

China Takes Another Step Toward Internationalism



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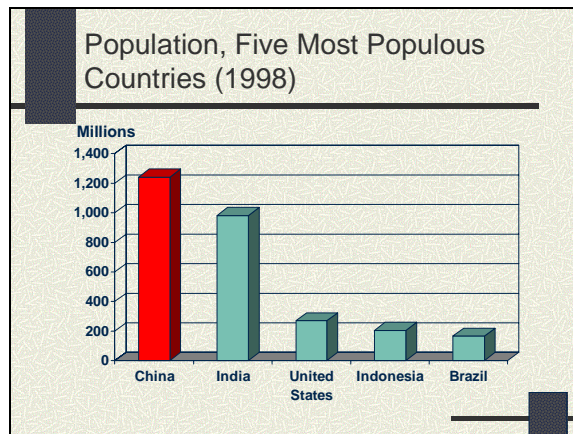
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The recent U.S. congressional vote on Permanent Normal Trade Relations with China has naturally drawn people's attention to China. After all, this vote was one step towards ratifying the particular agreement the United States made with China as part of that nation's accession to the World Trade Organization (WTO). However, the protests about the vote suggest that more explanations are in order. This document discusses China's economic liberalization and how it has spurred growth and opened China to the West. The document also discusses how the ongoing, important role of China's state-owned enterprises has caused economic difficulty for China. I begin with a general outline of China and its economy.

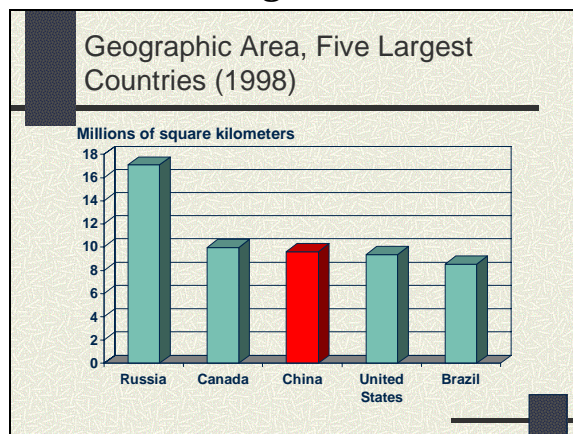
First, as Federal Reserve Bank of Dallas President Robert McTeer jokingly said in a *Dallas Morning News* editorial two months ago, "China is really big." Figure 1, which presents the populations of the five largest nations in the world, offers clear evidence. With more than one billion two hundred million people, China is not only the most populous country in the world, but it has 250 million more people than the second place country, India.

Figure 1



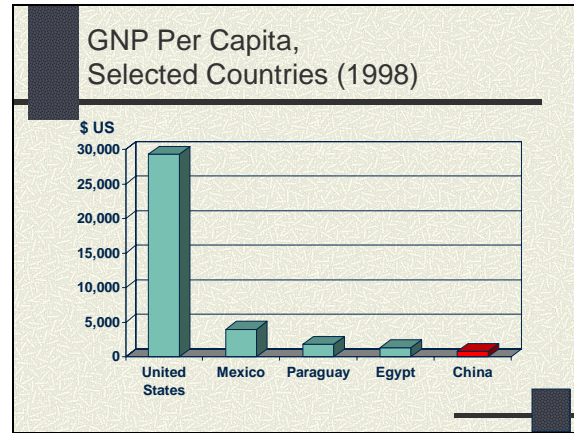
China is not only large in population, but also geographically. Figure 2 shows the five largest nations in terms of geographic size. China is third. While it is not nearly as large as the Russian Federation, it is not much smaller than Canada, nor much bigger than the United States.

