

Challenges of Balancing Economic Growth with National Strategic Interest

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Abstract. This paper explores the complex challenge China faces in balancing economic growth with national strategic interests, particularly in the context of managing Foreign Direct Investment (FDI) policies. Tracing the historical development of China's economic transformation, it examines key reforms such as the Household Responsibility System and the rise of Township and Village Enterprises (TVEs), which played crucial roles in transitioning from a command economy to a market-oriented system. The paper also delves into the privatization wave of the 1990s and the legitimization of the market economy under Deng Xiaoping's leadership. This paper discusses the policy paradox presented by the 2013 Third Plenum, which advocates for market forces in resource allocation while maintaining state dominance. Under Xi Jinping's strategic imperatives, China selectively liberalizes sectors to attract high-quality FDI while safeguarding national security. By discussing the challenges of creating a stable regulatory environment, fostering domestic innovation, and ensuring economic resilience, this paper emphasizes the need for a balanced approach to sustain economic growth and safeguard national interests.

Keywords: Economic Growth, National Strategic Interests, Foreign Direct Investment, China's Economic Transformation

1. Introduction

As the world's second-largest economy and one of the permanent members of the United Nations Security Council, China is playing an increasingly important role on the world stage [1]. What is more worth mentioning is that China is a socialist country with a CCP one-party system. No one had expected China to develop so fast decades ago when China was still making mistakes while exploring the path of socialism. However, in modern days, as the economic transformation goes, China has become a rising power, with a 2.3% GDP annual growth rate in 2020, one of the limited countries with positive GDP growth rates during the pandemic [2].

Huawei, a Chinese mobile phone brand that has begun to go global in these years, is the No.8 World's Best Employers in 2021 [3]. With a 20% market share, Huawei is China's largest smartphone seller and ranks as the world's second-largest after Samsung [3]. As shown in Figure 1, as a private enterprise in China, Huawei has earned great profits and contributed to tremendous economic development for China, with revenue, gross, and net income growing every year. By creating tremendous value, shown in Figure 2, from 1995 to 2018, the contribution of employment

in Chinese cities supported by private companies has more than quadrupled, and the export created by the business sector has more than doubled. However, going back to the late 20th century, China just started to reform and open up and transform the market. Therefore, this paper analyzes the effect of the development of private enterprises on China's socialist economy reform in the late 20th century.

	2020		2019	2018	2017	2016
	(USD Million)	(CNY Million)	(CNY Million)			
Revenue	136,717	891,368	858,833	721,202	603,621	521,574
Operating profit	11,120	72,501	77,835	73,287	56,384	47,515
Operating margin	8.1%	8.1%	9.1%	10.2%	9.3%	9.1%
Net profit	9,916	64,649	62,656	59,345	47,455	37,052
Cash flow from operating activities	5,402	35,218	91,384	74,659	96,336	49,218
Cash and short-term investments	54,812	357,366	371,040	265,857	199,943	145,653
Working capital	45,870	299,062	257,638	170,864	118,503	116,231
Total assets	134,491	876,854	858,661	665,792	505,225	443,634
Total borrowings	21,751	141,811	112,162	69,941	39,925	44,799
Equity	50,678	330,408	295,537	233,065	175,616	140,133
Liability ratio	62.3%	62.3%	65.6%	65.0%	65.2%	68.4%

Note: Converted into United States dollars ("USD") using the closing rate at the end of 2020 of USD1.00 = CNY6.5198.

Figure 1: Huawei Five-Year financial highlights[4]

