of savings imply, among other things, low rates of consumption. Both households and enterprises in China save at unusually high rates, shifting demand for consumption abroad (Hofman and Kuijs 2008). In fact, government expenditure has accounted for over half of consumption's share of GDP over the past 20 years, as opposed to 10-20 percent in most OECD countries (Penn World Tables 2010). The slack in domestic demand is picked up overseas, as evidenced by China's large trade surplus, which stands at over $300 billion today (IMF 2010). Based on the above data, one can infer that the composition of Chinese GDP is quite unbalanced. The Chinese economy relies heavily on both domestic savings and foreign demand for exports.

The Current Account

With a current account surplus of over $400 billion in 2008, China is the world's largest holder of foreign assets (World Bank 2010). The main contributor to China's massive current account surplus is its trade balance, which reflects a country's net exports. The value and volume of China's exports greatly exceeds those of its imports. As explained above, its large trade surplus is indicative of China's unbalanced economy; high rates of savings displace consumption, making investment funds readily available and more attractive.

In accumulating such extraordinary amounts of foreign capital, the People's Bank of China must sterilize the capital inflows. Sterilization is a method by which a central bank mitigates the potential negative effects of large capital inflows: inflation and currency appreciation. Typically, this is accomplished by issuing central bank paper through open market operations in an attempt to remove excess money supply from the domestic economy (Prasad 2008). The large supply of central government paper pushes domestic interest rates in China lower. These low interest rates encourage enterprises to reinvest profits in production or asset speculation, potentially leading to problems of industrial overcapacity or asset bubbles (Prasad 2008).

China's Financial System

The financial system in China remains underdeveloped. The four largest banks in China hold over half of the country's financial assets, and are still under majority ownership of the state. Until 1997, the state directly and openly influenced banks' lending decisions (Naughton 2007). Over the past two decades, banking reform has progressed slowly, with the introduction of an independent regulatory body in 2003 and allowing strategic foreign investors and foreign competition in the banking sector in 2004. However, imprudent lending decisions and a lack of risk management continue to plague China's banks (Naughton 2007).

Stock markets in China are also inadequate. The vast majority of listings on China's stock exchanges are SOEs, and listing opportunities are reserved for the most politically connected enterprises (Naughton 2007). While there have been efforts in recent years to reform the stock markets, the government still holds a significant portion of shares. Furthermore, shares are segmented into different categories based on currency denomination and availability, causing inefficiencies in pricing and information gathering. Contestability of corporate control remains elusive, insulating corporate governance decisions from shareholders' influence (Naughton 2007).

Many economists are highly critical of China's financial sector. As Daniel Rosen and Yam Ki Chan argue, too much credit is directed toward SOEs at the expense of small and medium sized enterprises (SMEs). They write, "…large firms employ 25 percent of the labor force and contribute 45 percent of GDP, but use 84 percent of total bank loans to do so" (Rosen and Chan 2009). Because very few Chinese firms enjoy stock market listings and bond markets are underdeveloped, bank financing remains the sole means by which many firms, especially SMEs, can raise funds. The fact that bank financing almost exclusively favors large, state owned firms further complicates SME financing. Larger firms also tend to be more capital-intensive, meaning that the employment creation per dollar spent is relatively low. In fact, rates of employment growth lag significantly behind rates of GDP growth, reflecting the way in which capital is often diverted away from employment-creation (Hofman and Kuijs 2008).

Therefore, inefficiencies in China's financial sector tend to exacerbate the structural imbalances discussed above. Profits are retained and reinvested by firms because low interest rates and inadequate investment opportunities make the financial sector unattractive (Prasad 2008). Financial sector flaws also adversely affect household consumption. Bank deposits remain one of the few viable savings vehicles for households, and offer low returns. Furthermore, credit allocation to larger firms hurts employment prospects. In fact, household income has actually been declining relative to GDP in recent years (Godement 2010). It is evident that the structure of China's financial sector has important consequences for the nation's economic imbalances. This paper will argue that financial sector reform, structural rebalancing, and exchange rate reform are all intricately connected in the broader economy.

"Factory to the World"

While public discourse focuses on the bilateral exchange rate between China and the United States, China's trade picture is much more complex. China is part of a complex production network in the Pacific region. Many producers in the region export intermediate goods to China for processing. With these countries, including Australia, Malaysia, Korea, Taiwan, and Thailand, China's imports exceed its exports (Garcia-Herrero and Koivu 2010). Such trade deficits are the result of various factors, depending on the country. In Korea, for example, exports to China are composed of high-value electronics, while imports are typically lower-value manufactured goods. Much of Korea's exports to China are in the form of intra-firm trade; computer processors are exported to China for assembly with other intermediate goods, and are then exported worldwide from China. Conversely, China's trade deficit with Malaysia stems from Malaysian exports of low-value goods, and little demand in Malaysia for the consumer goods exported from China.

This expanded view of Chinese trade has numerous implications for trade in the event of an exchange rate revaluation. China's exports, in the context of a regional production network, are better defined as complements to rather than substitutes for other Asian nation's goods (Garcia-Herrero and Koivu 2010). In considering changes in China's real effective exchange rate, then, one must view China's exports as both substitutes and complements, both regionally and globally. The implications of a more nuanced understanding of China's trade relations will be explored below.

MONETARY POLICY AND ECONOMIC OVERHEATING: AVOIDING ASSET BUBBLES

Recent reports have hinted at the possibility of an emerging asset price bubble in many Chinese regions (Reuters 21 April, 2010). The emergence of asset price bubbles is the result of a confluence of factors in China's economy. First, as explained above, many firms use retained profits for speculative investments because financial instruments with high returns are absent in the financial sector. Second, the CCP responded to the 2008 financial crisis with massive stimulus efforts (Rosen and Chan 2009). Rosen and Chan write: "The 7.4 trillion yuan of new lending pumped through the banks in the first half of 2009 equals more than three times the amount in the same period last year and 50 percent more than all of 2008." This government-directed easing of credit flowed through China's banks to eager borrowers, worrying Rosen because "China's state-owned banks have never been the best allocators of credit" (Rosen and Chan 2009).

"Because it effectively maintains a fixed exchange rate, China cannot raise interest rates appreciably without triggering large inflows of foreign capital"

Expanded credit availability is a crucial ingredient in fueling a speculative bubble. Asset price inflation can typically be counteracted through monetary policy; in the face of an asset bubble, a central bank will tighten monetary policy, easing speculation. China, however, has less room to maneuver. Because it effectively maintains a fixed exchange rate, China cannot raise interest rates appreciably without triggering large inflows of foreign capital (Prasad 2008). If a large inflow of capital were to occur, China would have to rely on extensive sterilization to remove the excess supply of funds from the banking system. While capable, the People's Bank of China (PBOC) would face an extraordinarily difficult task in maintaining appropriate levels of money supply. (Prasad 2008). Therefore, in managing prices and credit allocation, the PBOC's policy responses are significantly constrained by its fixed exchange rate obligations.

A FORWARD-LOOKING CCP? JAPAN IN THE 1980S

Before examining an appropriate exchange rate policy for China and its broader requirements and benefits, it is useful to analyze a relevant example of diplomatic pressure with regard to currency valuation. Alexander Gerschenkron, in his seminal paper "Economic Backwardness in Historical Perspective," discusses the conditions facing developing countries and the sources of their development strategies. By examining European industrialization in the 19th century, he concludes that while each developing country will create some distinctive institutions, they also look to the developed world for examples of success (Gerschenkron 1966). Gerschenkron's notion of forward-looking developmental strategy is highly applicable to China's stance on exchange rate policy. In considering a change in policy stance regarding the RMB, the CCP is undoubtedly looking to Japan in the 1980s as an example. This argues, however, that the CCP may be drawing the wrong conclusions.

In the 1980s, the US Dollar was exceptionally strong relative to the currencies of its main trading partners, Japan and Germany. This was mostly due to the high interest rates set by Paul Volcker and the Federal Reserve in the early 1980s to combat inflation. US officials were worried about the trade implications of an overvalued dollar, and diplomatically pressured Japan and Germany to participate in a solution (Flath 2005). In 1985, representatives of the United States, Germany, and Japan reached an agreement in which Germany and Japan committed to a revaluation of their respective currencies against the dollar. In the year following the September 22, 1985 agreement, the Yen appreciated 45% against the dollar (Corbett and Ito 2010).

There are clear parallels between Japan in the 1980s and China today. Japan, like China at present, was emerging as a global economic power. Its rise fascinated the developed world, and its economy became a significant source of export goods. China, like Japan in the 1980s, faces pressure from the United States to revalue its currency. What occurred in Japan in the late 1980s, and what the CCP leadership may see as a direct result of exchange rate appreciation, was the bursting of an asset price bubble and descent into over a decade of economic stagnation (Cargill et al. 2000). Economic growth between 1993 and 2003 averaged only 1 percent per year, contrasting sharply with the high growth rates of previous decades (Corbett and Ito 2010). Despite a decade of various interventions by the Japanese government, growth remained anemic and deflationary pressures persisted into the 21st century.

The Chinese leadership desperately wants to avoid any such stagnation. For "a country that needs growth rates of about 8% to generate jobs for 10 million Chinese who enter the workforce every year," a performance similar to that of Japan in the 1990s would prove disastrous (Bloomberg Businessweek 25 April, 2010). But Japan's stagnation was not a direct result of exchange rate appreciation. Japan held interest rates too low for too long, failed to recognize a growing asset bubble, and responded inadequately when macroeconomic problems became apparent (Posen 1998). To argue that Unites States pressure to appreciate the Yen caused Japan's stagnation ignores multiple factors. First, it was the bursting of an asset bubble that damaged banks' and enterprises' balance sheets, dampening economic growth. Second, loose credit and low interest rates fueled the bubble in the late 1980s. This is inconsistent with a response to United States pressure; Japanese authorities would raise interest rates, not keep them low, in an effort to strengthen the Yen (Corbett and Ito 2010).

Corbett and Ito argue that not only are the Chinese authorities drawing an incorrect conclusion, but also that they are missing a key lesson of Japan's stagnation. The authors insist that China's low interest rates and excess lending are more of a threat to growth than a stronger RMB, as was the case in Japan in the 1980s (Corbett and Ito 2010). By potentially missing this lesson, the CCP risks intensifying already-present asset bubbles. Therefore, a forward-looking CCP must be careful not to accept the politically convenient, but economically false explanation for Japan's retrenchment; China's future depends on continued pragmatic, growth-oriented leadership from the CCP.

CHINA'S PATH FORWARD

As China continues to grow, both economically and as a key player on the international stage, its leadership must meet a number of important challenges. China's success in its path forward is contingent on prompt, effective policy responses. It is important to note, however, that policy change alone may not be sufficient; the CCP must fundamentally alter the way in which reforms are implemented. Due to the interrelated nature of needed reforms, piecemeal policy revisions will not effectively improve China's prospects for future sustainable growth. This section will discuss widely agreed-upon reform essentials, and proceed to argue that truly efficacious reform in these areas is interrelated, and is only compatible with a more flexible exchange rate regime.

FINANCIAL SECTOR REFORM

Financial sector reform, while implemented in a piecemeal fashion in the early 2000s, remains incomplete. As discussed above, banks continue to favor state owned enterprises at the expense of small and medium sized enterprises, the true drivers of employment growth in China (Naughton 2007). Banks' lending decisions remain questionable, and the CCP's recent response to worldwide recession, directing banks to lend more, suggests a distinct degree of government control over the sector (Rosen and Chan 2009). When banks are forced to direct funds to certain sectors of the economy to the neglect of others, and when the central government can influence lending volume, credit allocation is likely to be much less efficient than it would be in responding to more pure market signals.

The financial system, as it currently exists, hurts both banks' profitability and depositors' economic wellbeing. The government-directed low interest rates, partially the byproduct of exchange rate management, as mentioned above, create low and sometimes negative margins on bank lending (Prasad 2008). Because the financial sector is underdeveloped and banks' primary source of revenue is lending, banks remain highly unprofitable. Logically, low interest rates also hurt consumers. Households' high rates of saving yield little return in the nation's banks. Because consumer credit is likewise underdeveloped in China, household savings is necessary in order to facilitate consumption of such goods as cars (Naughton 2007). Low rates of return on savings deposits thus depress consumer spending, and hurt the financial positions of households more broadly.

As discussed above, stock markets in China remain underdeveloped as well. The primary cause of concern regarding long run growth is the scarcity of listing opportunities (Naughton 2007). Because listing opportunities strongly favor SOEs, the ability of other enterprises to raise capital through equity issuance is virtually non-existent in China. Elsewhere in the world, smaller firms without public listings rely on more conventional methods of capitalization, such as banks loans. Banks loans in China, however, are offered primarily to very large or state owned firms. Thus, SMEs and larger, privately owned companies face significant obstacles in obtaining capital necessary for operations and company growth. Theoretically, a more inclusive stock market system could have multiple beneficial effects. First, larger but less politically connected firms would have better access to capital. Second, the burden of financing larger firms could be shifted from banks to equity markets, making funds more available to credit-starved SMEs and consumers.

There is a final benefit to financial sector reform to be discussed, relating to asset bubbles and economic overheating. One of the consequences of low savings returns and stock market volatility is increased investment for speculative purposes (Goldstein and Lardy 2008). This has helped to fuel various regional bubbles in property markets. Because of the high opportunity cost of savings deposits, many investors, including firms, simply shift their savings into assets, which yield higher returns. As learned from Japan in the 1980s and the present financial crisis in the United States, asset price bubbles can be very dangerous for an economy, producing what Richard Koo refers to as "balance sheet recessions." In such a recession, banks' balance sheets are crippled by bad loans, and declining values in their assets hurt businesses and households (Koo 2003). Therefore, it is in the best interest of Chinese officials to prevent asset price bubbles from growing too large.

Overall, China's financial sector needs further reform. Reform can have numerous benefits to the broader domestic economy. If freed from government control, banks can offer higher interest rates and become more profitable. Consumers and businesses alike would be able to earn higher returns on their savings, and money would flow into the banking sector rather than being used for more speculative purposes. More firms could issue equity on stock markets, and rely less on banks for financing. Furthermore, increased competition from foreign banks has the potential to improve credit allocation decisions. As China continues to develop economically, financial sector reform is key to its continued vitality. Its direct connection to exchange rate reform will be discussed below.