Figure 2



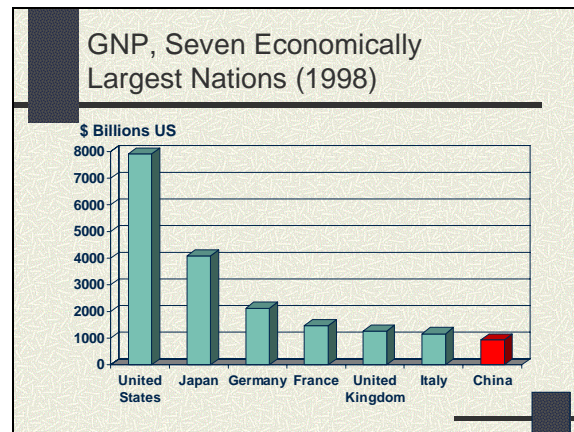
More significant is China's growing economic importance. However, China's income per capita is low. There are 148 nations in the world with incomes per capita higher than China. Figure 3 shows some of them. Egypt, Mexico and Paraguay all have incomes per capita greater than China's, as does the United States.

Figure 3



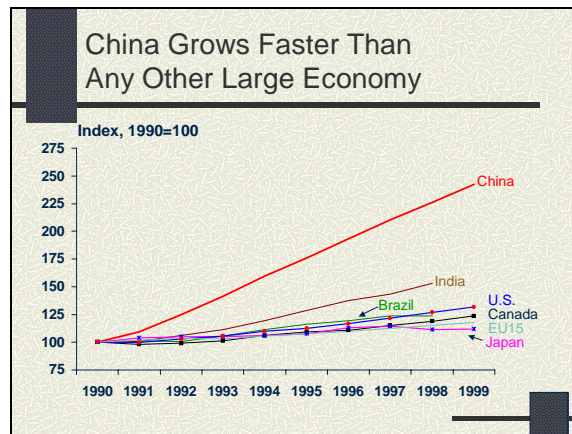
But despite China's low income per capita, its large population means China is the world's seventh largest economy, as Figure 4 shows. While China's economy is markedly smaller than the sixth largest economy, Italy, it is also significantly larger than the eighth largest economy, Brazil.

Figure 4



While it may be interesting that China is one of the world's largest economies, what is particularly noteworthy is the **increasing** importance of the Chinese economy in the world. Figure 5 presents the cumulative growth rate of China's gross domestic product, as well as cumulative growth rates for other large economies, including the European Union, United States, Brazil, Canada, India, and Japan. China is the thick red line. The United States is the thick blue line with red dots. Japan's line is lavender. As can be seen, China's gross domestic product—the red line—has grown faster than any of the other twelve largest economies in the world, even though the growth rate has slipped. From an Asian perspective an important detail here is what this figure tells us about China's rising economic importance relative to Japan. China's economic convergence with Japan may already be turning out to have political implications. Some observers have noted that when President Clinton went to Asia in 1998, he only went to China without visiting Japan. Even so, as I shall discuss, China's growth masks efficiency problems that cannot be ignored.

Figure 5



China Liberalizes, Some

The most important contributors to China's takeoff, the takeoff that can be seen in the last figure, are the market-oriented liberalizations that began in 1979. At that time, collective farming was phased out. And even though the state still owned all the land, each farmer got to control his own plot. This new policy was intended to motivate each farmer to grow more and it did. The government also permitted farmers to sell their products on the open market at a market price. The government did not open all farm production to the market. The government did take a set amount every year from each farmer and did pay a nonmarket price. But farmers could sell everything beyond that. These two steps—individual control of designated plots of land, selling in an open market—yielded large increases in farm output.

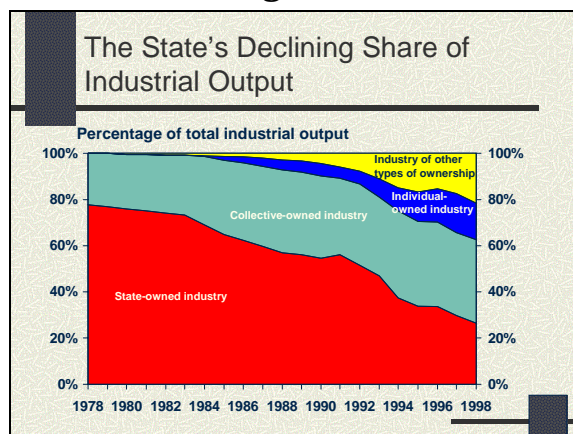
In 1984, similar market price reforms were applied to the state-owned industrial sector. So-called dual pricing systems—in which a certain quantity of output was allotted to the government at a government-determined price and the rest sold on the open market at market-determined prices—began to be permitted in the industrial sector. Meanwhile, labor moved out of agricultural work and into industrial work, which was more productive. Nowadays, 95 percent of industrial products are sold at market prices.