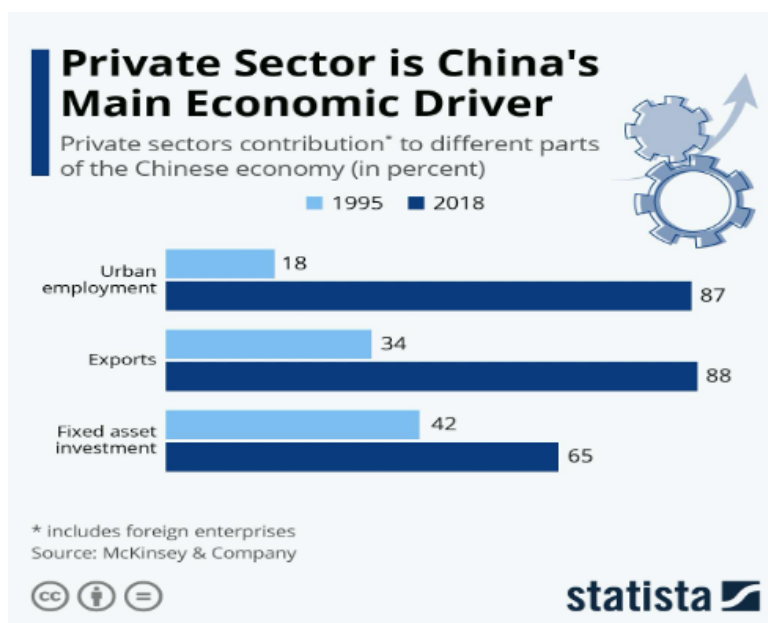


Figure 2: Private sector in China's economy[5]

As shown in Figure 3, since the 1980s, China's economic landscape has been transformed by an influx of FDI. It was because of Deng Xiaoping's introduction of Special Economic Zones (SEZs) and the adoption of an export-led growth strategy, mirroring successful models from East Asian economies, that turned China into a labor-intensive market to attract foreign capital for importing advanced machinery and technology [1]. However, if we turn our attention to Figure 3, there was a notable decline in FDI net inflows after 2013.

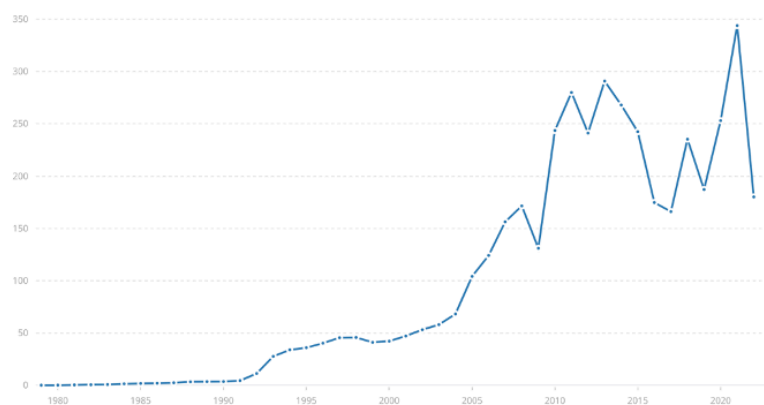


Figure 3: Foreign direct investment, net inflows (BoP, current US\$) - China[6]

Therefore, this paper analyzes the historical and contemporary impact of private enterprises on China's socialist economic reform, particularly focusing on the challenges China faces in managing foreign direct investment (FDI) policies to balance economic growth with national strategic interests.

2. Chaos in the mid-20th century

During the 1950s, the Soviet Union helped China develop industry, focusing on the heavy industry in central China. Following up the Soviet's step, China started the first five-year plan under Mao Zedong. China in 1956 found that the society was almost steady, but in 1957 the production was not as high as expected. Seeing that the Western powers cast iron and steel, Mao Zedong believed that ironmaking could help China's development. Thus, the Great Leap Forward began, which was not in line with China's reality and encouraged better, faster, and more economical agriculture. In 1958 the second meeting of the Eighth National Congress of the Communist Party of China passed the second five-year plan and formulated the general line and goal of "to gather energy, strive for the upper reaches, and build socialism quickly, efficiently, and economically." However, the unrealistic goals led to a disaster. The People's Commune was founded to support agriculture, collecting all the grain owned by the farmers and distributing it to all commune members as needed after unified cooking. However, due to the large amount of waste, the commune's food was quickly consumed, leading to subsequent food shortages. At the same time, the peasants misreported their output in order to achieve high targets, resulting in insufficient allocation of resources, exacerbating the famine. The famine made China's society into a mess, leading millions of people to die. Finally, China split with the Soviet Union Model and began its own way to develop socialism.

