The transforming Chinese economy: global and Canadian implications[1]

By Wendy Dobson

(*International Journal.* Vol. 61 No. 2. Spring 2006. Toronto: CIIA.)

Year after year China's economic transformation is the cover story of the year. Frequently the commentary is polarized between breathless optimism or gloomy skepticism, which usually means the truth lies somewhere in between. This will be true of many views and statements in this article because of diversity in a huge country and because of rapid change. Indeed, where all can agree is that China's re-emergence as a world economic power after a hiatus of several hundred years is a stunning accomplishment. Other Asian tigers have done better on export-led growth, but no economy of this size has reformed and opened so quickly.

Consider some of the numbers:

- Growth: For 25 years China has been the world's fastest growing economy; 9-10 percent annual growth means that the economy doubles in size every 7-8 years.
- Size: by purchasing power parity China is already the world's second largest economy after the United States; measured by current exchange rates its economy is the world's sixth largest after the United States, Germany, Japan, the United Kingdom and France, and will soon be the fourth largest,
- Integration through foreign direct investment (FDI): in the past 5 years China has emerged as a global manufacturer and trader because of FDI inflows; in the past four years it has received the largest absolute inflows (although round-tripping through Hong Kong is a contributing factor).
- Integration through trade: In 2005, the size of its total trade (imports plus exports) surpassed Japan's to make it the world's third largest trader.

These numbers need to be put in perspective in at least three ways. First, even when China becomes the world's largest economy, its average citizen will still be relatively poor. It has been said that China will grow old before it becomes rich. Second, many of the superlatives apply to three city clusters, in the Pearl River Delta, around Shanghai and around Beijing, where huge building programs and infrastructure projects have propelled more than 140 million people to first world status. Third, we cannot talk about the future without understanding thousands of years of history. Going back just to the 1949 revolution, private property was abolished and today attitudes remain ambivalent towards property rights despite their importance as a key building block of a modern market economy. Even so, the past 30 years provide a remarkable record of successful economic policies. China's managers are doing many of the right things to create a transparent market economy, but major political constraints remain because of the communist party's determination to maintain its grip on political power and on the commanding heights of the economy.

---

[1] The author gratefully acknowledges the support and assistance in research reported in this paper from the Research and Conference Fund, Foreign Affairs Canada and the China Center for Economic Research, Peking University, Beijing.

My purpose in this paper is to assess China's transformation using a long-term economic growth framework and to explore the implications for the rest of us. I will do this by reviewing the main drivers of growth: inputs of capital, labor, land and new technologies, and the role of key institutions, and then discuss some of the main implications for the world economy and for Canada in particular.

Prospects for sustained long-term growth

Mainstream economists agree that sustained growth is determined by inputs and technology, but also by institutions. In particular, government's role should be to provide the necessary frameworks for an efficient market economy. It should improve the economy's ability to reallocate resources from failure to opportunity. It should contribute a strong human resource base, encourage flexible labor markets and provide social safety nets. And it should provide an incentive framework, including a strong and resilient financial system, which supports and rewards innovation. I keep these "benchmarks" in mind in the following discussion.

The role of capital and financial markets in long term growth

China has the world's highest saving rate, at 43 percent of GDP, and an investment-to-GDP ratio of more than 45 percent.[2] The financial system that allocates these savings , while gradually evolving and modernizing, is not up to the task. It is bank-dominated and most bank are state-owned. Stock markets are widely regarded to behave like casinos; bond markets are still in their infancy, and venture capitalists are hindered by the absence of exit vehicles within the country. That China has achieved such rapid economic growth without a modern, efficient financial system is remarkable and probably partly explained by the efficacy of the many forms of informal finance. Recent growth analysis by IMF (2005) worries about the increasing reliance on capital accumulation to fuel growth. Production, as a consequence, is more capital intensive than it should be with so many workers still under-employed and it seems likely that capital is being wasted.

The banking system is partly responsible for the misallocation of capital. A lending boom in the 2003-04 period had to be reined in by the authorities late in 2004. Four large state-owned commercial banks hold more than half of bank assets. Created in 1984, they have behaved much like utilities, collecting savings and funneling them to government-mandated projects. Normal banks, while they aren't perfect institutions, address the central problem of finance in a market economy, asymmetric information (in which borrowers know much more about the risks of their projects than do the savers lending to them), by pooling the savings of depositors and allocating those savings to borrowers who they evaluate for credit worthiness and whose performance they monitor.