MONETARY POLICY CAPACITY

China's central bank, the People's Bank of China (PBOC) is significantly constrained in its ability to use conventional monetary policy tools. Because it cannot appreciably change interest rates without affecting the exchange rate, the PBOC relies on reserve requirements and other relatively unconventional methods of controlling the money supply (Goldstein and Lardy 2008). Chinese officials also restrict capital inflows other than foreign direct investment. These constraints pose many potential problems. Edward Prasad writes: "…the policy distortions needed to maintain this approach could generate imbalances, impose potentially large welfare costs, and become a source of instability themselves" (Prasad 2008). Independent interest rate policy is the most effective tool for promoting credit allocation, combating inflation, and keeping asset prices steady. By foregoing its ability to manage interest rates, the PBOC puts the Chinese economy at risk.

By following a more conventional monetary policy, the PBOC can improve the functioning of the Chinese economy. Market-determined interest rates will aid in many of the financial sector reforms addressed above, helping to improve credit allocation and financial sector profitability. As it currently exists, monetary policy exacerbates the structural imbalances in China's domestic economy and its current account imbalances with developed world economies. These imbalances shift demand abroad, stifle domestic consumption, and cause a heavy reliance on both exports and domestic investment for GDP growth. More liberal monetary policy measures can help, therefore, on broader needed reform initiatives. As Goldstein and Lardy acknowledge, "…China can either continue its large-scale intervention and sterilization operations or significantly reduce its large external surplus. It cannot do both" (Goldstein and Lardy 2008).

TOWARD A MORE BALANCED, SUSTAINABLE GROWTH

As argued above, there are two striking imbalances in China's economy. First, as made evident by its massive current account surplus, China has an external imbalance with the developed world economies. Its exports greatly exceed its imports, forcing Chinese authorities to sterilize large inflows of capital in the face of inflationary threats. Overall, trade surpluses are not bad for an economy; many countries strive to achieve trade surpluses. In China's case however, the size of its trade surplus can be problematic. It indicates a heavy reliance on foreign demand for China's growth; this leaves China highly susceptible to global economic slowdowns. Reliance on foreign demand is also a symptom of China's second dangerous imbalance: the large disparity between domestic savings and consumption. Again, Chinese households have extremely high rates of saving, and GDP growth is heavily reliant on continued increases in investment (Hofman and Kuijs 2008). Consumption is thus shifted overseas, as government expenditure in China accounts for over half of all domestic consumption, two to four times the percentage of most world economies (Penn World Tables 2010).

In order to improve the sustainability of its economic growth, China must work to correct these glaring imbalances. By reducing its enormous current account surplus, China can ease its vulnerability to shifts in global demand, as well as to increasingly competitive exports from other developing nations. A smaller current account surplus has the added benefit of removing the need for extensive PBOC sterilization efforts. Equally important is shifting the domestic economy toward a more consumption-based trend. According to Hofman and Kuijs: "… economic growth has increasingly relied on capital accumulation and less from employment and TFP growth. If China's rapid growth continues in its current mode, the investment rate will need to increase to 50 to 60 percent of GDP in the decades ahead, which will be difficult to finance given the pressures for savings to fall, including from demographics. Moreover, investment as such does not contribute to a population's standard of living" (Hofman and Kuijs 2008).

> "...it is therefore of paramount importance that GDP growth shift from a dependence on investment to the more sustainable growth of consumption and employment"

TFP refers to total factor productivity, derived from the contribution of technology and workers' skills to production. Because of heavy reliance on savings and investment for GDP growth in China, consumption and employment growth are stifled. From 1995 to 2005, employment growth averaged only 1.1 percent (Hofman and Kuijs 2008). Because the legitimacy of the CCP rests to a significant extent on the growth of employment opportunities, it is therefore of paramount importance that GDP growth shift from a dependence on investment to the more sustainable growth of consumption and employment.

THE ROLE OF THE EXCHANGE RATE

This paper has identified a number of structural flaws in the Chinese economy: an inadequate financial sector, constrained monetary policy, and both domestic and external imbalances. Their resolution is only compatible with a more flexible exchange rate regime. First, it is important to offer a succinct explanation of what a flexible exchange rate policy would look like for China. If allowed to float against the world's currencies, the Renminbi's value would be determined by forces of supply and demand. Chinese authorities would have to relinquish control over capital inflows, and, according to the estimates cited above, the RMB would appreciate relative to the dollar and many other currencies. This would inevitably decrease the competitiveness of China's exports, and potentially hurt the profitability of Chinese exporters. The CCP, of course, is worried about the economic consequences of a flexible exchange rate regime, as its legitimacy is based on continued high growth. This paper argues, however, that the benefits of exchange rate reform outweigh the costs.

By liberalizing the exchange rate, China can improve the efficacy of monetary policy. Because significant changes in interest rates hampers the ability to retain a fixed exchange rate, the PBOC currently foregoes an important tool in its ability to control the money supply. If the RMB were allowed to float, the PBOC could use interest rate management to affect the supply of credit in the economy without fearing capital inflows' pressure on the exchange rate. Interest rate management would also become the tool by which credit in the economy is determined, eliminating the distorting effects of government-directed lending volumes. The central bank would obtain an important tool in combating inflation and asset price bubbles, both of which currently threaten the domestic economy (Reuters 21 April, 2010).

A flexible exchange rate regime can also help to improve the functioning and strength of the financial sector. As part of its system of capital controls, the Chinese government restricts the entry of foreign banks (Prasad 2008). By removing these restrictions as part of a more liberal exchange rate policy, the government can invite foreign competition into the domestic banking sector. This, combined with the absence of administrative guidance in lending volumes, can aid in improving the credit allocation efficiency of China's banks. Foreign banking expertise would make the sector more competitive, making banks' survival depend on lending only to more productive borrowers, helping to eliminate the inefficiencies in credit allocation that currently persist. Furthermore, by removing the need for excessively low interest rates inherent in its fixed exchange rate regime, China can make bank deposits more attractive to firms and households, improving their financial positions as well as making the banking sector more robust. Higher interest rates would also improve banks' profitability.

Macroeconomic imbalances, too, can be at least partially rectified by establishing a flexible exchange rate regime. By definition, China's current account surplus would decrease if the RMB were to appreciate, as is probable in the event of exchange rate liberalization. As exports decrease and imports increase, China's trade imbalance would close and economic growth would be less contingent on export success. By considering Chinese goods to be complements to rather than substitutes for other East Asian exports, it is also possible that Chinese exporters' competitiveness would not be significantly hurt (Garcia-Herrero and Koivu 2010). Domestic imbalances, too, would be indirectly addressed, mostly through the now possible reform of the financial sector. Households' savings, in the absence of artificially low interest rates, could yield higher returns. At present, household income is declining relative to GDP (Godement 2010). Higher returns on savings can help to reverse this trend. As household income rises, so too will domestic consumption. In a more competitive financial sector, the emergence of consumer credit can also work to boost consumption rates, reducing China's reliance on foreign demand. Furthermore, by ensuring that the most productive firms have access to credit, financial reform via exchange rate liberalization can help to boost productivity rates and employment opportunities for the millions of Chinese citizens looking for work. Growing employment opportunities can create a virtuous cycle, in which domestic consumption growth based on expanded employment and credit availability act to reinforce economic growth. In these ways, exchange rate reform is imperative in shifting China's domestic economy toward greater consumption and productivity.

CONCLUSION

China's needed reforms require a break from the traditional method of incremental reform employed by the CCP. The interconnected nature of macroeconomic policies implies that comprehensive, coordinated reforms in multiple policy areas may be necessary to effectively address the economic imbalances facing the Chinese economy. Again, imbalances, both internal and external, have broad consequences. They create a reliance on foreign demand for Chinese goods, stifle domestic consumption rates, dampen employment prospects for Chinese citizens, fuel asset price bubbles, and result in suboptimal credit allocation.

Addressing these concerns is not only desirable, but is requisite for ensuring the sustainability of China's economic growth. By liberalizing its exchange rate policies, the CCP can create new opportunities for China's businesses and households. Reforms in the financial sector will be incomplete until competition is introduced and credit allocation and availability is subject to true market forces. There are a number of impediments to complete reform. As a newly emerging global power, China does not want to be seen as blindly acquiescing to Western diplomatic pressures, especially on economic issues. Furthermore, some Chinese companies, many of which are inefficient but politically connected, will inevitably be hurt by RMB appreciation. Perhaps the most cogent obstacle of all is the CCP itself. For the CCP, gradual reform has been the rule since the days of Deng Xiaoping. Sweeping changes, historically, have largely been avoided in favor of a more cautious approach. Given the interdependence of different aspects of macroeconomic reform, caution is an impossibility. Simultaneous, extensive reforms are necessary to ensure the long-run sustainability of Chinese economic growth. While the CCP has historically been careful in its reforms, it has also proven itself to be pragmatic and innovative. When the issue of exchange rate reform is framed in terms of enduring economic growth, rather than power politics, there is reason to believe that China's leadership will take effective action. ■

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Interview: Professor Avery Goldstein

Professor Avery Goldstein discusses China's foreign policy strategy, how it could change as the country becomes more powerful, how the Chinese government will be affected by Chinese middle class influence, and the possibility of democratic developments in China.

Interviewed by Susan Kolber for the Wharton Asia Economic Review.

Wharton Asia Economic Review: How did you get involved in studying Chinese foreign policy?

Avery Goldstein: It was pretty accidental. I was an undergraduate at Penn, and I had finished all my political science requirements but one. I couldn't find an eighth that I wanted to take. Somebody recommended that I go see a professor in the political science department who was always willing to do independent studies. He was a specialist on American politics, so I told him that I would do an independent study on American politics. His response was, "No I'm interested in China right now." Instead, he gave me a stack of books on China to read, and that is how I became interested in China. My initial interest was China's domestic politics and later shifted to China's foreign policy and international relations when I was in graduate school. It just so happened the best professors and courses in my PhD program at the University of California- Berkeley, were in International Relations. The reality is that I was one of a relatively small number of people that combined an interest in international relations and China, but that remains true today. The majority of people that study China today in universities study internal issues, especially China's political economy.

WAER: Since you published your book Rising to the Challenge: China's Grand Strategy and International Security in 2005, how has China's "Grand Strategy" changed?

AG: I think that China's basic foreign policy grand strategy has remained the same since 2005. The approach I described in 2005 has been more or less in place since the mid 1990's. I think this continuity reflects the fact that the Chinese, by the mid-1990's, grasped the underlying international situation they had to deal with, and they understood that the high priority they put on developing their economy required maintaining a peaceful international environment. Although they hoped to rise and become a true great power in the international system, they had to be careful about provoking opposition, especially opposition from the U.S. That required that they behave in non-provocative ways and cooperate with others to the extent that they could in order to protect China's vital interests.

WAER: What has Google's situation demonstrated about China's foreign policy?

AG: The Google situation reveals that there are limits on what China is willing to do in terms of cooperating with others. There are still areas where China's leaders believe they still have to draw a line. The Google situation is such a case because the Chinese saw it as fundamentally questioning the Communist Party's ability to maintain domestic stability. One of the two touchstones in terms of where China will draw the line is anything that challenges domestic stability (meaning the ability of the Chinese Communist Party to maintain one-party rule in China). The Google situation presented such a challenge because the CCP is concerned about the free flow of political information that could lead to challenges internally, especially with respect to issues like Tibet, and perhaps setting up independent alternative parties or social movements like the Falun Gong religious movement. The other line China will draw is with Taiwan. The CCP will not be looking for a confrontation with the United States over Taiwan, but they won't simply ignore things that the United States does, or ignore things that Taiwanese politicians do that they think could lead to Taiwan's independence—they will not tolerate that.

WAER: Can you explain the power transition theory that you present in your 2007 paper "Power Transitions, Institution, and China's Rise in East Asia"?

AG: The short version is this: There are international relations scholars who have argued that with the rise and fall of various nations, typically one country becomes dominant in the international system in any historical period. Under certain circumstances, other powers begin to rise and there comes a moment when it looks as though the rising power may become more powerful than what had been the previous dominant power. If that rising power is unhappy with the way the international system has been set up in the past, it may decide it wants to challenge the dominant power. So the power transition theory says that's the moment of danger. It is not power transitions per say—it is not just the fact that power is shifting—it's the fact that the rising power is dissatisfied and can't be satisfied without challenging the dominant power in ways that could result in war. That was the claim of the power transition theory, that war is certainly possible when these kinds of shifts in power happen. There were many people who said with China rising and with the United States being the dominant power, the question arises, of whether China will be one of those rising powers who ultimately decides to challenge the dominant United States.

WAER: What do institutionalists in the field of international relations argue, and how would that apply to China?

AG: Institutionalists argue that power transition arguments may be identifying the fact that power shifts over time but do not put enough emphasis on the fact that countries in the international system also work together and cooperate on many issues, and that in fact, especially in the modern world, there are international institutions and that great powers tend to be members of these international institutions. They can often realize their interests better by working through these institutions than by relying on brute force to challenge each other. Their argument is also that in these institutions, states become socialized to accept the rules and practices of these institutions as a way to achieve their objectives. Rather than challenge the United States militarily, it is possible that the Chinese would want to pursue their interests through organizations like the World trade Organization, the United Nations, and other multi-lateral organizations.

WAER: Do most people's view on China's foreign policy fall in line with the institutionalists' theory?

AG: I don't think so. I for one am agnostic. China is doing both; it is trying to build up its capabilities, economic wealth, and military power, but it is also working through institutions. Where the crunch will come is, what if China is frustrated with its ability to ensure its national interests working through institutions, and decides it needs to lean a little more on its hard power, its economic and military power?

WAER: Does this mean China may stray from its Grand Strategy and Peaceful Rise approach to foreign policy?

AG: For now, China believes that its only realistic option is to rely on mostly institutionalized ways of pursuing its interests.

WAER: How would internal instability affect China's foreign policy?

AG: If there were internal instability in China, China would presumably pull in its horns, forget about foreign policy, and focus solely on maintaining domestic order. I think they would be less active internationally if that happened.

WAER: How does geographical disparity affect central government control?

AG: The central government, through its whole array of reform policies, no longer has as tight control over the economic or political systems as it did in the days of old-style authoritarianism and planned economics. However, the central government has quite a bit of control through the party bureaucracy, and through the police system backed up by the military. Having said that, it is true there are all kinds of variations of wealth in the country. There have been three waves of reforms. The initial wave of reform benefited mainly the countryside in the 1980's, because agriculture was first reformed, and that improved the lives of the rural Chinese.