In the early 1990s, China launched a new wave of foreign investment and foreign trade liberalization. China liberalized foreign direct investment to attract firms that would export. In fact, China remained relatively closed to foreign investments designed to serve Chinese customers.

Turning to the issue of trade, in 1993 the government announced major import tariff reductions on 2,800 categories of products. Between 1992 and 1997, Chinese average tariffs fell by about two-thirds. However, I should point out that half of all imports were also subject to nontariff barriers. Many industries were still heavily protected and many imports are tightly controlled, regardless of tariff levels. China was afraid to permit foreign competition with its large state-owned enterprises, many of which were inefficient then and many of which even now are losing money.

Over time privately owned entities have begun to account for an increasing portion of Chinese production. Figure 6 shows that the share of total Chinese industrial output produced by state-owned enterprises—the red portion of the figure—fell from 78 percent in 1978 to 28 percent in 1998. Meanwhile, the portion of industrial output that came from individually-owned companies—the blue portion—rose from zero percent in the late 1970s and early 1980s to 17 percent in 1998. The share of total industrial output from other types of private enterprises—the yellow portion—rose from zero percent in the late 1970s to 23 percent year before last.

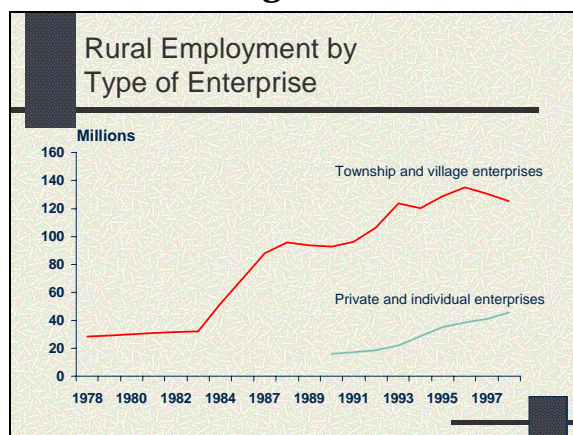
Figure 6



The shift to production by private enterprises is obviously an important phenomenon. There is much to suggest that, despite China's rapid growth, the nation's large overhang of state-owned enterprises has kept it from achieving efficiency gains that might otherwise have been possible. Some estimates show that the bulk of output increases in nonfarm output result from freeing labor from the farms and that relatively little involves real efficiency gains in industry. Meanwhile, as these reorganizations have occurred over the last two decades, government revenues have declined by two-thirds. The share of state-owned manufacturing firms that are losing money has been growing steadily since the 1980s. Falling revenues led the government to increasingly impose social service costs for workers onto the state-owned enterprises that employed them, creating additional financial stresses on these institutions.

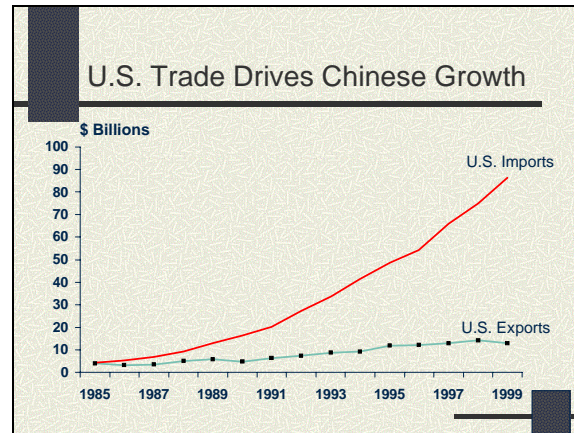
I mentioned that an important part of China's increase in output occurred because of a shift of labor from agriculture to industry. Figure 7 shows two examples of that shift. First, farmers left agricultural collectives and began to work in community owned factories known as Township and Village Enterprises, which are managed as market-oriented enterprises. In 1978, these enterprises employed 7 percent of rural Chinese. By 1984, they had expanded so much that they employed 11 percent of rural Chinese. By 1996, they employed 28 percent. Now, however, these enterprises are starting to cut jobs. In contrast, purely private sector operations, which are not part of the Township and Village Enterprises, are growing rapidly, taking up the slack. These are represented by the turquoise line on the figure. While these private sector operations may seem small on the figure, note that they employ more than 40 million people.