In the Lushan Plenum, Peng Dehuai wrote Mao Zedong a letter, criticizing the Great Leap Forward as a "petty bourgeois fanaticism" and pointing out to avoid the malformed Stalinism. Following the Lushan Plenum, Liu Shaoqi and Deng Xiaoping started to realize Mao's construction of socialism did not follow the trend of building up modern socialism. The divisions within the Communist Party, Mao Zedong's class struggle, and Liu Shaoqi building up a new socialism by inspiring people's working interests were getting worse. Therefore, as the conflicts got worse, Mao launched the Cultural Revolution to fight against the "bourgeois", such as intellectuals, capitalists, former KMT adherents, and reactionaries [7].

The Cultural Revolution lasted for 10 years, ending with Mao's death and the collapse of the Gang of Four. During the 10 years, China's economy was in a mess. In Figure 4, China's GDP

growth rate became negative when the Cultural Revolution ended. In the 1980s, Eastern European countries also faced an intensive economic crisis, boosting China's step and the necessity to start economic reformation. In the 1980s, due to the shortcomings of the Stalin model, the economies of Eastern European countries went from bad to worse, and the highly centralized economic system could no longer meet the requirements of economic development. Eastern European countries were generally heavily indebted, and inflation and people's living standards had fallen sharply. In the face of this challenging situation, some countries have carried out some reforms, such as Czechoslovakia and Poland, but failed to achieve the expected results. Increasing economic difficulties have led to severe social crises. In 1989, Eastern Europe underwent drastic changes. Within a year, the Communist Party in Eastern Europe, which had been in power for more than 40 years, lost power one after another. Gorbachev's reform led the Soviet Union to collapse. As a consequence, in the face of the drastic changes in Eastern Europe and the fall of the USSR, China was also at a critical point of reform, finding a Chinese approach.

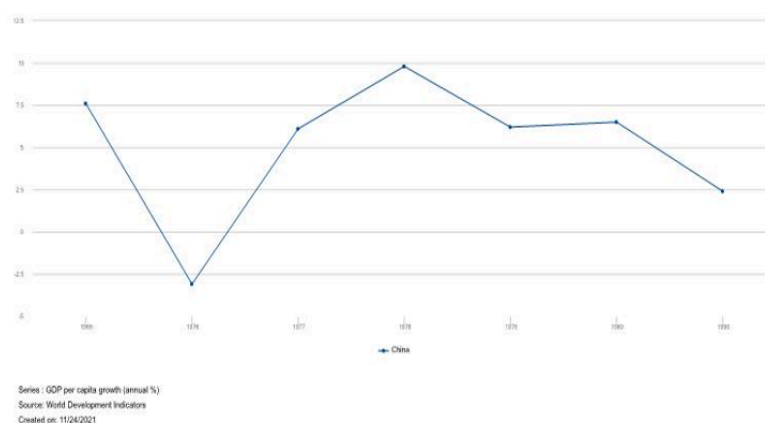


Figure 4: GDP per capita growth (annual %) - China[8]

3. China's economy transformation

3.1. The household responsibility system

The household responsibility system was one of the economic liberalizations under the economic reform in 1978, stimulating the enthusiasm for the labor force and providing enough productivity for the emergence of Township and Village Enterprises (TVEs) [9]. The drought in 1978 made Xiaogang Village to maintain a livelihood. Therefore, 18 farmers signed the "Life and Death" and separately contracted the land in the village, creating a precedent for the household contract responsibility system. Under this system, even though the land ownership belonged to the country, the farmers could manage and produce, distribute, and operate. After peasants handed in enough grain for the state and the group, all the remaining belonged to themselves. Peasants could trade their grains to make money, and all the money earned belonged to themselves. Therefore, the household responsibility system greatly mobilized the enthusiasm for production.