In anticipation of a WTO accession commitment to open fully the banking sector to foreigners at the beginning of 2007, the financial sector is now being globalized. The Big Four banks are undergoing radical overhauls to make them behave more like normal banks and to ready them to compete with foreign institutions. In 1999, the government used nearly US$ 170B of taxpayers' money to offload non-performing loans dating back to the days when the banks acted as mainly as sources of working capital to the state-

[2] IMF (2005).

owned enterprises (SOEs). Since 2004, the central bank has injected a further US$ 60 billion into three of them from its stock of foreign exchange reserves to restore their base capital to levels that meet international standards. These big banks (and some of the smaller ones as well) are now permitted to take on foreign strategic investors; two have now floated initial public offerings on the Hong Kong stock exchange.

Sensible and ambitious as this strategy appears, it is not complete. Strategic investors are confined to minority stakes; they are outweighed at board room tables by government representatives. The banks are having a difficult time teaching their legacy staff how to carry on normal bank business, where decisions are made on grounds of credit worthiness rather than on the basis of who you know. One of the weak links in the Chinese economy is the large debt overhang the banks have accumulated during the recent economic boom.

Strategic investors take such risks because of continuing majority government ownership of the banks. They are seen as “too big to fail”. The government is committed to having national champions regardless of the cost. Investors and depositors alike believe the government will bail out the banks again if anything goes wrong. And at least two things could go wrong: the economy could slow down as the recent capital spending boom is reined in -- or if US consumer spending slows, and the banks stand to lose their most lucrative customers to foreign competitors when the banking system fully opens in early 2007.

Labor and labor markets and long term growth

China has an abundance of labor and skills. Adult literacy is around 91 percent. The World Bank estimates that 98 percent of children now receive schooling up to grade 5. About 20 percent of the labor force is employed in the modern sector as an explosion of jobs in labour intensive manufacturing and construction has enabled China to absorb tens of millions of people moving from the countryside and out of loss-making SOEs. By current demographic projections, 225 million people will move from the countryside to the cities in the next 25 years, a process that will raise agricultural productivity and keep real wages in manufacturing low. China’s labor markets are flexible; people are willing to move and employers are allowed to hire and fire. Rural-urban migration has a certain circularity to it, as many young people return to towns and villages near their homes to get married and start businesses, bringing savings with them and new ideas..

But China’s population will also begin to age very rapidly in the next 25 years with the numbers of new labor force entrants (aged 15-24 years) shrinking markedly. There is also an underside to labor markets: labor laws exist on the books but are not enforced, and recourse for worker grievances is often minimal. Social safety nets are still largely non-existent; when the commune system was abandoned in the 1980s, low cost education and health care went with it. The *houkou* household registration system which restricts the rights of migrant workers at their urban jobs is gradually falling away. But these restrictions plus fees and payments for health and education services, and growing regional disparities, trap people in poverty despite the overall improvement in per capital incomes. Thus, China’s fast growth and job creation in the modern sectors are seen as essential to head off social unrest.

Land
All land is collectively owned by the state in one form or another and can only be leased by individuals. Lack of clearly defined property rights is associated with increasing stories of expropriation of land for urban and industrial uses without transparency or appropriate compensation of current occupants or users. These murky transactions, riddled with corruption and, frequently, violence, are behind many of the reports of political unrest. People have recourse only through petitions, appeals and demonstrations. Part of the problem is also unintended: party cadres are now being evaluated by the incidence of unrest in their areas – and they are often responding with repressive actions rather than with greater openness.

Technology and institutions
Technology, as the key source of sustained long term growth in an economy, is where we see some of the most interesting issues. China's total factor productivity is currently declining because of the financial system's inability to allocate capital efficiently. New technologies and ideas come from several sources. One is FDI flows from Chinese living abroad (the diaspora) and from multinationals. Since 1978 investment from the Chinese diaspora has poured into the country. Today, some 19 of China's top exporting companies are Taiwanese. Taiwanese investors are thought to account for a major share of China's $500B stock of inward FDI. The global production systems of multinational enterprises account for much of the remaining FDI stock. More than half of China's manufactured exports are sourced from foreign invested enterprises. The Chinese government is another major source. It has invested heavily in higher education and R&D and in modern infrastructure. Yet both OECD (2005) and IMF (2005) analyses of the sources of growth note that with the capital investment boom the marginal productivity of capital has declined. While this does not mean that China lacks technological change, far from it, rather its impact is offset by the misallocation of capital.