The second wave of reform in the 1990s and 2000s benefited mainly the people in cities along the coast, especially as China became more and more involved in international trade. What happened was, during that period, the hinterland (Western China) tended to lag behind and this population's incomes were not rising as rapidly as those in the eastern cities. This disparity caused people to want to move into the cities. The Hukou system was a remnant of the old planned economy that limited people's ability to move into urban regions. This was seen as a useful stopgap, but given the nature of labor markets, leads to inefficiencies. There were industries in the cities that needed laborers that could only be had by recruiting people from the countryside, and people from the countryside wanted to go work in the cities. Informally, the Hukou system began to give way and was not rigidly enforced. In the 2000s the Communist Party began to discuss reforming the Hukou system to make it easier for people to change their residencies, which is really an accommodation to reality.

However, there are problems, one being that the government understands not everybody can move from the west to the east. When Hu Jintao became president and Wen Jiabao became prime minister of the country, they were dedicated at least in principle to investing more heavily in the poorer areas that had lagged behind. They have done quite a bit to develop the interior so that people don't feel they have to move to the coast to get a better life. That is a hard thing to do, because obviously if you are addressing globalized production, it is a lot more difficult to become integrated with world markets from the interior of China than it is if you're along the coast. Western China is starting from a disadvantaged position. However, the advantage they do have is that labor costs are cheaper. If a company, for example, has a factory outside of Shanghai, and labor costs are going up because workers in the cities demand better wages, instead of moving that factory to Vietnam or Cambodia, perhaps they could move the factory to the interior of China where they could also find cheap labor. This is a strategy that in principle can work.

"One of the issues with foreign pressure is that it tends to lead the Communist Party to try and rally people around the idea of standing up to the foreigners. However, that is not to say that people in China blindly support the Communist Party."

WAER: Because of China's Hukou system and managed labor force, will the economy be able sustain itself?

AG: Well, China is a big country with a lot of people, so you do have a big labor force that can be tapped, and that low wage strategy can be viable if all you want to do is make sneakers or toys. What seems to be happening in the areas along the coast that did well in the first wave of economic growth is that they are essentially moving up the product chain; they want to develop enterprises that aren't relying on cheap labor but greater productivity or technology to produce products with a higher value-added. You might in fact see that interior China will begin to produce the things that the coastal regions use to do.

WAER: How will the Chinese government reform its politics as the country continues to develop? How does China's middle class influence political reform? Will political change be led by internal or external questions?

AG: Political reforms have taken place, just not as fast or in the direction we might like. China has obviously changed since the 1980s and the 1990s. Part of that has to do with the onset of the information age, the availability of various things. There are still severe restrictions on the kinds of political issues people can talk about and how much they can influence a process that is still dominated by the ruling Communist Party. That means things like the legal system works better than it used to, but it is still not completely reliable. On certain issues the Communist Party is just going to determine the outcome.

My guess is that internal pressure for change will be ever more important. One of the issues with foreign pressure is that it tends to lead the Communist Party to try and rally people around the idea of standing up to the foreigners. However, that is not to say that people in China blindly support the Communist Party. They appreciate the economic benefits they've gotten from the past 25 years, and in many cases, they can't imagine an alternative, but there is also deep frustration with the bureaucracy, the corruption, and the incompetence of some people in official positions. My guess is that this kind of frustration is going to lead to pressures for change. At some point, either the Communist Party is going to get out in front of making these changes for genuine political reform, or they are going to be pushed into it domestically.

WAER: What can the middle class do to stimulate this kind of change?

AG: There are a lot of protests,

and they get reported through the media. In China, they report thousands of "mass incidents"—protests, demonstrations, labor strikes, all kinds of things. There are all kinds of creative ways for political change to happen. Look at what happened in the old Soviet Union: there was a split in the Communist Party itself between the reformist wing lead by Gorbachev and the hard line wing. Gorbachev thought that he could manage the process of political reform, and it got beyond his control—that's one way things change. Sometimes, it is possible for the leadership to decide that it wants to promote radical political change, and if they can win enough support among the rest of the leadership or the part of the leadership that involves the military, perhaps that will work. My guess is that you can expect gradual change. The Chinese, both the government and the people, have a lot to lose at this point if they do something politically destructive. Even the middle class is afraid to rock the boat too much. They would like to see change, but they look at what happened in Russia in the 1990s and say, "What if we end up with 15 years of economic stagnation because we caused political turmoil in China? Is that a good tradeoff?" Generally speaking, the middle class doesn't want to run that risk. The strongest explanation for where genuine democratization takes place is revealed by studying the effects of the growth of the middle class and the average national per capita GDP reaching a certain level; there is a pretty good correlation between economic growth and the process of democratization. You saw it certainly in South Korea, Taiwan, and other countries in Asia, so it is not merely a cultural phenomenon.

WAER: Where is China compared to these other Asian countries that have democratized?

AG: China is at a stage similar to 1970s South Korea. So really, China is not close to the points where South Korea and Taiwan were at the time those two countries democratized. They had a much larger middle class and an authoritarian ruling party that realized they had to make accommodations. They realized that it would be difficult to continue sticking with an authoritarian development model, so South Korea and Taiwain tried to manage the process and relax control. You wouldn't want to say change in China will happen just the same way because there are differences between a country of 20 million and a country of 1.3 billion. That's part of the reason why even thought the Chinese leadership has said they need democracy, they assert that the country is just not ready for it yet. Any change, they claim, must be managed very carefully because it is a country of 1.3 billion people, and if they promote rapid political change, chaos will ensue. That is a traditional Chinese claim about what will happen if the authoritarian leaders relax their grip. And maybe that is a legitimate claim.

WAER: Where is your research taking you now?

AG: Actually, I'm still focused on China's foreign policy, but more generally on things that worry me. The two things that worry me right now have to do with the possibility that during this period, while China is still weak compared to the United States, the U.S. and China could find themselves in a genuine crisis—a crisis in the sense that there could be a confrontation in the near future where we could find ourselves using military force. It could be about Taiwan, the South China Sea, or situations we can't imagine at this point. How dangerous could a situation be, in which you have a strong country and a relatively weak country in that kind of a crisis? Is one side or the other likely to choose to use force rather than to continue to talk? There is an argument made that in a confrontation between the United States and China, the U.S. may be tempted to use force. On the Chinese side, if the fear that the U.S. is going to use force first exists, then the Chinese will believe that they have to preemptively strike before they become disarmed. In short, one of my concerns is short-term instability.

My other concern is longer range, which we discussed earlier about shifting power. Even if we make it through this current period without a crisis leading to armed conflict, in the more distant future. Over time, will the United States worry so much about how a rising China is going to use its power that the U.S. decides to craft policy preventing China from completing its rise? There are nuclear weapons around, so I don't think the United States would go to war, but you don't have to go to war to keep China down. You could try to convince allies to cooperate to contain China the way we tried to contain the old Soviet Union. I don't think that would actually work, but you can imagine that the relationship between the U.S. and China under those circumstances would be much worse than it is today. It would be much more difficult for the U.S. and China to cooperate in solving problems that we think are common problems, like global warming, dealing with problems like Iran or North Korea if instead of viewing ourselves as potential adversaries, we viewed ourselves as actual adversaries. But that is a longer-term problem. I don't think that is something to worry about for another ten or fifteen years. ■

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The Long March:
Reebok's Role in Advancing Labor Rights in China

While ineffectual in the short-term, Reebok's recent impelmentation of worker representation mechanisms has started China down the path towards labor reform thorugh internal education and external international pressure.

Elizabeth Rowland

In 2001, Reebok became the first known multinational corporation to facilitate trade union elections in a Chinese supplier factory (O'Rourke and Brown 2003). Following initial success, Reebok decided to expand the experiment to four other factories as well (Chan 2007). After being formally announced a couple of years after the first election, the project sparked much enthusiasm as well as controversy among labor activists and experts around the world. Ultimately, however, the elections and other Reebok worker representative experiments such as worker health and safety committees failed to achieve their purported goals of increasing worker representation and sustainable code compliance in Reebok's Chinese supplier factories (Reebok 2005). Several factors contributed to this failure, including government and factory management resistance to Reebok's plans; inherent tensions that exist between profit-driven corporate structures and expensive human and labor rights measures; the takeover of Reebok by Adidas in 2005; and others.

Nevertheless, Reebok's labor initiatives represent a step in the right direction in China's long march towards improved labor rights and working conditions. Since the first Reebok-facilitated election, the Chinese government, official state trade union, and the Chinese workers have undergone profound changes partially reflecting the positive influence of Reebok's efforts. This change can most dramatically been seen in the recent wave of well-publicized labor strikes at foreign-owned factories across China. Reebok's worker representation initiatives may not have achieved short-term success, but they set an example and blazed the path enabling other stakeholders in the global community to join in the long march to improve long-run human and labor rights in Chinese factories.

THE BUILDUP TO THE LONG MARCH

The idea for trade union elections in Reebok's Chinese supplier factories sprouted from a broader program of corporate social responsibility (CSR) and support for human rights at Reebok that began in the 1980s. By 1992, Reebok had formulated the first human rights code of conduct in their industry entitled Human Rights Production Standards (Van Tulder; Yu 2007; Reebok 2005). In the 1990s pressure on Reebok and other clothing and sportswear companies to improve their human and labor rights records rose as student groups and anti-sweatshop activist organizations across the United States organized boycotts of Nike, Adidas, Reebok, and other companies. The anti-sweatshop movement targeted major brands that sourced from third world countries in an effort to highlight the terrible working conditions under which the brands' products were made and to embarrass the companies into improving their sourcing and labor practices. At the time (and in many cases still today), supplier factories for these brands, including Reebok, employed repressive labor strategies, forced excessive overtime hours, verbally abused and humiliated workers, underpaid workers or paid them late, maintained hazardous and poisonous working conditions, meted out arbitrary punishments and fines, restricted time off and resignations, failed to provide proper safety equipment, and committed many other serious labor rights violations (Merk 2006; Yu 2007).

In reaction to this organized pressure, Reebok ratcheted up their labor rights enforcement programs, creating a multifaceted approach to improve labor standards in their supplier factories. The Reebok Human Rights Tracking System was created so that different departments within Reebok could have access to information on the compliance status of Reebok supplier factories around the world (Reebok 2005). They also designed the S-Process (short for

Sustainability Process) and Compliance Performance Resolutions (CPRs) to institutionalize consideration and achievement of labor rights into Reebok's production model (Reebok 2005).

In China, this program exhibited itself slightly differently in Reebok's various supplier factories. In 1997 at the Shunda (earlier called Fuh Luh) factory of Fuzhou, Fujian Province, Reebok first hired a part-time local staff to monitor code implementation. Some of the first steps taken were to ban child labor, shorten the regular work week to 60 hours, serve better food in the factory cafeteria, improve worker dorm conditions, and supply emergency exits, fire extinguishers, and protection equipment. These demands were not always met, however, particularly those such as the length of the workweek which would impose substantial extra costs on the factory (Yu 2007; Chan 2009). Factory accounting departments established entire sub-departments devoted to the creation of false piece-rate tallies, hours worked, and wage records in order to conceal overtime and minimum wage violations (Economist Intelligence Unit 2005; Gilley 2001). Factory managers likewise became adept at putting on shows for inspectors, particularly by coaching workers on what to say in audit interviews (Chan 2005; Gilley 2001). Even worse, monitors themselves often proved less than diligent at uncovering violations, as they wanted to please the company that hired them with good reports (Chan, 2009).

> "In the first eight months, RAT amassed a three-inch thick binder filled with distributed hazard notices"

In addition to hiring monitors and auditors, Reebok initially set up worker complaint mechanisms in the Shunda factory as well as the Kong Tai Shoes (KTS) factory in Shenzhen, Guangdong Province. The complaint mechanisms included stamped envelopes distributed to workers so that they could confidentially report compliance problems directly to Reebok as well as complaint boxes located in the factories where workers could anonymously deposit complaint cards. The first year workers in KTS filed 1,200 complaints, embarrassing the management and initially causing them to look more seriously at resolving problems in the factory (Chan 2009). Shunda did not respond as readily to the complaint mechanisms. Workers were initially enthusiastic and registered many complaints, but their enthusiasm was soon dampened by heavy management retribution against complainants and by a lack of effective transparent settlement mechanisms (Yu 2008).

In 1999 at KTS, Reebok also set up a "Livelihood Counseling Center" staffed by a social worker from Hong Kong who visited the workers in their dorms each night to discuss and help them deal with their problems. The Counseling Center proved quite helpful in increasing workers' knowledge about human rights and labor rights, cultivating a culture of awareness (Chan 2009). Reebok did not push for a Counseling Center at Shunda, seeing as it was located quite far from Hong Kong where the social workers were based. They did, however, open an "Environmental Office" staffed with a person who would mediate complaints and quarrels (Chan 2009).

The factories did make early progress in response to Reebok's initiatives, particularly KTS. In both factories it became standard for workers to get one day off work a week, rather than no days off as before. KTS in particular upgraded the physical conditions of the factory and worker dormitories, began serving higher quality food, improved some health and safety standards, and prominently displayed the labor law on the wall of the factory for all workers to see (Chan 2009). However, both factories continued to have code violations. Conditions at Shunda were so unbearable that worker turnover was 43% a year (Chan 2009).

Though code enforcement, monitoring, and complaint mechanisms set laudable standards and expose human rights violations, they were not solutions to the underlying problem (Santoro 2003; Merk 2006). The Asian Human Rights department of Reebok ultimately realized that more creative strategies were needed to create sustainable progress on labor rights and code enforcement. As a result, they devised a plan to foster sustainable code enforcement through worker empowerment via the formation of worker health and safety (H&S) committees as well as democratic union elections (Brown 2003; Chan 2007). Prior to these efforts, few workers even knew the labor codes existed (Merk 2006). The hope was that once workers were educated through H&S committees and empowered through union representation, workers themselves could be the monitors of factories' working conditions, since monitoring, auditing, and pressuring by Reebok were clearly not achieving the desired improvements (Chan 2009).

HEALTH AND SAFETY (H&S) COMMITTEES

In 2000, Reebok, in cooperation with Nike, Adidas, and four NGOs, began the two-year long China Capacity Building Project (China Capacity Building Project 2002). The Project involved workers, supervisors, and managers of three footwear factories (Reebok's KTS factory as well as one supplier factory for both Nike and Adidas) (Kurtenbach 2002). It consisted of a needs assessment, a four-day participatory H&S workshop, the creation of H&S worker committees for each of the three participating factories, as well as follow-up technical assistance and evaluations with the participants and the new H&S committees to measure the project's impact (Szudy, O'Rourke, and Brown 2003). In total, 90 key people received the training (Kurtenbach 2002; Szudy, O'Rourke, and Brown 2003; China Capacity Building Project 2002).

