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FOOTNOTES

CHINA'S ECONOMY: PROBLEMS AND PROSPECTS

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China's economy today is ten times larger than it was in 1978, and continues to grow at 10 percent per year. By contrast, since 1980, roughly the beginning of economic reform in China, up until 2005 yearend, the economy of Latin America as a whole grew 10 percent not per year, but cumulatively. And in comparison with 28 years of 9-10 percent annual growth in China, the growth of India's economy has accelerated to only 6 percent, and only since 1991. The result is that the Chinese economy is now three times that of India, and the gap is growing.

Two important dimensions of this growth are the emergence of a large middle class and a rising income gap. As an indicator of how a few people in China have become fabulously wealthy, in 2003, worldwide sales of Bentley automobiles were 200; 70 of them were sold in China at price of 2 million rmb, or 250 times average urban income. The U.S. equivalent would be if 200 people bought those cars at $7.5 million each.

The urban-rural gap was large even in the Maoist era (Mao gave a lot of lip service to promoting the peasants' interests, but most of that era's policies actually favored urban dwellers). The gaps that have increased in the reform period of the last few decades are between the coastal areas and the inland. The coastal areas have done extremely well because of the growing importance of foreign trade; most foreign trade involves production and workers along a narrow strip along the coast, particularly Pearl River Delta and the Yangtze Delta, the area from Shanghai up the Yangtze River and a little bit in the northeast. These areas have been the major participants in international trade, with a big demand for labor, and incomes in those areas have gone up particularly rapidly.

More important is the growing gap between skilled and unskilled workers, even in the urban sector. During the Maoist era, there was a rigid wage structure. The difference between highly paid and relatively low-paid workers was modest. But in the reform period, this wage structure has become marketized, and for people with skills, whether managerial or engineering or anything in short supply, the price has been bid up dramatically. The unskilled, entry-level wage, on the other hand, has been relatively flat. A lot of people have been able to move in from the countryside, so those wages have been slowly rising, but at nothing like the pace of wages for people with scarce skills.

At the beginning of the reform period China's inequality was substantially less than most countries one would compare it with--India or the East and Southeast Asian countries. Today its degree of income inequality is roughly the same as that in India and certain Latin American countries that are known for a high degree of income inequality.

SPECTACULAR GROWTH OF FOREIGN TRADE

Another important aspect of China's reform period economic performance is its foreign trade. China is now the third-largest global trader. Its total foreign trade volume in 2005 was $1.4 trillion. In 1978, when reform began, China's total trade was about $20 billion and it was the 30th-largest global trader. In the first nine months of 2006 its foreign trade was up by an additional 25 percent. In 2007 China will overtake the U.S. in terms of exports, and in 2007 or 2008 China is expected to become the second-largest trading economy.

Another aspect of China's integration into the world economy is large inflows of foreign direct investment (FDI). Its ranking varies year to year, but China has recently ranked from first to third in this. Cumulative FDI into China is about $650 billion, far more than into any other emerging market economy, some of which opened up to FDI decades before China. Of equal interest, remembering when CNOOC tried to buy Unocal in 2005, Chinese companies are starting to invest outward. The biggest and most notable successful transaction was Lennovo's purchase of IBM's PC business, which vaulted it into the very top ranks of global PC companies. More recently, China is making substantial investments in natural resources abroad, primarily in petroleum but also in iron ore and other minerals and metals that it is importing. It is investing substantial amounts, especially in Latin America, Africa, the Middle East, and some of the Central Asian republics.

In short, China's "global footprint" has expanded dramatically.

EXPLANATION OF CHINA'S PERFORMANCE

First, in the economic domain, China has become predominantly a market-driven economy. This is a substantial change from where it was in 1976, when Mao died. Then, the only evidence of a market was a few vegetable markets. There were a few fruits available on the market in South China, but once you got anywhere north, you could buy no fruit, just local products. There was no national distribution system. Most consumer goods were still rationed. Urban residents got grain coupons that

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allowed them to go to a state-controlled market and buy a fixed amount of grain. The coupons were distributed based on the number of household members. One needed coupons for vegetable oil, which was in scarce supply. There were almost no consumer durable goods available. One could buy only a bicycle, and even those were rationed. Even in the industrial sector, in transactions between firms, most goods were allocated through the planning process, with prices set by the State Price Commission in Beijing. That gave the bureaucracy a huge amount of power. Today, virtually everything in China is sold at a market-determined price. Of course, like any other market economy, the prices of utilities--electric power, water, etc.--are set by the regulators.

Second, the markets are very competitive. Having a market may do no good if there's only a single provider of a good or serve. Most of the markets are extremely competitive. One reason is the openness of the Chinese economy, the fact that imports are very large relative to the size of the domestic economy. Even in industries with few suppliers, for most buyers, there's always the alternative of importing. So the openness of the Chinese economy has been a discipline on domestic prices, most of which have converged toward international prices as a consequence of the high levels of imports. The value of imports in 2005 was equal to 30 percent of GDP--a very big percent. In Japan, for example, imports equal about 10 percent of GDP; for the U.S., it's something like 17 percent.

