Part IV

U.S.-CHINA ECONOMIC AND SECURITY RELATIONS
The decision taken by China’s leaders in 1978 to restore some property rights to farmers was a pivotal event in China’s modernization and the near-simultaneous beginning of the opening of its economy was of equal importance.

Openness is a crucial element in a strategy for successful development. According to Sachs and Warner, no country in a sample of 117 that pursued “appropriate” policies (involving a “property rights” test and an “openness” test) in 1970–1989 had less than 1.2 percent a year growth and not one of them having under $4,000 GDP per-capita grew at less than 2 percent.1 They found that 37 countries acted to open trade and grew an average of 1 percent more per year in the first two years after liberalization and 1.3 percent more in the longer term by comparison with the decade before liberalization.

Openness has several positive effects: It limits the market power of domestic monopolies; rent-seeking opportunities are reduced; it is a

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means of learning technologies and organizational methods used in advanced countries, with foreign direct investment (FDI) being an especially efficient way to acquire them; and larger scales of production can be realized from exporting.

There are also potential disadvantages of openness, the main one being exposure to destabilizing shocks. The financial sector is especially prone to disturbances, as demonstrated in the financial crisis of 1997–1998. Governments are prudent in not opening their economies to short-term capital flows until their financial institutions are strong enough to cope with monetary surges. Openness also exposes a country to economic sanctions by trading partners. (However, that is a two-way street, because a trading partner that imposes sanctions hurts its own economy as well).

Openness has three components: trade in materials (raw and manufactured) and services, the movement of capital (financial and direct investment), and the movement of people. In 1977, China was the world’s 30th largest trading nation, with total trade of less than $15 billion a year, while it played practically no role in international capital markets and its people were greatly restricted in their ability to move back and forth across its borders. Since then, China has freed substantially the movement of materials and services; it is selectively open to direct investment by foreigners but retains controls on financial capital; and it is much more permissive about its citizens moving across its borders.

TRADE

Deng Xiaoping’s strategy at the beginning was to increase exports of raw materials, especially oil and coal, in order to cope with a rapidly growing trade deficit in the late 1970s. As a result, exports of oil more than tripled and, together with the rise in its price, oil export earnings increased almost seven-fold between 1977 and 1985 (shrinking thereafter). Overall trade doubled between 1978 and 1980—from a low level—and kept on growing rapidly thereafter.² Then greater market access was offered in 1992 to foreign investors, especially to

those who would bring advanced technology. Exports grew at 14 percent a year during the 1990s, more than double the increase in world trade of 6 percent a year. In 1996, 60 percent of merchandise exports went to Asia and 19 percent and 16 percent, respectively, to North America and Europe; the pattern of imports was similar except that there were more from Europe and less from North America.\(^3\) Exports of foreign-invested firms grew an average of 30 percent a year between 1990 and 1996, making it the tenth largest exporter in the world, while the output of these firms grew even faster. These firms were then responsible for 41 percent of China’s exports.\(^4\)

By 1997, its total trade (imports plus exports) was about $300 billion, about 3 percent of total world trade. To put this number in perspective, its share of world trade in 1928 was 2.3 percent; by 1977 it had fallen to 0.7 percent and only reached its earlier 1928 peak share in 1993.\(^5\)

Exports of manufactured goods became dominant during the 1980s, growing from 1985 through 1993 at an average rate of 24 percent per year; by 1993 manufactured goods made up 80 percent of China’s exports. These were labor-intensive goods: textiles, clothing, shoes, toys, sporting goods, TVs, radios, washing machines, and refrigerators. These were low-technology products made by low-cost labor that could for the most part no longer be made competitively in advanced countries. In 1999, exports still were labor intensive, but they were becoming more advanced technically.

China’s exports could not have grown so much without a comparable growth in imports. Although there is much protection, most of it local, there already has been a substantial reduction in trade barriers. Tariffs have fallen by more than one-half since 1992 to below an av-

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average of 20 percent; a World Bank estimate of the average protective
effect of nontariff barriers was only 9.3 percent for 1993.6

A key part of the process of expanding exports was the expansion of
the number of foreign trade corporations and their decentralization
to the provinces. They were allowed to retain increasing shares of the
foreign exchange they earned, a powerful incentive to increase ex-
ports.7 From having fewer than 20 monopoly trading corporations,
China now has hundreds of thousands of trading firms.