The goals of the project included building the H&S capacity of all participants, establishing baseline H&S knowledge and inspection skills of plant H&S committee members, enabling workers to meaningfully participate in improving H&S on the job, providing post-training technical support, improving plant H&S conditions, and involving multiple parties in a collaborative process (China Capacity Building Project 2002). The participants were also presented with a 500-page training and reference manual, "Your Health and Safety at Work" (Szudy, O'Rourke, and Brown 2003).

Eight months after completion of the training, KTS workers had successfully created an H&S committee of four full-time inspectors paid at normal production wages. Through regular inspections the committee was able to identify and work with supervisors to correct or reduce some hazards in the factory (Szudy, O'Rourke, and Brown 2003; China Capacity Building Project 2002). The Risk Assessment Team (RAT) was charged with carrying out inspections twice monthly while the Risk Improvement Team (RIT) was responsible for ensuring elimination of hazards. When inspectors discovered an H&S violation, they would present written notice to the relevant supervisor along with a deadline for remediation (China Capacity Building Project 2002). If the hazard was not resolved within three notices, RIT would take the matter to management (China Capacity Building Project 2002). In the first eight months, RAT amassed a three-inch thick binder filled with distributed hazard notices (Szudy, O'Rourke, and Brown 2003).

Though the new KTS H&S committee achieved some initial success, many obstacles and problems also existed. First and foremost, the problem of supervisor resistance to inspections and lack of a mechanism for workers to enforce changes, especially ones that required expensive investments, made continued progress difficult (Szudy, O'Rourke, and Brown 2003). Inspectors were able to bring attention to H&S hazards, but if the supervisors and management refused to correct them, there was really no further action the H&S committee could take. The lack of respect for the work of the committee was exacerbated by the hierarchical structure of the factory and Chinese culture itself (China Capacity Building Project 2002).

Other obstacles existed as well. Sometimes, it was fellow workers who impeded hazard remediation by refusing to wear protection equipment that may slow down their work and thus decrease their piecework pay (Kurtenbach 2002). Further, the need for additional training, more inspectors, and more testing and remediation equipment impeded advancement (China Capacity Building Project 2002). Some of the most egregious violations were addressed, but in order to tackle the more numerous smaller problems or the more complex H&S violations, they needed more resources and manpower. But even making full use of the knowledge, manpower, and equipment available was challenging as committee members struggled to find time to perform their duties while also performing their regular factory work (China Capacity Building Project 2002; Szudy, O'Rourke, and Brown 2003). On average the part-time committee members put in 6.75 hours of committee work a week, cutting into their paid work hours, and resulting in high turnover of committee members. Considering the high level of turnover, the committee would have benefited from development of a peer training program and more exchange with and training from Reebok. Though the NGOs continued to follow the progress of the committees, little post-training support from Reebok existed (Report on ETI Biennial Conference 2003; O'Rourke and Brown 2003).

TRADE UNION ELECTIONS

A second tool Reebok made use of to empower workers, promote communication between management and workers, and make sustainable improvements in factory working conditions was trade union elections (Maitland 2002; Lee 2007). Beginning in 2001 with the KTS factory, followed by Shunda in 2002 and three other factories in subsequent years, Reebok facilitated factory election process training, election campaigns, and voting (Chan Oct. 2007; Chan 2005; Chan 2009; Tucker 2007). When the current terms of incumbent union officers in KTS and Shunda expired, Reebok took the opportunity to pressure factory management to allow for democratic elections as called for in Article 11 of the Trade Union law (Chan 2009). Because Reebok was the only client of both factories, factory management held a weak bargaining position and had little choice but to go along with Reebok's demands. The prospect of increased Reebok orders after the election also gave the factories incentive to participate (Chan 2009). Likewise, both KTS and Shunda were important tax payers in their respective localities, so the local governments agreed to permit Reebok's plans as well (Chan 2009). Negotiations over how to proceed with the elections lasted a year and Reebok clearly took the lead. The existing local union took a quite passive role while the upper levels of the All-China Federation of Trade Unions (ACFTU) did not participate at all (Chan 2009).

In the elections, all employees were allowed to nominate themselves as candidates for the union committee. The committee makeup was based on proportional representation among the various factory production units and the vote was done by secret ballot with one vote per person (Chan 2009). To encourage workers to self-nominate, a monthly union bonus of 70 RMB was instituted (Chan 2009). Ultimately, 62 employees self-nominated in KTS, and 192 employees self-nominated in the twice-as-big Shunda factory (Chan 2009; Merk 2006).

Early on, different factories had varying degrees of success with their newly elected unions. Initially, KTS was quite successful, largely because of their relatively more accommodating management (Chan 2009). During the first few months, the newly elected union held regular meetings and met once a month with top managers to report concerns. Several of these concerns were effectively addressed by management including the abolishment of monetary penalties, the institution of paid sick leave, and enrollment in the government social security system for workers employed at least a year (Chan 2009). However, Shunda management was less accommodating and the local union more controlling as they felt Reebok had invaded their territory (Chan 2009). The Shunda union leaders found it difficult to find time to conduct union-related work. Supervisors would transfer the union leaders to more difficult jobs with longer working hours and harass them for taking time off to manage union affairs. Eventually this pressure pushed the most hopeful leaders to quit (Chan 2009). Nevertheless, even in Shunda some initial progress was made, and communication between the union leaders and management resulted in the alleviation of the most severe problems within the factory (Yu 2008).

"the new Shunda union representatives were trained and instilled with the idea that the union should work closely with management rather than independently, thus undermining the true representative capacity of the union"

The more extensive pre- and post-election support that the workers and the new union committee members at KTS received from Reebok and NGOs also contributed to KTS's initial success as compared with Shunda. The Livelihood Counseling Center, which was set up early on to help workers with their personal problems, ended up acting like a union preparatory committee helping to organize the campaign and election (Chan 2009). After the election at KTS, Reebok had NGOs from Hong Kong hold a half-year training program for the new representatives during which they taught administrative skills, management negotiation and communication skills, as well as union values emphasizing independence from management (Chan 2009).

Shunda suffered from a lack of post-election NGO training. The local union at Shunda maintained that it was the official union's role to train the new union representatives, not the role of outsider NGOs and foreign companies. As a result, the new Shunda union representatives were trained and instilled with the idea that the union should work closely with management rather than independently, thus undermining the true representative capacity of the union and resulting in the new union leaders being reabsorbed by the official union (Chan 2009).

Though both unions had initial successes, ultimately the experiment failed in its primary goal of creating factory unions that genuinely represented the interests of the workers. Today all the Reebok-facilitated unions are effectively under management control (Chan Oct. 2007; Chan 2009). At the end of 2002, the Hong Kong management partner of KTS bought out the Taiwanese partner, drastically changing the management-union relationship dynamic. The new Hong Kong manager was much less tolerant of union requests and actually reversed much of the progress that had been made since the elections. Most importantly, KTS terminated the union-NGO training program and deemed further interference by Reebok as illegal. When confronted with these obstacles, Reebok largely retreated leaving the fledgling union to fend for itself (Chan 2009). In Shunda, management hostility and the lack of proper union leader training resulted in the demise of union independence even earlier. Now most of the originally elected union leaders have left and Shunda's union remains largely inactive (Lee 2007).

One factor that some observers claim contributed to the undermining of the young unions was Reebok's failure to engage higher levels of the ACFTU leadership in the election process. Though local union leaders did passively participate in the pre- and post-election process, higher level ACFTU presence was non-existent (Chan Oct. 2007; Chan Dec. 2007; Lee 2007). Jill Tucker, the Asia Human Rights Director for Reebok at the time and a principal facilitator of the elections, claims that Reebok did in fact reach out to ACFTU leaders in Beijing but that it was difficult to connect with individual upper-level leaders with true authority. Qualifying that statement, however, she conceded that had Reebok engaged national ACFTU leaders early on, the process of getting approval and negotiating election procedures with the national leaders would have greatly lengthened and complicated the pre-election preparation process (Tucker 2009).

It is possible that ACFTU did not actively intervene earlier because they wanted to wait and see how the elections turned out. If the elections did not go well, they could easily distance themselves from the process and blame the failure on Reebok. If the elections went well, however, the local union could claim responsibility and enhance their reputation (Lee 2007). Initially, the latter actually did happen. Both the newly elected KTS and Shunda unions were lauded by the local ACFTU branches as model unions to be emulated (Chan Dec. 2007). However, once upper leaders in the ACFTU saw that the elected unions had the potential to make real changes in factories, they decided to reassert control and push Reebok out.

In 2003 after the elections at both KTS and Shunda were completed, upper level ACFTU leadership did ultimately become engaged. Su Weiqing, a vice president of the ACFTU, criticized Reebok for intervening in China's internal political affairs and stated that it would be illegal for Reebok to meddle further. From that point on, Reebok confronted much more resistance to their activities with the unions and were forced to retreat. As a result, the local unions began to dominate the young elected union branches, and many of the early, enthusiastic elected leaders have since left or been driven out of leadership positions or of the factories altogether (Chan Oct. 2007; Chan 2005; Chan. 2009)

Another factor that made it easier for local unions and factory management to drive out or co-opt the newly elected union leaders was that the original union charters Reebok had formulated with the factory management failed to assure financial independence or the right to collective bargaining for the young union branches. Without financial independence, the unions quickly became beholden to the control of management; otherwise they would have been unable to garner sufficient funds for union activities. In Shunda, the full-time union officials were also paid middle management salary and benefits, thus distancing them from ordinary workers and creating corrupting incentives that encouraged union officials to ally with management (Chan Dec. 2007). Likewise, without provisions for collective bargaining, the negotiating power and the ability for the union to make positive change on behalf of the workers was greatly curtailed (Chan Oct. 2007).

The lack of trade union awareness and solidarity within the factories magnified these problems as well, resulting in the workers and elected union officials bowing to pressure earlier than likely had there been a more ingrained sense of duty and mission. However, such a trade union culture historically has taken years or decades to develop in other countries and only emerges out of collective struggles for union rights among workers, thus making the Chinese factories' failure to develop such a culture in the short period of time available unsurprising (Chan Oct. 2007).

OBSTACLES TO PROGRESS ON LABOR CONDITIONS

Though some initial progress on

labor standards via H&S committees and union elections proved promising, once Adidas took over Reebok in 2005, factory conditions worsened (Lee 2007; Chan 2009). Adidas took little interest in the development of the unions and even less interest in continuing democratic union elections. When Reebok's Asia Human Rights Director resigned, Adidas never replaced her. Further, Adidas pushed for the factories to shorten production lines by over half while maintaining output levels, thus resulting in even more intense and stressful working conditions (Lee 2007). To make matters worse, because inflation outpaced wage increases, the real value of wages actually decreased (Lee 2007).

Even before Adidas bought out Reebok, however, tensions existed between Reebok's sourcing and human rights departments that undermined Reebok's stated intention of improving labor standards. As expressed in Reebok's Human Rights Report for 2005, their "goal is to seamlessly integrate our human rights commitments with the day-to-day functions of our business" (Reebok 2005). However, later they frankly state:

"We recognize that inefficiencies in our purchasing practices sometimes contribute to violations of our Standards. It is not always possible to determine whether production lead times and prices accepted by suppliers are consistent with full implementation of our Standards" (Reebok 2005).

"We revealed that current sourcing strategies – premised on flexibility and fast turnaround – combined with lowering of unit costs, are significantly contributing to suppliers using exploitative employment practices such as: Short-term 'rolling' contracts…Piece-rate payments…Low wages to meet falling unit costs…Excessive working hours and forced overtime…Restrictions on freedom of association….Both at the retailer end and at the supplier end, codes are viewed as something that can be derogated from in the normal run of business. Code compliance staff admit that in certain circumstances, for example, with last minute orders, excessive overtime is overlooked" (Reebok 2005).

Whereas Reebok's production department worked closely with the Chinese factories and with Reebok's human rights department to assure decent working conditions, Reebok's sourcing department was much more detached from the reality on the ground. This resulted in sourcing decisions that often impeded Reebok's goal of improved labor standards (Tucker 2009). Reebok's sourcing decisions were based on annual supplier evaluations that gave consideration to price, quality, timeliness, and labor practices, though labor practices usually received less weight. The suppliers with the highest score would receive a larger volume of forward orders. Seeing as labor practices received less weight than price, suppliers had a disincentive to improve working conditions if such improvement required expensive reforms, and Reebok's sourcing department proved unwilling to shoulder any of the cost of such reforms (Yu 2007; Chan Dec. 2007).

Practices such as "just-in-time" and seasonal production as well as last-minute orders cause factory managers to delay finishing production in case there are last-minute alterations, thus compressing production schedules to minimize waste. This directly results in excessive overtime (Report on ETI Biennial Conference 2003; Gilley 2001). As Anita Chan states, despite Reebok's declared desire to incorporate human rights standards into the daily functioning of their business, "not coordinating the functions of the CSR department with the other departments in order to make CSR effective is not a simple oversight. Rather, the ultimate goal of corporate policy is to render the CSR program ineffective" (Chan Dec. 2007).

THE DEBATE

This claim underlines the inherent tension that exists between labor rights and a business' profit motive. Enforcing CSR codes and labor rights costs money, and in the competitive market for shoes and other products, increased cost could undermine a firm's profits and competitiveness. For example, paying all the workers at Shunda a living wage would cost an extra $3 million a year, accounting for less than 2% of Reebok's average profits per year (Yu 2008). However, if that amount were replicated across Reebok's thousands of factories around the world, it could significantly cut into profits. With regard to pricing, the same tension applies. The Reebok production and human rights departments did a joint study to figure out how much extra it would cost to manufacture a completely CSR-code-compliant shoe, and found that it would cost about $1 more per shoe. A difference of $1 for higher end, more expensive shoes might not affect the company's bottom line too much, but for less expensive, lower end shoes, the difference could have a large impact on competitiveness and profitability of the product (Tucker 2009).

As a result of this tension, some critics conclude that CSR codes and corporate-facilitated union elections are shams, simple marketing tools to gain market share where corporations "are the judge and jury of their own codes" (Ngai, 2004, p. 8). One disenchanted worker at KTS stated "Reebok peddled human rights as a commodity" while a Chinese trade union official claimed "Reebok doesn't really want strong unions" (Chan 2009). The belief existed that Reebok could have done what was necessary to truly integrate the CSR code into the business, but they chose not to because it would have cut into profits for the supplier factories, for Reebok, or both. Some in China even see CSR codes as Western protectionism aimed at eliminating China's competitive advantage in cheap labor (Chan 2005).