3.2. The rise of TVEs

The rise of TVEs was simulated by the peasants, deregulating labor forces and increasing the country's savings to a certain extent. When the household responsibility system was promoted in the

whole country, peasants were getting rich and started to manage their money and approach to making money. From 1978 to 1984, the annual average gross output value of agricultural production reached 9%. In order to gain more profits, some wise farmers invested their money in TVEs, and some worked for TVEs to make more money. As the government offered a relatively flexible environment and a series of policies to support TVEs, TVEs have grown rapidly since 1979. For example, in 1978, the TVE section in GDP increased by less than 6%, whereas in 1996, it had grown up to 28% [10]. Also, in 1996, TVE had four times as many employees as it had in 1978 [10]. As shown in Figure 5, in the following twenty-two years since 1978, China's total employment grew significantly from 401.5 million to 720.9 million, with the decline of the agriculture sector and the increase of industry and service sectors. The transformation of labor function represented that laborers were more flexible and focused on newly emerged positions, indicating the gradual increase in the number of city enterprises.

	1978	1980	1985	1990	1995	2000	2001	2002	2003	2004
Total employment (mils.)	401.5	423.6	498.7	647.5	680.7	720.9	730.3	737.4	744.3	752.0
Agriculture	70.5%	68.7%	62.4%	60.1%	52.2%	50.0%	50.0%	50.0%	49.1%	46.9%
Industry	17.3	18.2	20.8	21.4	23.0	22.5	22.3	21.4	21.6	22.5
Services	12.2	13.1	16.8	18.5	24.8	27.5	27.7	28.6	29.3	30.6

Figure 5: Employment by sector, 1978-2004[11]

TVEs, the most dynamic sector in China's economy, had grown rapidly during the 1980s, accelerating China's market transformation from a command economy to a market economy [11]. First, compared with the city enterprises, TVEs had a larger number of free laborers, giving priority to capital-intensive industries. For example, in Figure 6, TVEs found their advantage, focusing on specific fields such as furniture, building materials, and metal products, applying low-cost but huge labor forces into the business market. Second, TVEs entered the blank market niches where the State Owned Enterprises (SOEs) did not offer in the command market. For example, in Figure 6, furniture was a popular field that TVEs focused on. As many industries and enterprises needed to set up factories and as many farmers were getting rich, housing construction and furniture were in great demand. Therefore, TVEs that focused on furniture and building materials could get tremendous benefits in this newly emerged market. Third, the country's policy supported the development of TVEs, which further liberalized the economy, simulating the emergence of private enterprises. In 1982, the government permitted direct marketing by peasants, officially allowing private sectors to enter the market [12]. In 1983, the government raised nonagricultural private issues to discussion, such as long-distance trade [12]. Along with this action, the peasants were allowed to engage in trading activities personally and were granted the right to run a store or their own enterprises in cities [12].

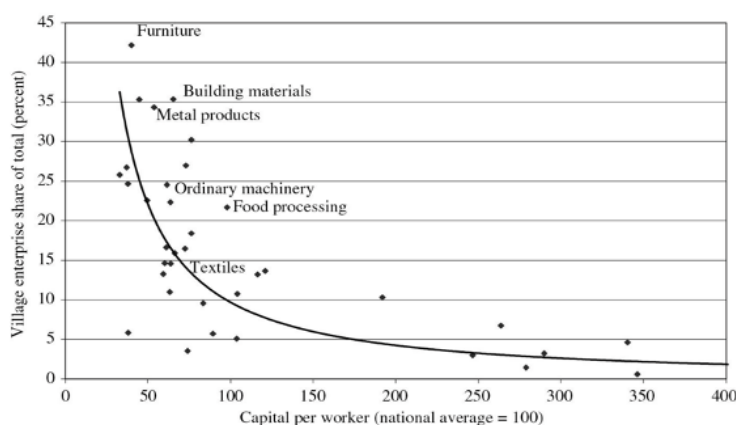


Figure 6: Village-enterprise share of total output \times capital intensity, 1995[10]

Additionally, the government supported TVEs' development. For example, the government played the role of guaranteeing for TVEs, helping TVEs to get loans from the bank. When some TVEs first enter the market with small scale and limited sources, the local government could play a role as intermediaries and guarantors, warranting that the TVE would pay for the loans. Therefore, with enough low-cost labor, market opportunities, and money support, the TVEs could enlarge their scale and expand their locations, which were not limited to staying in the rural areas. Consequently, as TVEs grew rapidly in cities, it started facing a broader and more open market, and the competition with SOEs stimulated the transformation of China's economy [10].