The American share of merchandise exports from China grew from
practically nothing in 1977 to about $21 billion in 1996—although
there is a large difference in the numbers reported by the two gov-
ernments. The U.S. government reports that the U.S. trade deficit
with China in 1998 was $56.9 billion, while the Chinese government
reports a trade surplus with the United States of $21 billion. (A bilat-
eral trade balance in a multilateral trading world is not a very mean-
ingful parameter economically but often is politically.) This gap of
nearly $36 billion in the two official accounts requires an explana-
tion, and Fung and Lau provide one.8 They make four kinds of ad-
justments: (1) for freight and insurance; (2) for mark-ups for trade
through Hong Kong; (3) for an estimated scale of smuggling autos,
cigarettes, and oil; and (4) for the inclusion of services. The result of
these adjustments is to reduce the estimated bilateral deficit in 1998
to about $35 billion, still a large number but much less than the $57
billion claimed by the United States. (Premier Zhu Ronghi cited this
analysis in his speech at MIT in April 1999, as well he should have.)
Fung and Lau also say that their adjustments do not alter the official
estimates that the bilateral deficit has been rising at about $7 billion
per year.

It is alleged by protectionists in the United States that imports from
China are at the expense of domestic jobs. However, few of these
products are being made in the United States any longer. In accor-
dance with the familiar product cycle, they have migrated to coun-

6World Bank, China 2020: Long Term Issues and Options for the 21st Century, World
7Perkins, Dwight “Completing China’s Move to the Market,” The Journal of Economic
Perspectives, Spring 1994.
8Fung and Lau, 1999.
tries with lower wage rates. China’s competition in the making of such goods is mainly in Southeast Asia: Thailand, Indonesia, Malaysia, and the Philippines. One consequence of the fall in currency values in Southeast Asia in 1997 was the shifting of some work from China to that region (e.g., disk drive components) but hardly any work shifted from the United States.

China’s imports grew about as rapidly as exports, and their composition also shifted away from commodities to industrial products, a move that was greatly helped by the increase in domestic agricultural output.

There is ample scope for continued rapid growth in China’s trade, and World Trade Organization (WTO) membership will help to assure that. With world trade growing at about $300 billion each year, there should be room for an additional $20 billion worth of Chinese products annually. Assuming continued growth of world output and trade at past rates for the next decade, the rest of the world would have to absorb $550 billion of Chinese goods and services in 2009 out of world total trade then of about $9,000 billion. That would about double China’s share of world trade to 6 percent, making it perhaps the world’s fourth largest trading nation (after the United States, Japan, and Germany). If the increment in world trade value over the decade is $4,000 billion, it should not be seen as remarkable that China is the source of an incremental $400 billion. But there would be displacements, both in competing suppliers and, to a lesser extent, in importing countries and no doubt some protectionist opposition in them. Even so, it might not make a great deal of difference to China’s development because, assuming sustained internal growth, the domestic market will be very large by then, perhaps $4,000 billion (in 1999 U.S. dollars).

FOREIGN DIRECT INVESTMENT

To attract direct foreign investment, China has offered substantial tax and customs duty exemptions in Special Economic Zones, Open Coastal Cities, Economic and Technology Districts, Open Economic Cities, and Open Economic Areas. The original incentives were highly successful, so much so that other provinces and cities wanted them, and they spread. In contrast, China has not opened itself much to financial capital, a prudent policy given the underdeveloped state
of its financial institutions. The wisdom of having controls on capital flows was shown during the financial panic of 1997–1998, which left China relatively unscathed. (It is noteworthy that three of the four parts of “Greater China,”—the Mainland, Taiwan, and Singapore—did relatively well during the crisis; the fourth, Hong Kong, was hurt by a combination of a currency fixed to the dollar and the inability of domestic prices to fall rapidly enough to avoid a slump in output.) The Chinese also have not encouraged equity investment by foreigners in Chinese firms. As of 1999, many foreigners have had disappointing experiences and are pulling back. Many funds started in the early 1990s, and in 1995, at the peak, more than $1 billion was raised, but by 1998 the figure was halved. Profits have been poor, and there have been disputes over agreements.9