In the meantime, the appearance of corporate social responsibility has benefited Reebok's bottom line. In the 1990s during the height of anti-sweatshop activity, Nike appeared in 61% of the related news reports while Reebok came up in only 3.1%. Further, partly as a result of their relatively prominent CSR program, Reebok profits went from $11 million in 1999 to $192 million by 2004 (Yu 2008). According to Stephen Frost, Executive Director of CSR Asia, the Reebok trade union election experiments are an example of "how workers' aspirations are repackaged into forms that suit external agendas. When Chinese workers want trade unions of their own making, they will need to fight for them in their own way" (Frost 2007).

Some also believe that corporate-facilitated worker representation mechanisms such as H&S committees or union elections are inherently illegitimate and cannot be truly representative of workers interests, sometimes going so far as to say that Reebok did not even have the right to engage in such activities (Frost 2007). In this view, H&S committees and unions resulting from corporate-facilitated efforts at best result in "managerial paternalism." "Rather than leading to labour power and resistance in the workplace, labour politics will be co-opted by the 'political' side of capital" with the potential consequence being "the shrinking of labour autonomy and collective power if labour protection mechanisms are defined, regulated and constrained by capital" (Ngai 2004). These critics see Reebok-facilitated H&S committees and union elections as potentially preventing the formation of "real trade unions" (Merk 2006).

Not all observers agree with such a cynical view of Reebok's CSR and union election initiatives, however. Ms. Tucker of Reebok has defended Reebok's worker representation experiments, explaining that they serve "not as a panacea, but as a process…that held the greatest potential for long-term change that would eventually reduce the need for the brand's intervention to ensure good working conditions" (Tucker 2007). She maintains that the key to long-term change is raising worker awareness and that Reebok's H&S committees and union elections made progress toward that goal (Tucker 2007; Tucker 2009). Others emphasize the importance of Reebok's efforts in creating the space for workers to elect their own representatives in a political and cultural environment where doing such would be almost impossible otherwise (Chan, Oct. 2007; O'Rourke and Brown 2003). Mistakes may have been made in the implementation of Reebok's worker representation initiatives, yet it does not follow that therefore all such corporate-facilitated efforts should cease (Chan 2009).

THE LONG MARCH FORWARD

Changes on the ground in China in the past several years reveal that this more positive take on Reebok's worker representation experiments might have validity to it. Evolution in the views and practices of the Chinese government, the ACFTU, and the workers themselves indicate that Reebok's initiatives likely were not a futile exercise in a vacuum of political restriction, but rather one step out of thousands that stakeholders in China have begun to take toward greater worker representation and labor rights. Anil Verma, Jing Wang, and Stephen Frost speak of a "Third Way" for labor standards in China, described as the "evolution of a web of institutions, some from the communist system, some from outside, that will create a web of formal rules and informal norms to improve labor standards" (Verma, Wang, and Frost 2005). Though Frost opposed Reebok's worker representation efforts in a CSR Asia Weekly article (as cited earlier), the "Third Way" does cite multinational corporations as one source of pressure for change, and Reebok's efforts fit quite well into that role (Verma, Wang, and Frost 2005).

GOVERNMENT EVOLUTION

Over the past twenty years, the Chinese government has slowly initiated many changes in law and administrative practices that have begun to address workers' rights and provide a legal basis for worker empowerment (Verma, Wang, and

Frost 2005). Many of these government changes are simply part of China's gradual economic reform and opening; however, pressure and influence from companies like Reebok have likely contributed to the acceleration of the pace of labor reforms. The passage of the Law on Protection of Women's Rights and Interests in the Workplace of 1992, the Trade Union Law of 1992, the Regulations for Handling Labor Disputes of 1993, the Labor Law of 1994, the amended Trade Union Law of 2001, the Law on Occupational Diseases Prevention and Control of 2002, the Law on Safe Production (Work Safety Law) of 2002, and the Labor Contract Law of 2008 each contributed to institutionalizing workers rights and labor standards into Chinese law and society (Howell 2006; Verma, Wang, and Frost 2005; Chan 2004; Chan 2005; O'Rourke and Brown 2003). In particular, the 2001 Trade Union law revisions deemed work stoppages and slowdowns as legal and allowed for democratic labor union elections, while the Labor Law protected the right to engage in collective bargaining, as well as mediation, arbitration, and litigation of labor disputes (Chan 2004; Chan 2005; ICFTU 2004; Verma, Wang, and Frost 2005). The 2008 Labor Contract Law required employers to sign written employment contracts with full-time employees, allowed employees to sue employers directly, and strengthened the role of the official union in areas such as collective bargaining (Harris and Luo 2008).

Aside from the creation of new laws, the Chinese government has instituted reform in other ways as well. In 1998, the high-level Office for Maintaining Social Stability headed by Wei Jianxing, then President of the ACFTU and a member of the Politburo Standing Committee, was created to deal with disputes (Howell 2006). The government also set up a labor inspection system, run by the State Administration of Work Safety (SAWS) to assure enforcement of workers' rights. As of 2003, however, SAWS only employed 20,000 inspectors, leaving only one inspector for every 35,000 workers as compared to one inspector per 4,000 workers for Hong Kong's inspection program (Verma, Wang, and Frost 2005; O'Rourke and Brown 2003). In 2008, the Ministry of Human Resources and Social Security outlined a policy, known as the Rainbow Plan, which included the goals of increasing union representation and establishing collective wage bargaining systems in private companies across China by 2012 (An, Isaacs, and Lauffs 2010). Though enforcement of these laws and mechanisms remains a problem, they play an important role in the evolution of labor standards in China, including a delinking of political authority from managerial power by providing various levels of alternative dispute resolution systems (Howell 2006; Verma, Wang, and Frost 2005).

Government propaganda has also moved in a pro-worker direction, as has Beijing's willingness to tolerate protest and criticism (Verma, Wang, and Frost 2005). At the 16th Party Congress in 2002, it was decided that the Chinese Communist Party would officially move away from being a "revolutionary party" towards being a "ruling party," reflecting a desire in the government to strengthen accountability and the rule of law (Howell 2006). Movement towards becoming a "ruling party" could over time have the effect of improving enforcement of all laws, including pro-worker labor laws. An example of this took place in March 2004, when a statement by Premier Wen Jiabao sparked a government campaign to address problems of wage arrears. The State Council allegedly committed to resolving wage arrears problems in the construction industry resulting in 98.4% of arrears being successfully paid to workers by June 2004 (Verma, Wang, and Frost 2005). More recently in response to a wave of strikes at foreign-owned factories across China in the spring of 2010, the state-controlled media allowed relatively broad coverage of the strikes at Honda and Toyota factories, although as labor unrest spread, media coverage was curbed (Mitchell 2010). In response to demands of the strikers, Beijing also encouraged local governments to increase the minimum wage in their areas. At least 14 provinces and regions have raised minimum wages by up to 20% (Richburg 2010). Actions like these reflect the shifting tide towards support for workers.

ACFTU EVOLUTION

The ACFTU has also undergone changes in the past several years that could bode well for labor rights, and Reebok's efforts to promote worker representation likely helped pushed the ACFTU toward these changes. Though history of isolated direct elections in Chinese factories go back as early as 1982 and 1986, recent action has propelled union democracy to the national stage (Howell 2006). After Deng Xiaoping's tour south in 1992, "Implementing Regulations for Trade Union Grassroots Organizations Election Work" were issued, and then five years later the ACFTU issued "Opinions on Some Core Issues in Advancing Trade Union Reform and Construction" which called for direct union elections in small and medium enterprises (Howell 2006). In 2002, the ACFTU launched a national campaign promoting "democratic management" in the non-state sector, with maintaining industrial peace and stability as a primary motivation (Yu 2008).

Direct union elections have also sprouted from regional initiatives, such as in Zhejiang province which reportedly held more than 300 factory-level union elections around the year 2000 (Chan 2005; Chan 2009). It has been reported that in the provinces of Guangdong, Fujian, Zhejiang, Hubei, Shandong, Hebei and Inner Mongolia up to 70% of medium-sized private enterprises had directly elected trade union chairpersons, though the definition of "directly elected" in all of these cases remains questionable (ICFTU 2004). In 2003, an ACFTU press release announced that the ACFTU would promote similar elections across the country (Chan 2005; Chan 2009).

"Reebok's initiatives likely were not a futile exercise in a vacuum of political restriction, but rather one step out of thousands that stakeholders in China have begun to take toward greater worker representation and labor rights"

In January 2010, the ACFTU also announced plans to strengthen implementation of the Rainbow Plan described earlier by establishing a collective bargaining system nationwide, an important step towards finally enforcing the right to collective bargaining set out in the 1994 Labor Law (An, Isaacs, and Lauffs 2010). The union set up a committee of 60,000 members to negotiate wages on behalf of workers, and hopes to have collective contracts signed with more than 80% of enterprises in China by the end of 2011 (Chen 2010).

One motivation for the ACFTU's movement toward more genuine worker representation has been to increase the legitimacy, responsiveness, and accountability of the unions in the face of increasing worker unrest, seeing as elected union leaders tend to be younger, more capable, approachable, and energetic with a greater emphasis on workers' interests (ICFTU 2004; Howell 2006). Another may be to give the appearance of progress on labor rights so as to prevent more foreign firms such as Reebok from pushing their own efforts (Chan 2005; ICFTU 2004). In that way, the ACFTU is attempting to take ownership over the idea of union elections and gain control over the process, thus improving the union as a bridge between workers and management rather than as an independent voice for workers (Howell 2006).

A further motivation for ACFTU reform is its desire for self-preservation. Currently, the state sector has the highest percentage of unionized firms, thus serving as the base of the ACFTU. However, as the state sector shrinks, so does the ACFTU's relevance and funding (Chan 2005; Howell 2006). To prevent this outcome, the ACFTU has extensively promoted the extension of union branches to non-state enterprises and boosted union membership from approximately 90 million members in 1998 to 134 million by 2003 (Bodeen 2003). But to maintain relevance, the ACFTU has to do more than maintain a long member list. It also has to represent workers well enough so that worker unrest keeps at a minimum. Enterprise-level union elections and collective bargaining are two tools that the ACFTU hopes to use to achieve that goal (Chan 2005).

In 2004, the ACFTU achieved the ultimate goal in global labor organizing – the unionization of Wal-Mart. As the first in the world to successfully force Wal-Mart to unionize, the ACFTU has increased its stature and set a powerful precedent (Chan 2005; Howell 2006). By August 2006, the two parties also agreed to direct union elections according to ACFTU guidelines. Not only has this created great momentum towards worker representation in China, but it also provided an opportunity for the cooperation between the ACFTU and foreign unions, particularly the International Trade Union Congress (ITUC, formerly ICFTU) which formerly refused engagement with the Chinese union on the basis that it was not truly independent (Chan 2009). Over time, increased communication between foreign unions and the ACFTU could result in a transfer of knowledge and labor practices that could nudge the ACFTU toward more democratic, independent policies and worker representation.

WORKER EVOLUTION

In the past 15 years, Chinese workers have also undergone profound changes. Largely as a result of foreign companies' CSR commitments, such as Reebok's H&S committee trainings and union elections, workers have gone from not knowing the purpose of a union or what their labor rights were to being increasingly aware, actively using the law to serve their interests and fight for improved labor standards (Howell 2006; Chan 2005; Chan 2009). Because of corporate training initiatives like Reebok's, a large percentage of southern China's 10 million migrant workers have completed at least a couple hours of labor rights awareness training (Chan 2005). This increased worker awareness combined with the promulgation of more pro-labor laws has even spawned a new industry of lawyers and paralegals that help workers navigate the increasingly favorable labor law landscape (Chan 2005).

As workers have become more aware, they have also become less willing to make the move from their hometowns to cities for work (Chan 2005; Tucker 2009). Before, demands for improved labor standards were continually undermined by the estimated five million new workers searching for jobs each year and the 140 million migrant workers willing to accept any available jobs regardless of working conditions (O'Rourke and Brown 2003). However, around 2003 Chinese newspaper reports about migrant labor shortages in southern China began appearing. Due to deteriorating factory working conditions, falling real wages, and improving rural economies, migrants' cost-benefit analyses began favoring staying home rather than going out to the city for work. By 2004, some claim that 80% to 90% of factories in certain areas could not attract enough labor and had to cut production (Chan 2005). After Chinese New Year in 2005, approximately 10-20% of industrial workers in Guangdong traveled to their hometowns for the holiday and never returned to the city for work afterward (Economist Intelligence Unit 2005).

Demographic changes are beginning to impact labor dynamics as well. Thirty years after the implementation of the one-child policy in China, the once-bulging working-age population is beginning to taper off, exacerbating labor shortages and giving young migrant workers a stronger hand in demanding improved labor rights and working conditions (Watts 2010; China Labour Bulletin). Having grown up in the age of computers, these workers are also more technologically savvy than their predecessors, making it easier for them to take advantage of text messaging, blogs, and internet message boards when organizing labor protests and spreading information about their labor rights (Barboza and Bradsher 2010).

Recent economic conditions have changed this trend of greater worker empowerment somewhat as millions of workers were laid off due to falling export demand (Tucker 2009). Nevertheless, the global economy will eventually recover, and rural Chinese workers are not likely to change their minds about staying home unless rural economies worsen significantly or labor conditions and wages in the cities increase substantially. Workers' spontaneous decision to "vote with their feet" coupled with demographic changes could ultimately increase workers' bargaining power vis-à-vis factory management and bring rise to new opportunities for worker empowerment and improvement of labor rights in China (Chan 2005).

CONCLUSION

Reebok's introduction of worker representation mechanisms and development of worker awareness may have failed to achieve the short term goal of improving working conditions in Reebok's Chinese supplier factories; however, these initiatives did manage to influence larger dynamics in China that are arguably just as important. By putting outside pressure on the Chinese government to begin enforcing labor laws and by demonstrating how cooperation with outside actors can lead to innovative strategies for incremental reform, Reebok made an important contribution to the development of the "Third Way" towards improving workers rights in China. Likewise, Reebok's example of initially successful enterprise-level union elections demonstrated to the ACFTU and the Chinese government the enthusiasm of the workers toward greater representation in the workplace and the potential that such representation could have for improved labor standards, increased union legitimacy, and stabilized industrial relations. Without this exposure, the ACFTU's evolution towards more democratic and accountable representation very well may have taken much longer. Finally, Reebok's programs to directly educate workers on labor rights, as well as their role as a leader of the CSR movement in China encouraging other firms to launch their own efforts, have had substantial positive impacts on the development of worker awareness and activism in China. When evaluating the success or failure of the Reebok-facilitated union elections and H&S committees, these important positive externalities must be taken into account.