The government also supported TVEs by allowing the existence of diverse models, which was another trigger of the market transformation. Different from SOEs, TVEs could be private and did not have to follow the organizational model. As TVEs were more flexible in business operations, SOEs were willing to cooperate with TVEs, building up relations to obtain cheap labor forces and subcontracting operations to TVEs to reduce the costs [10]. Due to the less restricted policy for TVEs, they expanded the operation scale and became a considerable economic force in China's economy during the 1980s. As TVEs were reaching its peak, it was getting supersaturated in the command market. SOEs gradually occupy all fields, making it difficult for TVEs to compete. Therefore, TVEs had to transform.

3.3. The legitimization of market economy: 14th national congress of the CCP and the 1992 southern tour

Reform and opening up introduced Western economies into mainland China. As a window of reform and opening up, Shenzhen is at the forefront of its transition to a market economy. The establishment of the Shenzhen Stock Exchange caused domestic controversy because it brought the shareholding system of the Western capitalist market to Chinese companies. Zhu Rongji's development of Pudong in Shanghai has also been questioned. Some people believe that learning the Western economy and thinking is the peaceful evolution of China in the West. With the collapse of the Soviet Union in 1991, people began to question whether the market economy fit China's socialism and whether China would collapse as the Soviet Union.

In order to appease the anxiety about China's social nature, Deng Xiaoping started his southern tour in 1992, separating the economic nature from the social nature. In one of Deng's famous speeches, he encouraged the Shenzhen government to be more confident and dare to practice new things. Deng pointed out that stocks not merely belong to the capital market, but socialism also

needed to experiment in these areas. Bravely stepping into the new things could help China find a new way to develop its economy. After the southern tour, Deng's theory that "no matter if it is a white cat or a black cat; as long as it can catch mice, it is a good cat," became widely known by the public. In 1983, the Third Plenary Session of the 14th Central Committee of the CCP established the legitimacy and authority of the socialist market economy, further transforming the operating mechanism of SOEs to meet the requirements of the market economy [13]. The plenum indicated the rationality of POEs, providing a relatively safe approach for TVEs' transformation.

3.4. Privatization

In the 1990s, there was a remarkable decline in the TVEs' employment and the employment in the private sectors increased. One of the reasons was that with the government's relaxation of policies and the gradual increase in POEs' acceptance, those POEs that had previously operated under the banner of TVEs recognized their identities, and some TVEs transformed into POEs [10].

The external factors leading to the privatization of TVEs were not limited to the government's policy. Additionally, the labor market was another element. SOEs are strictly controlled by the state. It is called an iron rice bowl because the country needs to consider the issue of employment rate at any time, which is a livelihood issue. In order to ensure the employment rate, even when SOEs are in difficult times, it is difficult to lay off jobs like POEs. Moreover, as China's economy tended to be a market economy, income was becoming a consideration for people in the high positions of an enterprise. TVEs managers found more profitable opportunities in POEs. In SOEs, it was almost impossible to become rich as there was strict regulation and supervision of the highest salary from the government. However, an excellent manager could earn more money in the same position as a POE rather than in an SOE. In figure 7, in the 1990s, there was a remarkable decrease in the TVEs' employment. Obviously, labor forces transferred to the POEs [10]. Therefore, driven by the labor market, in the transformation of SOEs and POEs, more TVEs chose to become POEs.