Major institutional changes are also underway as part of the reform process. Governments have rationalized ownership of the means of production. State owned enterprises (SOEs) account for a wide range of economic activity, from public education and research to industrial production. The industrial SOEs, many of them in manufacturing, have declined in number from an estimated 114,000 in 1995 to less than 32,000 in 2004. Since 1998, employment in these firms has dropped from nearly 40 million to just over 20 million in 2004. Today it is estimated that more than two-thirds of industrial production comes from the private and non-state-owned enterprises.[3]

But other institutions still hamper innovation in significant ways. First, the state's influence continues to pervade economic activity and indirectly innovation. Property rights, though now enshrined in the constitution, are not enforced. Successful entrepreneurs find they often attract unwanted attention from local authorities who impose arbitrary taxes or pose ownership challenges. Entrepreneurs require sponsors among bureaucrats and politicians to get things done. Thus, instead of the horizontal idea

[3] Garnaut et al (2005) and *China Statistical Yearbook 2005.*

networks we see in OECD countries, we see relationships between entrepreneurs and their bureaucratic protectors.

Similarly, Chinese laws on intellectual property (IP) are acknowledged to be consistent with international standards but are not enforced. One reason is that Chinese entities have yet to produce much intellectual property that would create a demand for such protection. Chinese attitudes and traditions on what westerners regard as intellectual property are unique; what westerners see as individual property in China is seen as collective; songs and stories, once published, are seen to belong to “the people” to be adapted as the teller pleases. IP is a foreigner’s problem. Foreign producers themselves regard IP violations as a cost of doing business in the large and potentially-lucrative market.[4]

Summary

In summary, this thumbnail sketch of the sources of long-term growth paints a mixed picture of strengths and weaknesses. Overall, Chinese authorities have done a remarkable job of managing the transition to a market-based system. The spectacular growth rate is driven by opening the economy to trade and investment, by the government’s partial withdrawal from production and ownership, by the world’s highest domestic savings rate, and by robust capital investment.

Despite attempts to reform the banking system, the financial system remains a weak link as existing institutions waste resources rather than allocate them to productive uses. Non-state enterprises, which now number in the millions and are potential sources of both new jobs and new technologies, are shunned by the risk-averse banking system. Starved of funds, they are forced to rely on retained earnings or informal financial arrangements. Without enforceable property rights, land is allocated inefficiently and disputes are a source of political instability. The outlines of an innovation system are emerging but the investment thrown at R&D and science parks by governments is not driven by market forces. China is also dependent on foreign technologies which are then adapted to Chinese requirements. The labor force is the unambiguous strong point, supplying educated skilled workers in large numbers (although the numbers of new entrants are now slowly shrinking for demographic reasons) to its low-cost manufacturing machine. As the population ages, however, demand for health and social insurance and pension rights will only grow.

The story is therefore mixed – but changing fast. The Chinese economy has flaws that need to be fixed if it is to sustain high rates of economic growth; the paradox is that if some of these flaws – particularly the broken banking system -- had been fixed before now, China could have grown even faster than it has.

Global implications of China’s growth and integration

First, I provide a few philosophical comments reflecting my interpretation of Chinese views of the world. Most Chinese, and indeed most of the world, accept assurances by the leadership that China’s re-emergence is peaceful in intent. Some Chinese use the metaphor of a dragon when they talk about relationships among large countries. If there

[4] Author’s interviews and research in Shanghai and Beijing in July 2005.

is only one dragon in the sky, they say, it can become arrogant and willful. We are better off if there are two or more dragons, not because they will fight, but because they will balance each other. The single (US) dragon can benefit from a stronger, balancing, role played by the European Union and in future, by China and India.