Figure 7



An important engine of growth that is dominated by private sector firms is China's export sector. An important component of China's international trade has been trade with the United States. Figure 8 shows U.S.-China imports and exports over the last 15 years. Over this period, total U.S.-China trade as a percentage of Chinese gross domestic product has gone from 2.6 percent in 1985 to 10 percent at the end of the 1990s. This same trade has gone from less than 0.2 percent of U.S. GDP to more than 1 percent. So China has not simply grown as an economy, but also has grown in economic importance as a supplier of products to us, and as a market. Note that U.S. imports from China have grown over this period a great deal more than U.S. exports to China. China's overall trade is much more balanced.

Figure 8



Last year, China was Texas' 15th largest export market out of 235 countries. About one billion dollars in Texas products were sold to China. China was not in the same league with Mexico. Last year \$41.4 billion in Texas products went to Mexico. Of the two pie charts in Figure 9 that characterize Texas exports, the chart on the left shows the share of the \$1 billion in last year's exports to China that went to various products. The pie chart on the right shows the shares of total Texas exports accounted for by the same products. Texas' exports to China focus more heavily on instruments and chemicals than our overall exports do. Compared with China, Texas is rich in technical skills and in physical capital. Those are important inputs, respectively, for the production of instruments and chemicals, so it should not be surprising that we export relatively large quantities of these products to China. Moreover, our exports to China are likely to accelerate.

Figure 9

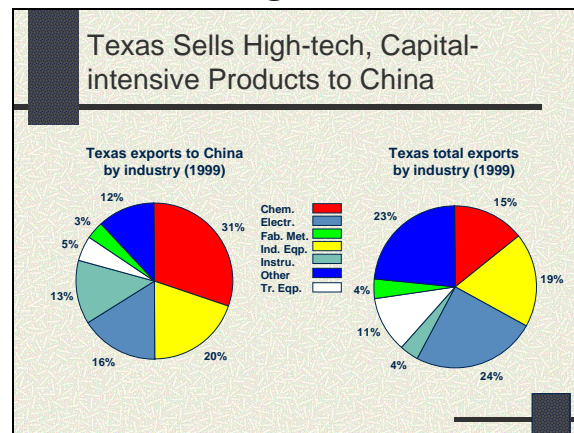
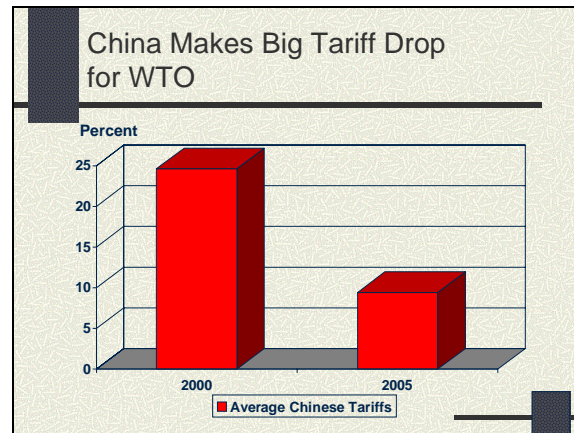


Figure 10 offers one reason why Texas' exports to China are likely to accelerate. The products on the pie chart of Texas exports to China were industrial products. These two bars depicting average Chinese tariffs on industrial products now and five years after WTO accession offer a reason why. The United States, in contrast, does not lower tariffs. The United States is already giving China the trade regime liberality that a WTO country would get, but up to now we have not guaranteed to the Chinese that they will get to keep it. China will get to keep this trade regime liberality if the Senate follows the House in voting for what are called Permanent Normal Trade Relations with China—which is our agreement for Chinese accession to the WTO—and if China is permitted to join the WTO by the other members. Even so, average Chinese tariffs on industrial products will be more than double those of most developed countries. China's accession to the WTO is not comparable to Mexico's joining NAFTA. The WTO is not a free trade agreement.