Though Adidas shows little interest in continuing Reebok's worker representation initiatives, the stage has been set for other stakeholders to pick up where Reebok left off. Reebok's collaboration with the National Retail Federation of the United States and the Retail Council of Canada to create the Fair Factories Clearinghouse in January 2005 further cemented this legacy by creating a platform for the sharing of information about the thousands of factories around the world from which corporations source (Economist Intelligence Unit 2005). The more transparent information on sourcing factories is, the more accountable and responsive corporations are likely to be to consumer demands for improved labor conditions. Likewise, efforts by the International Labor Organization to develop a "decent work index" could be used to compare localities and help create a race to improve working conditions that could help counteract the infamous "race to the bottom" for which many have claimed China responsible (O'Rourke and Brown 2003).

China has only just left the starting line at the beginning of its long march towards improved labor standards. Reebok played an important role by shooting the starting gun of corporate social responsibility in China, but it will take many more actors to keep the march moving forward. That will not only be the job of multinational corporations, governments, NGOs, and the workers themselves, but also of individual consumers across the globe. In order for steps to continue being made in the right direction, consumers must take the cue from China's migrant workers and "vote with their feet" by standing behind corporations that contribute positively to worker empowerment and calling out corporations that do not. No single actor, including Reebok, can assure the protection of labor rights, but when we each do our part, the long march may just become a little shorter. ■

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Interview: Professor Marshall W. Meyer

Professor Marshall Meyer discusses China's experimental decentralized transition to a market economy, the influence of state-owned monopolies on private firms' capabilities, and the fundamental differences between Chinese and American firms.

Interviewed by Susan Kolber for the *Wharton Asia Economic Review*

WAER: When did you start researching China?

Marshall Meyer: In 1992, I flew to a conference in Tokyo, and I thought it would be interesting to take a side tour to Beijing. At that time, if I recall correctly, you had to fly through Hong Kong to Beijing, so I flew down to Hong Kong. It was an eye-opening experience. In 1992, China was competing for the 2000 Olympics and in preparation for the bid, construction cranes were already hard at work. In 1993 I went back with my children, and I toured a little more extensively. The change between 1992 and 1993 was dramatic. There were no private cars and very few limousines in Beijing in 1992, but by 1993 cars were bumper-to-bumper. The bicycle parking lot off of Wangfujing was gone. Ten thousand bicycles disappeared somewhere. The largest McDonalds in the world at Wangfujing was gone because they were preparing for the construction of the Oriental Plaza, so I was amazed at the pace of change. In 1996 I did a little teaching in Hong Kong and did a side tour of Shanghai. I discovered that the map I had bought (which was then a year old) was entirely out-of-date, because it didn't even show Pudong. In 1999 I taught a six-week course at Tsinghua University in Beijing. That too was an amazing experience because I was only teaching one day a week, so I had the other six days to wander around the city.

WAER: What was your initial reaction to Chinese companies?

MM: What struck me just walking around were the signs of nascent entrepreneurship and contrast between the lumbering state-owned enterprises, which, with a few exceptions, didn't seem to be globally competitive, not even efficient within their own markets. So I decided to figure this out—I had to understand it, because it looked to me as though it was going to be extremely important. I didn't know why exactly, but I felt the way to understand it was to get inside of the state-owned enterprises, because my suspicion from the outset was that the future of China was going to be tied closely with those state enterprises. This comes from a Western prejudice that large enterprises are really what drive large economies.

WAER: How did China's economic reform process compare to Russia's and Eastern European countries'?

MM: After that summer, my initial impulse was to study the reform process in China, which I did. That became a really interesting exercise because one of the things we discovered was that the Chinese reform process was entirely different from the process in Russia, and also entirely different from the reform process in Eastern Europe. Russia was shock therapy; overnight change from state ownership to marketization of large enterprises. It was a very tumultuous process that depressed the Russian economy, concentrated economic power in the hands of a few, and Russia is still recovering from it. They had a boost with oil prices, but now they've lost that boost, and the Russian economy still has not taken off the way people anticipated it would.

Eastern Europe had a much more gradual process, very incremental, which has been reasonably successful. It hasn't lead to spectacular growth rates. However, the growth rates that have seen the greatest change in Eastern Europe are from the countries that had the most vibrant economies prior to the Soviet takeover in 1948. China's process was entirely different; it was neither shock therapy nor gradual. It was a deeply decentralized, experimental process, with the central government paying for the experiments, but it otherwise did not coordinate economic reform. Not only that, when the economic reform process finally got underway in the early nineties, it in a sense de-funded the countrysideof China.

WAER: Can you explain China's economic reform process, and how it created great regional economic discrepancies?

MM: The first reform process in China was actually somewhat centrally coordinated when applied to the countryside. The main result of that was the replacement of collective farms with the household responsibility system. Individual households were given the use of but not ownership of plots of land. Anything beyond the set targets of production households could keep and sell, so you got rudimentary capitalism going in the countryside, referred to as township village enterprises (TVE). All the way to the mid-nineties, scholars said that Chinese economic growth would be with the TVE's and the so-called red-hat enterprises that pretended to be state owned but really were not. But the government changed their policy, the countryside did not grow as rapidly post-1993-94 as from 1978 to the early nineties, and growth took off in the special economic zones like Shenzhen, designated by the government, because these were magnets for foreign investment. But the whole process for reform was very decentralized and fragmented in China. The result was a lot of variation and outcome. In the SEZ's (Special Economic Zones), there were some very interesting outcomes. In non-Special Economic urban areas, there were some very contorted outcomes. In the countryside, there weren't good outcomes at all. What struck me was the experimental nature of the process: trial and error distinct from a centrally-planned coordinated process and centrally-reengineered institutions. My interest in China stemmed from this, because it was extremely different from anything I had read about or seen.

WAER: What is the dynamic between local governments and the central governments in China? Is China decentralized?

MM: Even to this day I don't think all the scholars realize how decentralized China is. Particularly political scientists like Berry Weingast at Stanford who continues to write about China as a "Federal System" as if it's like the USA. A federal system has different layers of government, but the responsibilities are well delineated, and there is a process for reengineering that balance. In China, it is a much more traditional system where the responsibilities are not clearly outlined, and even more interestingly, there seems to be no clear process for adjudicating differences. There is a constant tug-of-war between the central government and the local governments in China. It reminds me of 16th century Elizabethan England: the nobility versus the crown. China is a fascinating place because it is so complicated.

WAER: Can you discuss your current research project on Chinese "administrative monopolies" and how they affect private businesses and commerce?

MM: One project with colleagues at Peking University involves unpacking the Chinese industrial census. We have ten years of data covering all firms with revenues over 5 million RMB. It's a monstrous data set, very imperfect. Other scholars have access to it in China; about six universities have access to it as well. We are eager to understand a phenomenon unique to China called "administrative monopoly."

China has local government monopolies. When we think of state-owned enterprises, we typically think of centrally-owned enterprises. If all goes according to plan, China will have ultimately between 60 and 80 centrally-owned enterprises. They are intended to be leading enterprises in China: centrally-owned enterprises like the three major oil firms, PetroChina, Sinopec, CNOOC and shipping company Cosco.

> "This company in China is trying to do exactly the opposite, at least in managing the company as if it were broken up into many smaller companies... The fragmentation of a large company is consistent with the larger pattern in China of decentralization."

However, there is a myriad of locally-owned government enterprises. They are called state-owned enterprises, but they are locally owned in a variety of industries, some even in the automotive industry like First Auto Works. An issue in China, a legal issue, is the ability of local government monopolies to block commerce. We are studying the impact of local dominance on the capabilities of surrounding firms, particularly privately-owned firms. Sure enough, using our meticulous analysis, we are finding locally-owned firms with dominant market share tend to impede the export capabilities and profitability of the private firms. We are not sure exactly how this works, whether dominant local firms constrain the size and hence the capabilities of the privately owned firms, or the locally owned firms constrain other resources available. We cannot identify the mechanism from the aggregate data. However, the effect is clear.

The policy of China is also to encourage exports. Hence it is ironic that administrative monopolies continue to exist even though the 2008 Anti-Monopoly Law bans them and these administrative monopolies impede private-sector exports even though it is central policy to promote exports. This is illustrative of the more general pattern in China of local and central government working at odds with one another. China is not a consistent system by any means. The inconsistencies persist because there is no consistent central enforcement mechanism.

This research illuminates the tension between central policy, good economics, and local government policies. We've always known that the markets are fragmented in China, but it has been really hard to prove the consequences of that fragmentation since whatever data are available are old. What you really want to get at is the trade between the provinces which is difficult to document, so we are looking at the export capabilities of firms as a function of local dominance by locally-owned state enterprises.

WAER: Can you discuss your research and consulting efforts to reorganize and apply a completely unique company structure for a large Chinese firm?

MM: The other project I'm working on is a project with a very well known Chinese company (whose name cannot be disclosed) whose management is attempting to implement radical innovation in the way they organize internally and compensate their people. Basically, they are trying to take a multi-billion dollar company and break it up into thousands of little companies each with their own income statement, balance sheet and cash flow statement. They would compensate people based on bottom-line performance. In effect, this creates a platform in which innovation and entrepreneurship become not only possible, but also necessary in the context of what is otherwise a very large Chinese firm. In the US, this would be totally counter-cultural because we've had the opposite effect: the mantra we have is scale economies and bulk your units within companies. A firm like General Electric that in the 1960s had 120 separate business units has only seven or eight today. This company in China is trying to do exactly the opposite, at least in managing the company as if it were broken up into many smaller companies. There is an opportunity to track this process and track its consequences. The fragmentation of a large company is consistent with the larger pattern in China of decentralization. If we are able to get this research it will interesting to see if, for reasons of culture and history, management systems in China will be quite different from management systems in the West. That is a big question right now.

WAER : How do Western companies approach the Chinese management style?

MM: It's not clear yet that there is a dominant Chinese style. The old style was state-run until fifteen years ago, so no one tries to emulate that. I think that the larger companies have a good understanding of the fragmentation of China. For example, major pharmaceutical companies going into China will not organize by product line. Rather, they will organize by geography, by province. Procter and Gamble in the past has had different organizations for different product categories, but they've exempted China from this and have understood that China is a different market. Multi-national companies (MNCs) do adapt, but whether they are going to operate as unitary organizations or as geography-based organizations within China or further devolve the organizations I don't know at this point. I tend to think that beyond the accommodation to China and provincial differences, MNC's generally operate with similar management systems as they do outside China. That is my guess, but my research is not focused on MNC's.

WAER: What are the fundamental differences between Chinese and American companies?

MM: The first thing is between ownership and governance. Ownership can be totally opaque in China. Usually there is a governmental component of ownership. Often, Chinese firms run on a parent-subsidiary system. That is not unusual in the West, but what is unusual about the Chinese subsidiary system is that the parent companies don't have one hundred percent ownership of its subsidiaries. The parent may be state owned, but the subsidiary maybe partially listed. The percentage of listed shares tends to go up over time as the reform process continues. Moreover, their subsidiaries may be partially owned by local governments. Typically, subsidiaries are locally based. There can also be cross-ownership among the subsidiaries. With US banking for example, typically you have a bank holding company that owns different financial subsidiaries sometimes geographically based, sometimes product based. However, the parent companies' board populates the boards of the subsidiaries; they have one hundred percent ownership, entirely overlapping boards, with the subsidiary board as a subset of the parent board, so there is one hundred percent control.

The second big difference is that stock options are scarce to nonexistent in China. The government has severely limited the availability of stock options, so the incentives are based on current performance, not on the performance of shares. Share holdings by senior managers are very small.

The third piece has to do with listed firms. Most listed firms are in fact subsidiaries of parent corporations because the listed entities are enmeshed in group corporations; they have a lot of connected or related transactions. These connected or related transactions are not always audited as closely as they should be. In fact, the Chinese government gets very concerned about connected or related transactions, since they will affect reported profitability, reported revenue, and hence income taxes due. There is an interesting form of government supervision and very complex rules accounting for connected related transactions amongst firms. It would be an obscure question but for the fact that listed companies typically engage in a lot of these transactions, so it can get quite difficult to interpret reported financial results. ■

Since 1987 Marshall Meyer has been a Management Professor at Wharton. Previous to Wharton he taught at University of California, Riverside, Cornell University and Harvard University. He has been a visiting professor at Hong Kong University of Science and Technology, Singapore management University, Chinese University of Hong Kong, Tsinghua University, Yale University, University of California, Los Angeles and university of California, Irvine. Professor Meyer is the senior editor of Management and Organization Review and an advisory editor for Harvard Business Review—China. He also consults Chinese firms on design and evaluation strategies.

Indian Higher Education: A Logic of its Own

India's rapid economic growth masks a proliferation of low-quality higher education, a result the politicization of the educational system itself; while the economy has been able to circumvent the deficiency of well-educated workers until now, the need for extensive education reform is imminent.

Allison Carroll Goldman

As it looks toward the future, India will face a series of challenges. From developing infrastructure to eradicating poverty and managing the effects of climate change, India will find itself far better equipped to confront serious problems if it can first manage to rapidly and significantly improve human capital. The role of higher education in building human capital has been largely accepted. Yet the specific goals of higher education remain imprecise. Higher education is complex in that it serves a myriad of separate but often overlapping objectives, on both a national and individual level. India's goals arguably include harnessing knowledge for social benefit, training a labour supply that is either directly employable or easily trainable by firms, promoting greater socio-economic mobility, growing a middle class and, especially in so large and diverse a democracy as India's, shaping the sensibilities and values of citizens. Clearly, higher education has broad aims. The trouble with the Indian system, however, is that while it boasts the third largest enrolments in the world and the largest number of institutions, it has become increasingly incapable of fulfilling these aims (Agarwal 2009).

As one of the last bastions of the license-control raj, higher education in India remains tightly regulated by government agencies. Prime Minister Manmohan Singh lamented that the system is in disrepair, with almost two thirds of its universities and ninety percent of its colleges of below-average quality and following a curriculum out of sync with employment needs (Singh 2007). Given that universities in India remain highly regulated and India has been purposely trying since Independence to marshal its system of higher education to promote development, why has the system fallen into such disrepair? Further, if the quality of India's universities is indeed so poor, why is it not clearly handicapping India's rapid economic growth?

The current state of education can be explained by i) the nature of inequality and identity politics in the Indian state, and ii) the structure of university regulation systems which create fertile ground for rent seeking and politicization of academic appointments. These factors have caused a rapid proliferation of universities and colleges, lower unreliable standards and increasingly scarce resources of both faculty talent and finances. The result is a large, unwieldy, self-serving system that has lost touch with the needs of a rapidly changing economy and can no longer indicate qualifications to firms. Even the few elite institutions of excellence have lost touch with national goals and face daunting shortages of talented faculty. India's rapid development of a knowledge-based economy may mask failings of its educational system to the outside world. Economic expansion appears to have been fostered by the ingenuity of firms who have managed to circumvent shortages of qualified labour and succeed despite pervasive deficiencies in India's system of higher education.