Instead, China has become the enemy to parts of the US congress. The U.S. administration's tone, adopted by US Undersecretary of State Robert Zoellick in a September speech at the Council on Foreign Relations in New York and by Treasury Secretary John Snow and Fed Chairman Allan Greenspan during their October 2005 visits to Beijing, is the right one. They treat China as an equal. They do not shrink from pointing out the weaknesses in the Chinese economy that need fixing, but their tone is professional and thoughtful.[5]

Anxieties expressed by US interest groups are perhaps understandable. Chinese history provides Chinese people with a robust perspective on how a country can rise to economic prominence and then lose it. And then rise again. Their own history of maritime exploration and global exchange in the early 15th century also teaches them about how trade can be a positive sum game. The United States, in contrast, has known only one trajectory: from a small colony to world superpower; it has not yet known any serious economic decline. But the tendency to treat China as a threat is counter-productive when the two economies are now so deeply interdependent.

An economist can easily accept the story of the peaceful rise and the positive sum game. China is seen as a threat because it is not "like us" and because of the speed at which it opened its economy and integrated with the rest of the world. When an economy of this size does so, it is bound to disrupt standard-technology labor intensive industries. Western consumers have done very well from Chinese imports. The rest of us must adjust rather than protect (a subject to which I return).

Second, as senior members of the US administration have also noted, success in world markets brings responsibilities. The Chinese leadership has valid arguments to support the small revaluation of the RMB when it shifted the exchange rate regime to a managed float on July 21, 2005, but it must eventually permit the currency to be determined by market forces. The economics profession is split on what China should do, just as it has always been split on the merits of fixed and flexible exchange rates. Some look at the massive size of foreign exchange reserves and charge that China is violating IMF rules against currency manipulation. Others blame the rise in reserves on the savings-investment imbalances perpetuated by dis-saving in the US economy.

Both factors play a role, but the Chinese leadership will do what it deems is in the country's best interests. Since the new exchange rate regime was introduced, the central bank's Governor Zhou has warned Chinese exporters that they must learn how to manage currency volatility. Signs of change are appearing: new financial instruments for managing exchange risk are being permitted. The RMB will be allowed to revalue;

[5] See Reuters, October 16, 2005; Zoellick 2005.

perhaps not by the 27.5 percent sought by U.S. Senator Schumer, but perhaps by 25 percent over the next five years.

Third, China is a major player in world trade. One of its advantages in trade negotiations is its willingness and ability to undertake internal reforms and adjustment. China has signed a China-ASEAN FTA which is being implemented on schedule and which permits an expansion of agricultural exports to China by South East Asian economic producers such as Indonesia and Thailand. China and India have also embarked on a comprehensive study of their bilateral relationship, including a possible FTA. Such an agreement, (rather than a Japan-China-Korea FTA) could be the best place to begin an Asian FTA since the interests of other Asian economies would clearly be served by joining. Some observers have pointed out that an Asian FTA focused on trade integration (rather than the non-trade issues of human rights and labour and environmental standards preferred by western interest groups) might help return the WTO negotiations template to its trade-only origins. Indian manufacturing would also be challenged by more direct competition with China and such competition might act as a badly needed catalyst for further Indian reform.[6]

What we do not yet know is how the United States will position itself in regional affairs in the light of these developments. Some argue that if the United States turns away from, rather than engaging in, these developments Asian integration could become more a stumbling block to multilateral trade liberalization rather than a building block.[7] Yet, since the United States is a major market for finished goods produced in the region, it is difficult to see how regional trade arrangements will have global clout if they exclude the United States. Significantly, while Southeast Asians seek closer economic ties with China, they still see the United States as the guarantor of the region's security.[8] The bigger risk to multilateral negotiations is the inability of the United States, European Union and Japan to summon sufficient political support for significant forward movement on the agenda of the Doha Development Round.

A troubling trade development is the recent EU and US negotiations over the surge China's textiles exports following the removal of quotas at the beginning of 2005. China thought it joined a rule-based system of governance when it joined the WTO. Yet the EU used protectionist measures to shut out cheap Chinese imports, effectively abandoning the rules when the rules did not suit them. The United States later followed suit, arguing that further safeguard measures were foreseen as a possibility and provided for in the WTO negotiations.[9] For now, Chinese officials are determined to play by the rules but this is an unfortunate and potentially counter-productive precedent.