Direct investments are another story. China is now second after the United States as a destination for foreign direct investments, receiving 30 percent of all FDI going to developing countries—as conventionally reported. However, a large part of reported FDI, about 25 percent of the total, apparently has been capital recycled through Hong Kong (and elsewhere) and brought to China to take advantage of the benefits accorded capital labeled “foreign.” Chinese enterprises exporting to Hong Kong understate the value of their exports relative to their market price; the difference is stripped off in Hong Kong when the goods are resold. This is a good way to move funds out of China altogether (and doubtless some of these funds have found their way to such places as Vancouver and California), but much of it comes back to China in the form of “foreign” investments that take advantage of tax and other benefits. (This maneuver, as discussed above, greatly distorts U.S.-China trade data.)

Nonetheless, since 1992, FDI has played a large role in China’s rapid growth. In 1983, it was only 0.2 percent of GDP, and it did not go much over one percent until 1992. By 1997, FDI accounted for 7 percent of its gross industrial output, 11 percent of gross domestic investment in fixed assets, and, in 1998, 13 percent of gross domestic capital formation.10

There is a close connection between FDI and trade. In 1998, foreign-invested enterprises were responsible for $81 billion out of a total of $184 billion in exports. If foreign-invested enterprises and processing and assembly exports are excluded, the average growth rate of Chinese exports from 1990 to 1998 would have fallen from 14.5 percent to 7.5 percent a year. There is also a link between investments in China and exports to it via the propensity of investing firms to supply foreign affiliates from within the firm.

Lardy asks, Why has there been so much foreign direct investment given China’s undeveloped legal structure, the nonconvertibility of currency, and corruption? The answers seem to be investments by ethnic Chinese throughout Southeast Asia and elsewhere and the fact that China kept liberalizing its foreign investment rules. The ethnic Chinese have a comparative advantage through their language competencies, family and clan ties, and a tradition of operating through personal connections. However, their potential for future growth in FDI is becoming smaller relative to that of other sources because the scale of foreign investments is growing larger and because advances in China’s technological level implies a demand for more advanced technologies that can mainly be supplied by firms in advanced countries.

After a big increase in the early 1990s, “realized” (as distinct from “contracted”) FDI has been on a plateau at about $40 billion a year. This is because the backlog of commitments made earlier had yet to move into reality and because of the slowdown in China’s growth over the past five years. Also, some foreign investors have not made money, are investing less, or are pulling out.

The recent history of foreign investment in the electric power sector illustrates some of the uncertainties, risks, and promises in China. From the early 1980s to the early 1990s, China was perceived as one of the best countries for direct investment in independent power projects, and many deals were made. Then problems arose in the

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12Fung, Lau, and Lee, unpublished.
13Thanks to Robert Crow, former chief economist of the Bechtel Corp, for these observations.
1990s over who among central and provincial administrators had authority to make deals. Also Prime Minister Li Peng decreed that foreign investors’ could not get a rate of return higher than that in the United States. Because they perceived more risks in China, this cooled their interest—except in power plants of less than 300 megawatts that could be authorized at the provincial level without central government approval. Then in the late 1990s, several other events occurred to cool foreign investors’ interest further: a slowdown in energy-intensive heavy industry and the raising of electricity prices toward market levels reduced demand for electricity; this left excess capacity. And the shift of some authority over such projects to the center from the provinces led to some cancellations.

A few big foreign-financed projects have, nevertheless, gone ahead, and as excess capacity is reduced over the next few years, and with institutional learning and reforms, there will likely be more foreign projects. There is a long-term demand for 10–15 gigawatts a year in generating capacity, an amount comparable to that being added in the United States. However, the capacity of Chinese equipment and engineering firms has grown, so foreign firms will be facing much more competition than in the past.