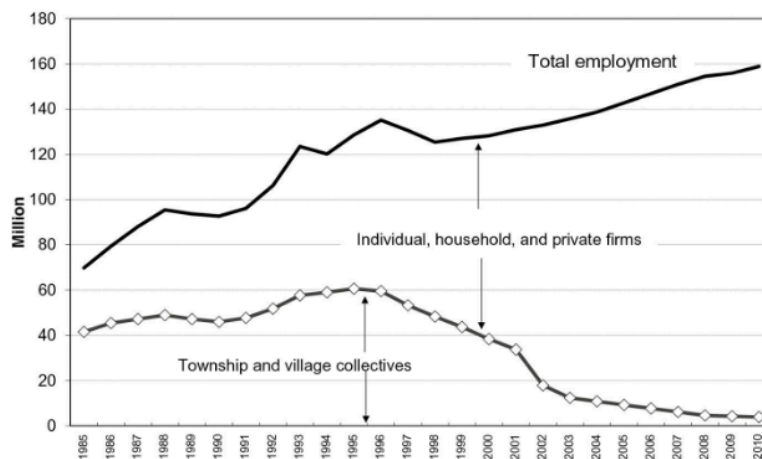


Figure 7: TVE employment[10]

Another considerable external factor that inspired the privatization of TVEs was capital markets. Following the Western trend and with the opening up of the market economy, the bank started to focus on the risk of lending to an enterprise and the ability of an enterprise to gain profits. Instead of lending money to SOEs automatically, banks were more willing to lend money to POEs. SOEs only had the government as their promise, whereas the POEs had actual collateral that could be seized

when facing risk.[10] Therefore, as POEs could get more financial support from the bank to invest on more profitable products, it was likely for TVEs to be privatized.

4. Case study: Xu Wenrong and Hengdian group

Since the reform and opening up, TVEs have become the mainstream in Zhejiang. Xu Wenrong, who started his business in 1975, with his Hengdian Group is a typical example of TVE transforming into POE. At that time, Hengdian, like many places, was short of materials and people lived in poverty [14]. Xu Wenrong started with a 2,000 yuan loan and established the Hengdian Reeling Silk Factory in Dongyang County, which became the starting point for entrepreneurship [14]. This TVE earned 7.6 thousand yuan in the first year [14]. Later, Hengdian Group began to develop chemicals, electronics, and entered the cultural tourism industry. Since 1996, Hengdian Group has set foot in the film and television tourism industry, and built the first film and television shooting base "19th Century Guangzhou Street in Southern Guangdong". It is a precedent for enterprises to invest in film and television bases. Taking advantage of the filming base to attract popularity, Xu Wenrong integrates tourism into film and television filming and develops into a unique Hengdian film and television cultural industry. Taking advantage of the shift from China's economic system to a market economy, Xu Wenrong was actively investing in emerging industries. Nevertheless, the various industries were too fragmented, lack of contact, and the headquarters' ability to control branches was not strong. Therefore, Xu decided to form a group, so Zhejiang Hengdian Enterprise Group was established, marking it as a step into the market economy and becoming a POE.

Xu Wenrong's success was not only because of his acumen to the market economy, but more importantly, under the background of market transformation, sufficient and loose business conditions enabled him to own so many enterprises at the same time. First, the fields of Hengdian Group corresponded with the blank market niches and the low-cost labor industries shown in figure 4. Also, it was precisely because of the government support for TVEs that Xu could get loans from the bank to invest in multiple areas of business and further expand them.

Consequently, as Xu Wenrong was keen enough to grasp the market opportunity, the Hengdian Group successfully fit into the market economy, following the trend to transform from a TVE to a POE.

5. The paradox in economic growth regarding FDI

The 2013 Third Plenum presented a policy paradox that has significant implications for FDI in China. It advocated for market forces to be the "decisive" determinants in resource allocation, suggesting a shift towards a more market-oriented economy, while it also emphasized the state's predominant role in economic affairs.[15] What is noteworthy is that China under Xi Jinping is driven by six strategic imperatives: legitimacy, sovereignty, wealth, power, leadership, and ideas, with legitimacy at its core [15]. Therefore, while market mechanisms are encouraged and often shape trade policies, they are circumscribed by the boundaries of state interests [16]. To be more specific, markets are permitted to set prices for goods and services, but not allowed to have one step forward beyond that, especially where strategic interests are involved.