---

[6] See Panagariya 2005.
[7] Gordon 2005.
[8] As, perhaps does China which depends on security in the Malacca Strait for reliable deliveries of most of its oil imports. See the *Economist*, November 19, 2005.
[9] IMF (2005:6) notes that textiles account for 14 percent of Chinese exports and that these exports in the first four months of 2005 climbed by 53 percent to the United States and by 71 percent to the EU.

I have omitted a number of other potential systemic issues in the interests of brevity, including China's demand for natural resources and other traded inputs to production and their implications, as well as such pressing issues as environmental deterioration and water quality and supplies. I will touch on some of these issues in the next section on implications for Canada.

Implications for Canada

For Canada, China's growth implies both opportunities and challenges.[10] The opportunities will come —and it's not surprising an economist would say this—through the operation of the principle of comparative advantage. It is popular to predict that China will eventually produce everything; even the Chinese themselves sometimes give this impression. But by the principle of comparative advantage, China will produce goods it makes relatively more efficiently than its trading partners and it will import what it is relatively less efficient at producing.

Current trade patterns confirm this principle is operating. In 2004, China's merchandise exports were C$ 24 billion, consisting mainly of price-sensitive manufactured goods; more than a third of the total was electronic equipment and computers (based on Statistics Canada data). Canada's goods exports to China, at C$ 6.65 billion were less than 30 percent of the Chinese total. They consisted mainly of wood products, foodstuffs, organic chemicals and nickel, iron and copper ore; electrical equipment and computer parts accounted for 9 percent of the total.

Chinese interest in our natural resources is reflected in the government's decision to upgrade the bilateral relationship to strategic partner status in 2005, prior to Prime Minister Hu Jintao's September visits. This upgrade led to the signing of a flurry of bilateral agreements (some of which had languished for years) that will activate Chinese ministries and agencies; for example, as Canada becomes an approved tourist designation, Chinese travel agencies will bring increasing numbers of Chinese tourists to Canada.

Canada's natural resources assets are also attracting China's new wave of outward-bound FDI by SOE national champions. This interest has raised questions in Canada about the implications of SOEs taking sole ownership positions in Canadian assets. Any country has the right to review the implications for its national interests of potential takeovers by foreign owners; but international rules do not permit discrimination against the firms from a particular country. A more significant issue is the potential impact of capital investments by state companies to acquire designated supplies. New large oil consumers like India and China face a major dilemma in a world of high oil prices because they have not yet accumulated strategic stock piles. To them, a rational alternative is to seek to designate supplies. But petroleum and most other natural resources are traded in international markets at world prices (admittedly, in the oil market influenced on the supply side by a cartel). If large investments begin to rigidify the demand side as well, reduced access to the total market will hurt all consumers. A preferable and more

[10] See, for example, Dobson (2004).

efficient strategy would be to invest in establishing new sources of supply and create new value.

Another issue is one that became apparent in the debacle of the China National Overseas Oil Company's (CNOOC) hostile bid for Unocal in the first half of 2005 and the failure of the Haier bid for Maytag. Chinese boards, managers and political leaders may be committed to globalization, but they are still learning the rules and practices of international business. While they gain experience, perhaps the Chinese SOEs should restrict themselves to 20 percent equity stakes, something they practice at home, at least with the Big Four banks where foreign investors face such limits.

The most important issue for Canadians, however, is a different one. We should ask whether maintaining a complementary trading relationship (where they sell us finished goods in return for our natural resources) will sustain our standard of living over time. The answer is that it will not.

If we are to sustain our living standards, we have to adjust to China's growing manufacturing prowess by producing sophisticated goods and services that China cannot. We have to reduce our costs, increase our productivity, deepen the knowledge-based economy, and foster the talent that produces those sophisticated goods and services. We can expect Chinese exports to compete with our less sophisticated manufactured products. This is already happening.[11] But Canadians can benefit from such competition if we export more sophisticated products to China. For example, current trade figures cited earlier (in electrical and computer parts) and the latest information on auto parts exports imply that some Canadian producers participate in global supply chains and export parts to China for assembly there. As auto firms such as General Motors increase their production in China and export cheaper cars to North America, we will have to adjust our domestic production to source lower value added parts and models in China and upgrade Canadian production to supply higher value added parts and models.