Figure 10

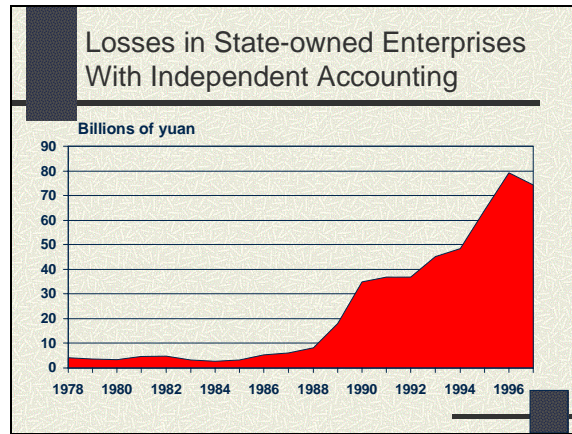


China Loosens Much More Than Tariffs

Despite the large reductions in tariffs, China's largest and most important openings in our WTO accession agreement with them involve reductions in nontariff barriers. China's accession to the WTO will include phase-out of import licensing and import quotas. There will be reductions in monopolization of import rights either by the state itself or by importers designated by the state. Offsets—under which foreign firms are only allowed to set up operations in China if they agree to use a minimum quantity of Chinese inputs, or transfer some minimum quantity of technology to China, or export some minimum quantity from China—will be phased out. Many other nontariff barriers will also fade away. I should note also that there is a full schedule of service sector commitments that open China to import/export trading companies, retailing and wholesaling, insurance, accountancy, legal and other professional services, and of course banking. Again, these openings are large and important.

I am going to outline China's opening of its banking system under the WTO. To prepare for that explanation, a reiteration of the current problems of China's banking system deserves attention. Figure 11 depicts the growing losses of state-owned enterprises with independent accounting systems. These enterprises are very important debtors of China's banking system. This is a major reason why, right now, the Chinese banking system is in something it is hard not to label a crisis. Chinese capital controls mean that the capital outflows we saw in Asia three years ago will not be happening in China. We will not see the sort of sudden financial stop we saw in Russia in 1998.

Figure 11



However, last year the central bank labeled 20 percent of bank loans as nonperforming. Some economists have estimated nonperforming loans at closer to 50 percent of total loans. Government bailouts are going on right now, but banks have in the past simply been rolling over the dead loans. As this has occurred, lending for new projects has dried up and even now bankers are gun shy about further lending.

Chinese Market Opens to Foreign Banks Over Five-year Period

The agreement under which China's accession to the World Trade Organization takes place will move banking in the right direction in China after this experience. Right now, foreign institutions have strict limitations on where and to whom and in what currency they can carry on banking operations. They cannot deal with domestic Chinese businesses. They cannot lend to Chinese individuals. To the extent that foreign banks can deal at all in Chinese currency, it must be with foreign firms and in certain locations. China's accession to the WTO will change all of that over a five-year period. After five years, a U.S. bank will be able to lend Chinese currency to Chinese businesses and individuals anywhere in China. Right now foreign firms cannot bring their expertise at separating bad borrowers from good ones to the real Chinese markets. Five years after accession they can. That is a very large opening.

A Few Things We Learned in China

In late May my research department colleague Dong Fu and I went to China for a series of presentations to groups of bankers and certified public accounts in Tianjin—the fourth largest city in China—and for a presentation to scholars at the Unirule Institute in Beijing. Five particularly striking economic issues turned up in conversations we had with government officials, scholars, bankers and CPAs. First, we were impressed by the very strong support we heard for trade liberalization. Dong Fu and I were surprised to be invited to a meeting with the mayor of Tianjin, who is also a member of the Communist Party's ruling body, the Central Committee. We were even more surprised to see that the meeting was televised and that it was featured on the front page of Tianjin newspapers. This was nothing personal. The point was that persons from the United States Federal Reserve were there to discuss and support trade liberalization in general and the World Trade Organization in particular.