What makes China restrict the market and requires FDI to follow the "correct line is history matters. The 1942-44 Yan'an Rectification Movement settled Mao Zedong's absolute leadership position via ideological unification. By using mass accusations and struggle sessions, three movements targeted at the CCP members, directed against cadres, and the movement targeted at the

bourgeois, especially the wealthy, which consolidated Mao's power [16]. Anti-spiritual pollution campaign did not work well and the remaining democratic thoughts led to Tiananmen Square incidents. The fall of the Soviet Union made Xi understand that historical nihilism to Mao can destroy the legitimacy of CCP [17]. Even though Xi and his family suffered under Mao's totalitarianism, Xi was now praising Mao as he realized China must avoid a CPSU-repudiated-Stalinism-similar "historical nihilism." [17].

The "strongman rule" also matters [17]. CCP has reasserted control over all policy spheres. The reinstatement of Party committees within private, including foreign enterprises, reflects a broader trend towards tightening political oversight [17]. Xi successfully gets in charge of the military, politics, and economy [18]. Therefore, by restricting and having party sectors in FDI, the CCP ensures that foreign investments align with national priorities and do not threaten the ideological and political stability that the Party deems essential. While FDI is seen as a vehicle for economic modernization and growth, the CCP worries the most that the FDI can introduce democratic values just like the stage prior to the Tiananmen Square Incident. Foreign investors thus navigate a complex landscape where economic opportunities are weighed against the need for political conformity.

Apparently, China's restriction and politically related FDI policies have made many firms aware of their information security and trade flexibility. In 2023, FDI in China was negative overall in the third quarter, with capital outflows exceeding \$11.8 billion [19]. The Chinese government has also expanded its counter-espionage laws in response to perceived foreign threats. Therefore, firms are leaving the Chinese market and seeking new labor-intensive markets in Southeast Asia.

It could be argued that FDI restrictions are intended to protect and nurture domestic industries to make Made in China 2025 and 2035 go through well, allowing them to become competitive at a global level without being overshadowed by foreign giants. Another counter argument can be that China is not interested in the quantity of FDI but rather the quality. The country may be aiming to attract FDI that aligns with its long-term strategic goals, such as high-tech industries, rather than short-term capital inflows.

6. Conclusion

China's economic policy faces the complex challenge of balancing the need for rapid economic growth with the imperative to safeguard national strategic interests. The management of FDI policies is a crucial aspect of this balancing act. On one hand, FDI brings advanced technology, capital, and managerial expertise that can spur economic growth and modernize industries. On the other hand, the Chinese government maintains stringent controls to ensure that such investments do not undermine national security or lead to undue foreign influence over key sectors.

Selective liberalization has been a strategic approach for China, allowing foreign investments in sectors that align with national priorities while protecting strategic industries. This strategy helps China gain the benefits of globalization without compromising its core interests. Encouraging joint ventures and technology transfers ensures that domestic firms can benefit from foreign expertise while maintaining control over critical areas.

The regulatory environment in China, while crucial for maintaining national security, often presents challenges for foreign investors. Frequent regulatory changes and the emphasis on political conformity can deter potential investors, leading to capital outflows, as seen in recent years. To mitigate these challenges, China must strive to create a more stable and predictable regulatory framework that balances security concerns with the need to attract and retain high-quality FDI.

Economic diversification is another key aspect of China's strategy. By fostering the growth of domestic industries alongside FDI, China aims to reduce its dependency on foreign investment and

enhance economic resilience. This approach not only supports national strategic interests but also promotes sustainable economic growth.

The historical context of China's economic transformation, from the household responsibility system and the rise of TVEs to the legitimization of the market economy and privatization, underscores the importance of adaptability and strategic planning. As China continues to navigate the complexities of economic globalization, it must remain vigilant in balancing economic growth with the safeguarding of its national strategic interests.

In conclusion, China's journey towards economic modernization and global integration highlights the delicate balance between embracing foreign investment and protecting national interests. The future success of China's economic policies will depend on its ability to harmonize these often conflicting goals, ensuring sustained growth and stability in an increasingly interconnected world.

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