Governments have a significant role to play in facilitating this international division of labour by removing bureaucratic obstacles and tax burdens that raise our costs, relative to our competitors, of production and of doing international business. The menu of what needs to be done is well known, including investment promoting framework policies, greater emphasis on learning by Canadian firms through clustering (recommended by Trefler (2005)), and changes in business taxation to reduce the burdens that limit business motivation to invest and stop taxing productivity-enhancing investment recommended by Mintz (2005) and the Ontario Task Force on Competitiveness, Productivity and Economic Progress (2004, 2005).

Finally, our relationship with the United States is central to this upgrading process. The competitive challenges from China should be the catalyst for a new thrust in North America to remove the barriers that remain post-NAFTA. We need a vision – of one seamless North American market and three sovereign political systems. Much of our technology comes from, and many of our knowledge industry opportunities lie, in the US

[11] See, for example, Michael Francis et al (2005).

market. They require the unobstructed movement of people, capital and ideas within the North American economic space. Yet we still rely on NAFTA which introduced cumbersome rules of origin and didn't address obstacles in the knowledge economy -- such as movement of people and regulatory differences. We need new arrangements that eliminates those obstacles.[12]

Conclusion

China's economic transformation implies major challenges and opportunities based on the outlines of what we can already see. The Chinese leadership, and millions of small businesses, are transforming the Chinese economy into a more efficient and market-driven one. Even though the process is far from complete, China is a significant economic force in global markets because of its low-cost skilled labor force, ambitious competitors, smart leadership, and a heavy emphasis on investing in the future. We cannot afford to under-estimate the changed world that will face our children. It will be much more competitive, but it will have a plethora of opportunities. Our governments must cooperate in providing new skills and educational opportunities so that young Canadians have what is needed to take advantage of our shifting comparative advantage. This basic principle requires that as China continues its economic reforms we must adjust faster and organize ourselves to exploit the emerging opportunities.

References

Council on Foreign Relations. "Building a North American Community". *Independent Task Force Report. No. 33.* New York: Council on Foreign Relations, June 2005.

Dobson, Wendy. "Taking a Giant's Measure: Canada, Nafta and an emergent China". *C.D. Howe Institute Commentary.* No. 202. September 2004.

----. "Shaping the Future of the North American Economic Space". *C.D.Howe Institute Commentary.* Toronto: C.D. Howe Institute, April 2002.

Economist, The. "Special Report: China's world order: Aphorisms and suspicions". 19 November 2005.

Francis, Michael, Francois Painchaud and Sylvie Morin."Understanding China's long-run growth process and its implications for Canada". *Bank of Canada Review.* Spring 2005.5-17.

Garnaut, Ross, Ligang Song, Stoyan Tenev and Yang Yao. *China's Ownership Transformation: Process, Outcomes, Prospects.* Washington, D.C.: International Finance Corporation and World Bank, 2005.

Gordon, Bernard K."Asia's Trade Blocs Imperil the WTO". *Far Eastern Economic Review*. 168:10. November 2005.

[12] For further analysis of these issues see Dobson (2002) and Council on Foreign Relations (2005), among others.

Institute for Competitiveness and Prosperity. “Realizing Our Prosperity Potential”. Third Annual Report. Toronto: Task Force on Competitiveness, Producitivity and Economic Progress. November 2004.

------------------. “Rebalancing priorities for prosperity”. Fourth Annual Report. Toronto: Task Force on Competitiveness, Productivity and Economic Progress. November 2005.

International Monetary Fund. “People’s Republic of China: Staff Report for the Article IV Consultation”. Washington, D.C.: IMF. 8 July 2005.

Mintz, Jack with Duanjie Chen, Yvan Guillemette and Finn Poschmans. “The 2005 Tax Competitiveness Report: unleashing the Canadian tiger”. C.D. Howe Institute Commentary 216. September 2005.

Organization for Economic Cooperation and Development. [title]. Paris: OECD. September 2005.

Panagariya, Arvind. “An India-China Free Trade Area?” *Economic Times.* 20 April 2005.

Reuters. “Snow: China must prepare for shocks”. 16 October 2005

Trefler, Dan. “Policy responses to the new offshoring: think globally, invest locally”. April 2005. Accessed September 2005 at www.chass.utoronto.ca/trefler.

Zoellick, Robert B. “Whither China: From Membership to Responsibility”. 21 September, 2005. www.state.gov (accessed October 2005).