The first part of this essay will outline the structure of higher education in India and describe the driving forces behind its rapid but low-quality expansion. It will then discuss the effects of this expansion and suggest likely obstacles to reform. The second part will briefly outline how the private sector has sought to circumvent these obstacles by setting up massive in-house training facilities and captive partnerships with specific universities. Finally, the essay will end by stressing the market failures inherent in higher education, which cannot be satisfied by the private sector. It will suggest that to achieve the quantum leap in higher education India requires, it needs to enact even more transformative reforms than those recently suggested by the recently appointed National Knowledge Commission (NKC).

PART 1:

The Indian university system is highly centralized. Until recently, most institutions came under the purview of the University Grants Commission (UGC), the All India Council for Technical Education (AICTE) and the National Council for Education (NCTE). While Parliament recently passed a bill to replace all these existing statutory bodies with a new super-regulator, the National Commission for Higher Education and Research (NCHER), the proposed functions of the NCHER do not appear to be drastically removed from the previous roles of the UGC, AICTE and NCTE and it is unlikely that this move will create much change in practice (Business Standard Reporter 2010).

Historically, the UGC was the body through which the Government of India discharged its constitutional responsibilities to promote and coordinate higher education and maintain standards of teaching, examining and research in universities. UGC was also responsible for allocating resources from the aggregate higher education budget determined by the Planning Commission and Ministry of Human Resource Development. Kapur has pointed out such "such extraordinary centralization of allocations is bound to produce significant distortions, because it presupposes an omniscience that few decision makers can have" (Kapur and Mehta 2007).

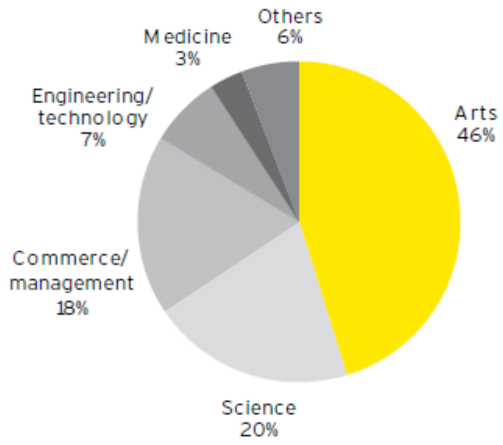
The higher education system includes various types of institutions, based largely on the British model, but also partially on the American model. It includes elite institutions of national importance, such as the Indian Institutes of Technology (IITs), Indian Institutes of Management (IIMs) and deemed-to-be universities, also called deemed universities. These elite institutions, viewed as tiny islands of excellence, are largely removed from the challenges of the system as a whole and receive funds annually from the Ministry of Education (Eisemon 1974). Other institutions include universities, either unitary or affiliating, and colleges.

Categorized by:	Types
Degree-granting powers	University (unitary or affiliating) vs. college
Legislative origin	Central vs. state or deemed-to-be university
Funding	Public (government/ aided) institutions vs. private (unaided) institutions *non-for-profit* (*or de facto for-profit)*

Source: Agarwal, Pawan. *Indian Higher Education: Envisioning the Future* (New Delhi: Sage Publications, 2009)

Colleges constitute the vast majority of the system. They generally have no degree-granting powers, but are affiliated to universities, which prescribe the syllabi, set exams and grant degrees. The many structural obstacles to excellence facing the Indian higher education system culminate in the affiliated colleges, where the bulk of expansion has occurred. They now enroll an estimated 87% of all student enrolment but a daunting 90% are rated below average on quality parameters (Singh 2007). There is a hierarchy among colleges. The most prestigious tend to be located at the center of cities, attract students from upper middle class backgrounds and have better facilities, larger libraries, and better qualified faculty. Other colleges are small and, especially in rural areas, are understaffed, ill-equipped and often non-viable (Altback 1977; Agarwal 2006). The student body of most colleges is homogeneous and faculty are often themselves graduates from that college (Altbach 1977). Teachers are not expected to publish and are more 'transmitters of knowledge' from those who do research and publish. Many college teachers fail to keep up with developments in their field and continue to teach outdated material. Facilities are poor, libraries are small, and few teachers have their own offices. Many lack even their own desk (Altbach 1977). As a result, in most colleges "teaching and learning have been reduced to purely examination oriented exercises, and even the limited task of preparing students for exams is virtually taken over by bazaar notes (cram books) and coaching classes" (Chitnis 1993). The courses offered and material covered in these colleges are poorly transmitted and disconnected from the needs of the market. While the market increasingly demands technical skills, 66% of students are enrolled in arts and sciences, with another 18% in commerce and management (Kapur and Mehta 2007).

Course-wise enrollment in higher education (2005-06)



Note: Data based on UGC estimates

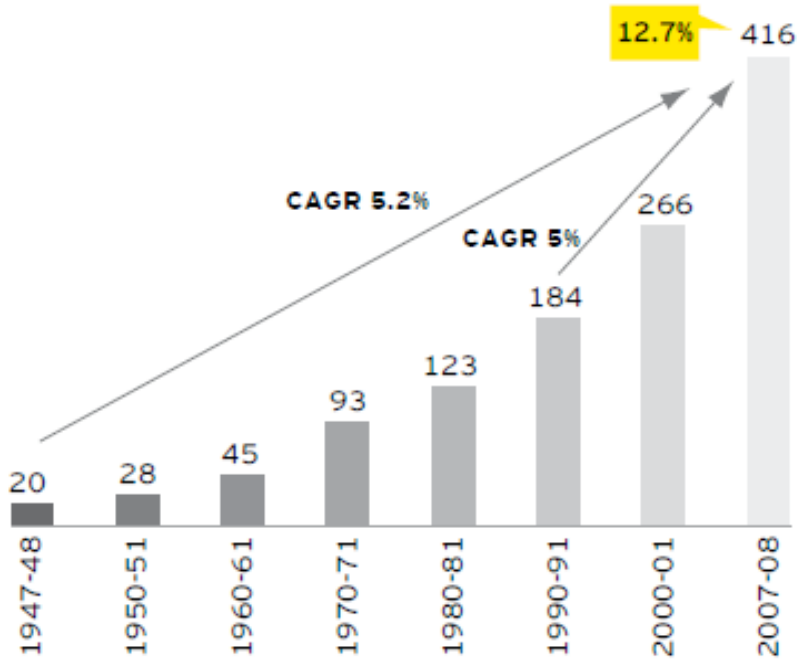
Under a misguided policy of the 1950s, research was separated from instruction. This bifurcation of research from teaching has created a dull and disheartening environment both for those teaching without the excitement of original research and for those researching without interaction with bright young minds. Bhattacharya observes, "in that environment, research became largely imitative and sterile" (Bhattacharya

2009). Education was overtaken by centralized bureaucracy, fixed and often outdated curriculum, and a deeply flawed system of standardized exams (Agarwal 2009). Indian undergraduate education takes place largely in colleges, post-graduate education in universities, and research in institutes (Bhattacharya 2009).

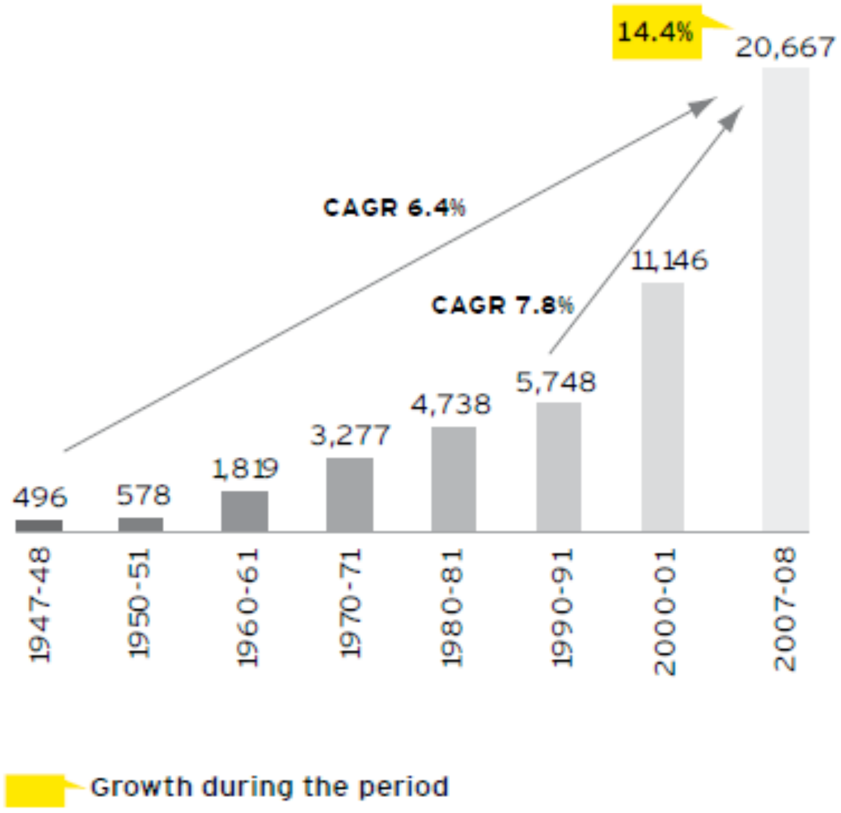
The NKC has recommended that India undertake a massive expansion of higher education to attain a gross enrolment ratio (GER) of at least 15%, from the current GER of 11%, and be in line with most modern societies by 2015 (Kapur and Mehta 2007; The Indian Council of Social Science Research 2007; Singh 2007). While the NKC has also emphasized that such a quantitative expansion of the university system must be accompanied by qualitative improvement in existing universities, it is unclear how such a feat can be achieved. In fact, the rapid proliferation of educational institutions has led to a degrading in the quality of instruction and the level of competence of graduates. While India's higher education system has grown at a remarkable 5% annually over the past two decades, this figure is not even half of the 13% or 14% annual rates seen in the 1960s and early 70s (Kapur and Mehta 2007; Singh 1984). Overall, India's system has grown from 28 universities in 1950-51, including 370 colleges for general education and 208 colleges for professional education, to 416 universities by 2008, with 20,667 colleges (Ernst&Young 2009).

Between them, universities and

Growth in universities



Growth in colleges



Sources: MHRD Annual Report 2007-08; MHRD Annual Report 2006-07; MHRD website; EY-EDGE 2008 report: Globalizing Higher education in India ; Pawan Agarwal report – Higher education in India: The need for change ; Higher education in India website colleges enrolled 14 million students in 2007 (Kapur and Mehta 2007). To reach the NKC's goal, India's higher education system will have to grow at an annual rate of nearly 9%, or enroll an additional 870,000 students in universities and about 6 million in colleges in the next 5 years (Kapur). To finance its expansion target, the 11th plan mandates a massive increase in government spending from Rs. 91.4 billion in the 10th plan (2002-07) to Rs. 745 billion in the 11th plan (2007-12) (Kapur). Considering the shortages of funding and talent already plaguing existing institutions, it is unlikely the 11th plan will be able to achieve increases in both quality and quantity. And, if history is any indication, the temptation of quantity is likely to win out and resources will be stretched ever more thinly.

Expansion serves powerful forces in Indian society. Altbach observes that the rapid growth of higher education "has been largely unaffected by the many plans and proposals to guide it" (Altbach 1993). In 1984, Singh noted how "whereas in most areas of education, the state was not able to achieve targets it had set for itself, it had overachieved the targets for establishing undergraduate colleges in small towns and rural areas" (Agarwal 1993). According to Kapur, higher education is the "collateral damage of Indian politics" (Kapur and Mehta 2007). It appears the recent proliferation of colleges has been more driven by politics than pedagogy and is largely a reflection of political responses to demands by various social groups. Politicians please their electorates by opening colleges in their constituencies. Skill premiums are rising and higher education degrees are perceived as the golden gateway to a middle-class lifestyle. The unintended result of haphazard growth is that the system has fallen out of sync with the economy's occupational structure and absorptive capacity for labour. Thousands of graduates are either under- or unemployed. Agarwal, who has worked with the higher education bureau in the Ministry of Human Resources, the UGC and the Indian Council for International Economic Research observes "unemployment rates are lowest among illiterate Indians, but rise progressively with education" (Lahiri 2010).

Instead of accomplishing the goals of higher education, chaotic burgeoning of institutions has led to spiraling credentialism (Wolf 2004). While nominal access to higher education in India has expanded drastically, the number of quality institutions has remained small. Despite the best intentions of the central government to monitor quality standards through the UGC and other statutory bodies, quality standards are inconsistent and many institutions are sub-standard and non-viable (Agarwal 2009). The quality of learning has been so degraded that university degrees no longer signal employability to potential employers and this function has been taken over by standardized exams set by the affiliating universities.

The distribution of enrollment across subject areas is lopsided towards general education, where 83.59% of students are enrolled. Only 16.41% of students are in professional programs, with a majority of this group in engineering and technology, followed by medicine. Enrolment in agriculture is 0.58% and in veterinary science merely 0.15% (Agarwal 2009). Distributions are out of tune with both the labour market and national needs. Significant public resources are spent giving young people qualifications not in demand.

Many local institutions serve to further the narrow financial and political goals of the politicians who control them rather than academic purpose or national policy goals. Pressures of continued expansion have depressed qualification standards for faculty and highly politicized appointments do not always reflect pedagogic ability. Many politicians who control colleges at the local level also run private professional colleges. Kapur and Meta point out "it makes good financial sense to run government-run higher education institutions to the ground since it forces students and parents to look for more meaningful alternatives in the private sector – which are controlled by them" (Kapur and Mehta 2007).

How can these low-quality colleges continue to receive political support from voters and the tacit support of federal regulatory agencies like the UGC despite their poor quality, unemployability of graduates, and misappropriation of public finances? Growing prosperity and rapid advances in communications build rising aspirations among young people. Higher education is considered the golden ticket to upward social and economic mobility. Proliferation of low-quality institutions at least allows India to absorb the massive demand for higher education and create a determined sense of equitability. The current system provides an important latent function. By offering access to higher education to huge numbers of middle-class aspirants, then failing over half of them by providing inadequate training for standard exams, it offers hope of social mobility to huge sectors of the Indian population who aspire to

> "By treating academics like civil servants, with automatic raises based on years of service, the system created a financial disincentive for faculty mobility among institutions and removed incentives to work towards academic excellence"

middle class status, and then lets them down more indirectly from within the system itself (Saxena 1990). This may offset social instability caused by increasingly visible inequality of opportunity. Access to higher education is treated as a right. Prime Minister Singh stressed the need to ensure "no one who wants to pursue further education is denied this opportunity for lack of resources" (Singh 2007). Of the three broad goals of national education policy, quality, quantity and equitability, targets that focus on the later two are easier to measure, and publicly popular.