Second, because China's growth has lately slowed and because we have already seen several years of absolute deflation there, one sometimes hears conjectures in the United States that the Chinese currency may devalue to create a quicker price adjustment, at least from an international perspective. We met with officials at China's State Administration of Foreign Exchange in Beijing to discuss the possibility of loosening China's exchange rate with the dollar. They were adamant that this would not

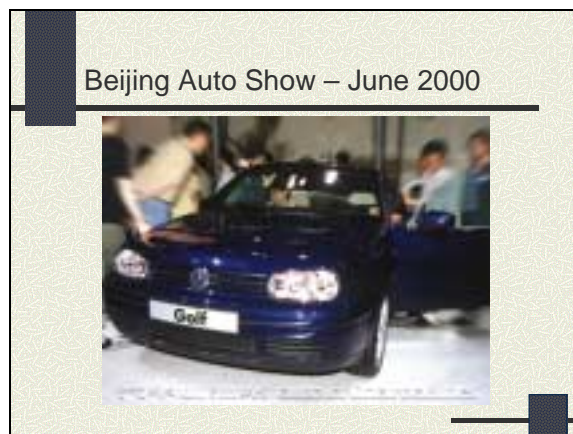
happen. China's closed capital account means that a speculative attack is not in the cards and, even if it were possible, China's extremely large foreign currency reserves would discourage potential speculators.

Third, particularly because of China's financial problems we were curious about any opening of China's capital account so that foreign capital inflows that are not permitted now might occur. At the central bank of China, younger officials supported capital account liberalization but said that the older officials, who were the ones in power, continued to oppose it. The issue of capital account liberalization has been a topic of concern in any case in China. It is widely felt that China's closed capital account contributed significantly to China's avoidance of the problems so many other Asian countries faced during the late 1990s. On the other hand, in a country where banking problems have soaked up a good deal of credit in the last few years, and where corporate governance has not seen much expression through the financial sector, younger policy makers would like to see it. So-called policy loans, in which loans are given to companies—usually state-owned enterprises, as a part of the policy to support certain industries or sectors, rather than because they are really creditworthy in any market economy sense—are still on the books of banks that were intended to behave like private commercial banks.

Fourth, we were struck by the interest in financial market liberalizations—what happens during them and what the downsides may be—in China. There was much discussion over the relative virtues of universal banking versus the more traditional type. It should be noted that China's government-owned banks were for a while permitted to act as universal banks. As the banking system began to take turns for the worse, however, the government chose the route that is perhaps easier to regulate and made banks return to their more traditional roles. Also there were a lot of questions about how one resolves a financial crisis.

Finally and very striking, while income distribution in China does not come close to taking on the extremes we see in Brazil or Mexico, Chinese income distribution **is** more uneven than in most countries where it is measured, including the United States. This kind of an income distribution in China means that people who have any money have a lot of it.

As incomes have gone up there has arisen amongst people with more money a consumer culture whose manifestations are increasingly striking. Thus, while most people in China ride bicycles, there was talk and interest in this year's Beijing auto show at a level we would not see in the United States.



Conclusion

In conclusion it should be noted that China has carried out a different type of liberalization than some of the former Soviet-bloc countries, certainly than what we now refer to as the Russian Federation. China began its real liberalization twenty years ago. Russia has only been at liberalization for ten years. China went slowly and, in some ways, more smoothly, despite Tian-an-men Square.

Even so, the slowness of China's transition has been costly as can be seen by China's large banking difficulties. It is hard to estimate other costs that are imbedded in the persistence of China's state-owned enterprises in employing large portions of China's labor force, although these enterprises do employ a far smaller share of workers than ten years ago, or twenty.

Nevertheless, China is opening. First China opened to markets within its own country. Since the 1980s, China has been internationalizing. With the World Trade Organization, this will continue. Despite the difficulty of China's transition, it is hard not to be optimistic for further growth.