Another aspect of openness that creates these competitive domestic markets goes back to FDI. One way to look at this is, how important are the foreign firms in any economy in terms of their contribution to output? In the large manufacturing sector, the foreign companies in China--the joint ventures, the wholly-foreign owned companies, etc.--produce roughly a third of the output. In the EU, where they have been promoting cross-border integration, capital flows, and mergers and aquisitions back to the 1950s, the average industrial output produced by foreign companies is 25 percent. So China is ahead of the EU in the importance of foreign companies producing domestically. For the U.S., the figure is about a fifth. Singapore is higher, but China's is a high share for a large, continental-sized economy.

China's openness means that over time, Chinese companies have had to compete successfully internationally. They are competing not only with imports, but also with foreign firms that have moved their operations to China.

A third growth factor is the high savings rate. In any economy, growth is ultimately determined by two factors: how much it invests and how efficient it is at investing. These govern the productivity gains you achieve over time. China has a very high investment rate. Not just households, but also companies and the government, save a lot. Adding these up, you get the national savings rate, and China saves about 50 percent of what is produced, the highest of any country in the world. Its rate is almost twice that of India and several times the rate in the U.S. The great majority of these savings is invested; some is used to invest in foreign financial assets. So they are able to build their capital stock.

SUSTAINABILITY

China has already grown more rapidly for a longer period of time than even its most successful East Asian predecessors. First Japan and then Korea and Taiwan grew extremely rapidly in the 1960s and '70s, but China has been growing as rapidly as any of those countries for nearly three decades.

China will increasingly be a market economy. The manufacturing sector is the largest part of the economy, but a large services sector is also being marketized. One thing driving that is that, under its 2001 commitment to come into the World Trade Organization, China agreed to open up its services sector. At the end of 2006, foreign banks were able to compete on an equal basis with domestic banks, and there was increased competition in insurance, securities, asset management, and telecommunications.

We should see more competition and further expansion of the role of international trade. Tariff levels are now extremely low—the average tariff in the Chinese tariff schedule is slightly under 10 percent, and China exempts so many of its imports from actually paying tariffs, much comes in duty free. Actual tariff collections relative to the value of imports are only 2 percent. That contribution of the external sector to competition in the domestic economy will continue, as will the savings rate until about 2015, when China's population is anticipated to begin to age fairly rapidly. If what has happened in most other economies happens there, many people who have been saving a lot will retire and spend down their savings, so even if the savings rate at every age stays the same, the national savings rate will fall.

IMPLICATIONS FOR THE U.S., ASIA, AND THE GLOBAL ECONOMY

China is both a challenge and an opportunity for the world; on balance, the latter outweighs the former.

The challenge for the U.S. is how to deal with rising world economic powers like China and India. Huge pools of skilled labor that have not been participating in the global economy are now entering it. One reason the average wage of hourly workers in the U.S. has not risen over the last decade is the increasing competition in labor-intensive goods from China. Some of the most important products where China has had a profound effect on the global economy are textiles (16 percent vs. 4.6 percent in 1980), apparel (23 percent vs. 4.0 percent in 1980), footwear (26 percent vs. 1.9 percent in 1980), and toys (27 percent vs. 2.3 percent in 1980). Much of this represents foreign firms that have moved their manfacturing to China. The global center of the toy industry in the 1960s-70s was Hong Kong, but the entire industry moved to China the minute China's economy opened. Shoes were largely made in Taiwan until the 1980s, when Taiwanese firms moved their factories to China. Prices have dropped as China's manufacture share has increased. Now it's not just toys and footwear, but also laptop computers, an interesting recent example. A handful of Taiwanese companies that dominated the manufacture of laptop computers started moving production to China in 2001. By the end of third quarter 2006, the last production line in Taiwan had closed. These Taiwanese companies produce 80 percent of global output of laptops. So right now, 80 percent of global output is made in China.

This yields downward price pressure. The same is true for apparel, which has seen downward wage pressure. This is the biggest challenge China's rise poses, and contributes to the rising U.S income inequality.

The opportunity is a market for our high value-added exports like semiconductors and Boeing airplanes. All the high value-added parts of the laptop, for instance, are produced outside of China. China is the world's largest importer of semiconductors and microprocessors--of the total global semiconductor output in 2005, about 60 percent were sold to China. Most of these go into cell phones, DVD players, laptops, etc. These products are then shipped back to Europe and the U.S. Hard disk drives, operating systems, even computer cases are typically imported into China.

China is an important export market for countries like Singapore, Malaysia, and Taiwan. It is the largest trading partner for virtually every country in the Asian region, and also a huge importer of agricultural products such as soybeans, giving countries like Brazil huge trade surpluses with China. Over the past five years China has contributed enormously to the demand for commodities. Its increased consumption of things like nickel, copper, and aluminum over the past five years accounts for 95-100 percent of increased global demand; for petroleum, it's 45 percent, for iron ore, 50 percent.

China is now the fourth largest U.S. export market. The U.S. sold to China in 2005 nine times more than in 1990. Meanwhile, in the second-fastest growing U.S. export market, Mexico, exports are only roughly quadruple what they were in 1990, despite NAFTA. Exports to Japan are up only 15 percent since 1990, and were lower in 2005 than they were in 1996.

The bottom line is that China has the potential to continue to grow for the next 5-10 years, with complicated implications. We need to enforce China's WTO commitments and enhance its role in those international bodies that promote cooperation in international economic policy issues.