Structural factors create a vicious cycle of politicization, mediocrity, and entrenched special interest at all levels of the higher education system. The highly politicized regulatory system has smothered academic autonomy such that "universities have steadily declined into factories that churn out graduates in response to economically pressured and politically defined demands" (Chitnis 1993).

Access to higher education is a high-stake issue that figures prominently in identity-based populist politics. Politicians often see higher education as the panacea for broader societal problems. Political considerations affect every aspect of higher education, from academic appointments and admission criteria to decisions on curriculum and selection of textbooks (Altback 1993). Since the State Governor is also Chancellor of state universities and affiliated colleges and is responsible for appointing the Vice-Chancellor, he holds the power card to enforce his own political preferences. In 1988, the Governor of Bihar dismissed all of the Vice-Chancellors in the state on political grounds. Similar dismissals and patronage appointments continue to occur in states across India (Saxena 1990). In 2007, Prime Minister Singh expressed concern that in many States "university appointments, including that of Vice-Chancellors, have been politicized and have become subject to caste and communal considerations" (Singh 2007). The consequence of how social inequalities play out in Indian identity politics is that while "many of the underlying handicaps faced by students from lower socioeconomic groups appear to occur much earlier in the life-cycle – at the primary and secondary school level-…policies to overcome these handicaps seem to be more politically expedious in higher education" (Kapur and Crowley 2008). Under such pressure, even elite IITs and IIMs have been required to lower admission requirements for Scheduled Casts, Scheduled Tribes and Other Backward Casts (Chitnis 1993).

While quality of education depends crucially on quality of instruction, the Indian system creates unfavorable conditions for academic excellence among its faculty. In 1973, the UGC implemented pay scales for university and college faculty that emphasized seniority over academic achievement (Singh). By treating academics like civil servants, with automatic raises based on years of service, the system created a financial disincentive for faculty mobility among institutions and removed incentives to work towards academic excellence (Altbach 1977). It promoted academic delinquency. Saxena lamented that many teachers "do not come prepared for their lectures and do not supervise the research scholars. They dictate 'notes' and continue to teach out-dated syllabi" (Saxena 1990). The quality of instruction in most Indian institutions illustrates how simplistic government policies on higher education can undermine, rather than advance, quality. As Wolf predicted, the effects have been that education has become a process of intense competition for credentials that remains "extremely unlikely to develop the types of skills which enhance productivity" (Wolf 2004). Kapur observes, "the vast majority of institutions are incapable of producing students with skills and knowledge" (Kapur and Mehta 2007). Although every year the system releases a growing number of credentialed graduates into the labor force, skill premiums in India continue to rise, by 13% from 1987 to 1999, and again by 25% from 1998 to 2004 (Kapur). Rajdeep Sahrawat, the Vice-President of the National Association of Software and Service Companies (NASSCOM), estimated merely 25% of technical graduates and 10% to 15% of general graduates are considered employable by multinational companies (Pai 2008).

The system has fallen victim to itself and veered away from its stated objectives. The Survey of Higher Education in India (1984) disparagingly observed, "the curricula and syllabi of many of our institutions would have, perhaps, been much the same if they were situated on the moon" (Saxena 1990). Higher education in India has lost touch even with its own needs for qualified post-graduates. 89% of students are enrolled in undergraduate programs, with only 9.42% in post-graduate programs, and a mere 0.64% in doctoral programs (Agarwal 2009). Disproportionate enrollment at the undergraduate level creates acute faculty shortages across all fields. In economics, for example, although the number of economics departments in Indian universities increased from 72 in 1971 to 119 in 2001, "the number of PhDs produced by India's premier economics faculty – Delhi School of Economics – has dropped from about 4.5 a year in the 1970s and 1990s to barely 1.5 a year in this decade" (Kapur and Crowley 2008). The Pay Review Commission of the UGC found that 44.6% of sanctioned positions of lecturers at the university level and 41% at the college level were vacant (Kapur and Crowley).

The quality of undergraduate education cannot be improved without more teachers with PhDs, and yet prospects for overcoming this challenge in the near future are slim. The higher education system has grown through the proliferation of affiliated colleges, which conduct no research and have no hope of graduating students with facility in this area. In Tamil Nadu, about 400 colleges offer undergraduate science degrees but even the large university town of Coimbatore has only 5-10 PhDs in its university faculties. Similarly, Bihar has over 264 colleges offering undergraduate degrees, but only 16 offering postgraduate ones (Thadani 2005). Awarded PhDs are of varying quality. With so many new institutions, including supposed high-quality IITs and IIMs coming up, it is unclear where all the faculty will come from. No five year plan will be able to ease this shortage easily. Bhattacharya believes the "scarcity is bound to get worse for at least a decade," and since "academic institutions are especially sensitive to conditions that exist at the time of their inception…a rapid recruitment of less-than-stellar faculty can quickly doom institutions to a future of mediocrity" (Bhattacharya 2009). The challenge in attracting talent is heightened by the lack of autonomy, and high politicization in most Indian institutions that creates adverse work conditions. These make academic positions far less attractive than the lucrative opportunities offered by the country's growing private sector or academic positions abroad. Ironically, while Indian's higher education institutions urgently need resources to attract talent, they suffer from strict controls that make it difficult to grow private resources through higher fees, licensing arrangements or even private donations. Those resources they do raise "are often offset by cuts in public expenditure" (Kapur).

> "Infosys has invested over $450 million in its training institute and spends about $5,000 training each recruit through its 14-16 week comprehensive training program"

Restricted from adjusting faculty pay-scales to meet the global market for talent, even India's elite IITs, IIMs and deemed universities face faculty shortages (Kapur). Short of qualified researchers, prized research institutes have had to start their own integrated masters and doctoral programs and acquire deemed university status. Higher education in India is neither producing talent to fulfill demand nor providing the conditions necessary to retain what talent it does produce. Approximately 25% of all IIT graduates up until 2003 (31,900 of 113,245) left India to pursue post-graduate and doctoral studies abroad and did not return. (Agarwal 2009). Stringent regulations are driving away both India's brightest talent and the financial resources they take out of the country with them. This has emerged as so serious a problem that the Parliament's standing committee on Human Resource Development recently recommended taxing students who accept overseas jobs after graduating from India's premier education institutions, as well as their employers abroad (Agarwal 2009).

The government is deeply aware that, considering disrepair of India'a higher education, failure to reform the system in a meaningful way will adversely affect the country's future. The 11th plan is dedicated to amending the problem and many reforms are being passed. It is clear that heavy regulations have obstructed the development of quality institutions. In seeming response, Parliament has announced plans to replace the UGC, AICTE and NCTE with the NCHER as a new regulatory body. Unless its primary mission is to liberalize the education system, allow more flexibility and allow greater academic processes of horizontal accountability to take root within institutions, however, the NCHER is unlikely to accomplish much change. Higher education is one of the most difficult sectors to reform. There is a high risk that, like the UGC before it, the NCHER will simply fall victim to popular influence and rent seeking. Higher education has proceeded largely according to an internal logic of its own, and is laden with entrenched interests that federal regulatory bureaucracies have often failed to overcome. Over the years, the UGC tried to promote exam reform, grant autonomy to selected colleges and restructure syllabi, all with limited success. The NCHER will face similar political pressures. Not only does the current system serve important latent functions necessary for stability of the state and rent-seeking functions for local politicians, but movements toward reform are also typically met with fiercely determined opposition by students and faculty. Higher education is so contentious an issue that even the Supreme Court has been unable to overcome the force of political pressures. Although it has ruled that reservations must not exceed 50 % of enrollment, this ruling has been simply overlooked by several states (Kapur). Replacing the UGC with a similar regulatory body will not change the central challenges to reform: i) political preferences, ii) entrenched interests in maintaining the status quo by teachers and students who will actively protest any efforts for reform, and iii) scarcity of resources. In India, no bureaucracy is immune to the pressures of politics. The NCHER is likely to fall victim to rent-seeking and political pressure from the Ministry of Education, the HDR ministry and key higher education institutions as did the UGC. The current system provides lucrative opportunities to politicians who set up their own private education facilities, teachers who write cram books and offer private tutoring for exorbitant fees and a myriad of other players. Before meaningful changes take root, incentive structures must be changed at every level. A key limitation of the UGC's ability was lack of resources to inspect the functioning, supervise or monitor standards at recognized colleges. It is hard to ensure programs are being implemented without being able to adequately monitor progress (Chitnis 1993). The costs of large bureaucracy are too high and inefficient to justify continued paternalistic regulations of the state. To move towards achieving the goals of higher education, the NCHER should be tasked with liberalizing and providing flexibility to higher education institutions.

Despite government restrictions against de jure privatization, breakdown of the system has led to de facto privatization on a massive scale, both within the existing structure and parallel to it. As the public system has fallen woefully out of touch with needs of the market, private providers have moved in. In 2004, private institutions accounted for close to 75% of higher education enrollment (Kapur). A stunning 56% of general colleges and 96% of engineering colleges in Tamil Nadu are now private, self-financing institutions (Kapur and Mehta 2007). Most of the private investment is concentrated in engineering, medicine and management and therefore does not reach the majority of student who are enrolled in general studies programs (Kapur and Mehta 2007). Quality is low and emerging private institutions are "at best teaching shops, and very rarely knowledge-producing institutions" (Kapur and Crowley 2008).

PART 2:

Why has India's dilapidated system of higher education not manifestly hampered growth? As they have done before in response to poor infrastructure, firms have successfully adapted to the weakness. Innovations pioneered by the IT sector have expanded to other sectors such as retail, banking and finance and even public research centers. They circumvent obstacles of the unqualified labor market by setting up in-house training facilities and captive partnerships with local universities. India currently accounts for 65% of the global industry in offshore IT and 46% of the global Business Process Offshoring (BPO) industry (Nasscom-McKinsey Report 2005). To maintain this market share, IT companies invest massive resources training new recruits. According to T.V. Mohandas Pai, director of education and research and human resource development at Infosys, Infosys has invested over $450 million in its training institute and spends about $5,000 training each recruit through its 14-16 week comprehensive training program (Pai 2008). Wipro Technologies similarly runs a 12-14 week program. In the growing retail industry firms like Reliance Retail, the Future Group, Pantaloon, Bharti Retail and Shoppers, Stop, as well as the Retailers Association of India, have developed captive training programs through various universities. Pantaloon collaborated with the Maduraj Kamraj University to start a 3 year retail-focused bachelor of business administration (BBA) program (Kapur). By 2008, Bharti Resources had set up 60 learning centers across India that offer training in insurance, telecom and retail. That number should grow past 1,000 by the end of 2011. In the banking and insurance sector, ICICI Bank created the ICICI Manipal Academy of Banking and Insurance. This one-year residential program was designed jointly by Manipal University and ICICI. After completion of the program, candidates are absorbed directly by the bank, which covers the full $ 5,425 per student cost. Ernst&Young has opened a tax academy that trains recruits for its tax audit department. Even certain public-sector organizations, like the Department of Space, the Council for Scientific and Industrial Research (CSIR), and the Defense and Research and Development Organization (DRDO) have set up captive deemed universities to train qualified research and development personnel (Kapur).

These are not ideal solutions and industry is increasingly seeking to work with India's higher education institutions to redesign curricula and raise the quality of instruction. To increase the employability of recruits to the IT industry, Nasscom estimates that 12,000 to 14,000 faculty will need to be trained over the next 3 years (Pai). Under its 'Mission 10x', Wipro plans to train more than 10,000 faculty members in 1,500 engineering colleges over these 3 years. The Confederation of Indian Industry (CII) has been working closely with both the government and large companies to develop a public-private partnerships that will upgrade the public Industrial Training Institutes (ITIs) and align them more closely with the needs of industry. Bosch, Hero Honda, Ashok Leyland, Larsen Toubro and Bharat Heavy Electricals Ltd. have already taken on partnerships with ITIs. Tata Consultancy Services, Cognizant Technologies and Satyam Computer Services are also working with CII to integrate soft-skill courses into university curriculum.

It is important not to be overly optimistic about the ability of the private sector to make up for public sector failings in providing adequate higher education. Says Sabharwal, Chairman of Team Lease Services, Indias largest human resource provider, "skill development is only part of the solution" (Pai 2008). While these private-public initiatives provide a much-needed dynamism between universities and industry, this can satisfy only a small piece of the higher education puzzle. There are significant market failures associated with higher education. The market will rarely "create an environment that has long time horizons or which responds to important social needs" (Kapur and Mehta 2007). This is observed in that top research universities worldwide are largely publicly funded. Many OECD countries, such as Denmark and Holland, provide 98% of funding for higher education. Canada and the US provide 90% and 78% respectively. India faces large financial restrictions, but much headway could be made through restructuring the regulatory system to allow more flexibility and dynamism. The answer to India's higher education woes does not lie in under-cover privatization.

As it continues to rapidly develop, India will face many obstacles. While governments since the time of Nehru have sought to harness the power of higher education to achieve national goals, the system has buckled under the combined weight of their expectations. Politicians persistently look to higher education to solve broad social inequalities. As fertile ground for identity politics and rent-seeking practices, higher education in India has degenerated into a system of entrenched special interests that operates according to its own self-serving exigencies and not as the tool for nation-building it was hoped to be. Stakes are high for both the nation and the individual. In India, broad notions of justice, equitability, and nation-building mask the urgency of looming challenges the country will soon face. India can no longer afford to rely on the trickle-down effects of foreign research. To address climate change, expand its infrastructure, adapt to resource scarcities and take its place on the world scene, India will require location-specific research and innovation. While the government is taking important steps to confront dilemmas in higher education, programs of expanding access, increased spending, construction of new elite institutions, a new regulatory body and allowing the entry of foreign providers will not have their desired effects unless they are accompanied by a massive reformulation of the higher education regulation structure. As the academic marketplace continues to globalize, India must address adverse trends of elite flight for research posts and education abroad. The nation cannot afford to perpetuate a system that concentrates resources on competitive exams that fulfill signaling functions to employers but produces no real knowledge. The huge funds set aside for higher education under the 11th plan ought not be used in a sub-optimal way. To reap the maximum benefits from its investments, India's best hope is to unshackle the higher education system and allow flexibility, innovation, and academic standards of accountability to restore quality to the system. ■

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