Although the creation of privileged zones for foreign investors has been a success, it has also created problems. One is the widened disparity in incomes between the favored areas in the south and along the coast and the less favored in the interior and north. To some extent, this regional income disparity reflects prior differences in human capital; for example, the Shanghai area was long more advanced than other parts of the country, but the policy of selective openness to foreign investment widened existing differences. The income disparity has naturally led to large-scale migration of people to the fast-growing areas. The resulting huge “floating population” consists of people who are on the whole better off for having moved but who are denied various social benefits received by many of their settled coworkers. However, with the passage of time the privileges afforded foreign investors have become more widely distributed throughout the country.

Although it seems impossible to measure it with any precision, arguably the greatest effect of FDI is in transferring technology, management methods, business models, and the building of institutions.
(It is hard to argue that a country that saves 40 percent of its national income lacks financial capital.) There are many ways for less-developed countries to acquire technology: licensing, studying academic and trade journals, reverse engineering, learning from trading partners, inviting expatriates to come home, sending students abroad (hoping that they will return sooner or later), and FDI. The last of these is an especially effective way to get advanced technology because it comes via an institution: a multinational corporation that can bring tacit knowledge that is often crucial and that is not conveyed via arms-length techniques such as licensing. China’s rapid progress must be due in substantial measure to FDI, and there is much more to come if it continues to make itself an attractive destination.

THE IMPORTANT ROLE OF HONG KONG

Throughout, China’s outward-oriented strategy has had a special role for Hong Kong. The British colony had developed a sophisticated knowledge of how to operate in world markets. This knowledge, its role as a financial center, its management competencies, and its contacts proved valuable to Chinese enterprises trying to operate in the wider world with which they were unfamiliar.

Hong Kong has served in several ways to help the development of China, especially the bordering province of Guangdong. Hong Kong firms receive goods from China, sometimes add further value to them, and distribute them to customers around the world. Another role played by Hong Kong firms is to invest in Special Economic Zones such as nearby Shenzen. The pattern is one in which headquarters’ functions, such as finance, product design, and marketing, are done in Hong Kong, and products are made, often nearby, in China. The scale of these operations has gotten quite large. Naughton observes that much of Hong Kong’s investment in China represents the ordinary process of growth in a metropolitan region expanding outward in concentric circles and that the more liberal trade regime China has created space for Hong Kong and, ultimately, Taiwan to expand.\textsuperscript{14}

\textsuperscript{14}Naughton, 1996.
Although the general opening of China suggests that Hong Kong will play a less important role than in the past, Beijing has a strong incentive to sustain Hong Kong’s competencies. These center on the rule of law and relatively little regulation and corruption, all attributes in short supply in China proper. The slogan of “one nation, two systems” refers to a political structure likely to be of continuing value. It still remains uncertain that this precious asset will not be depleted.

**CHINA AND THE WORLD TRADE ORGANIZATION**

The agreement between the American and Chinese governments on the terms of China’s accession to the World Trade Organization is a signal event (although at this writing, the U.S. Senate has yet to confirm this agreement). Because it entails far-reaching concessions on China’s part, it is not surprising that it took a long time to happen. Among many other consequences, China’s accession means the end of the annual congressional vote on “normal trade” (formerly “most favored nation”). One might think of this as a U.S. concession, but it is a ritual the United States will be well rid of.

Viewed from an American perspective, three attributes of the WTO are paramount here: The first, of course, is its liberal content. The second is its multilateral character, one that should diminish the role of the United States as a nag in getting China to conform to market rules. And third is its potential for strengthening the hand of China’s center versus local protectionism. This last point deserves comment.

Even before the reforms began, China was much less centralized than the Soviet Union, and with the reforms it has become a markedly decentralized one. As one scholar put it:

> [I]n a space of fifteen years or so, the Chinese political structure has been transformed from one that was once reputed for its high degree of centralization and effectiveness into one in which the center has difficulty coordinating its own agents’ behavior. Because power and resources are dispersed, the exercise of central control now de-
Evidence on the fragmentation of power is extensive and local protectionism is rampant. Moreover, this dispersion of power coincides with a fundamental characteristic of the regime, which is that Communist Party interests—as interpreted though a vast bureaucratic apparatus—trump objective and public rules, i.e., laws. The system is both fractionated and obscure. Many laws, regulations, and rules are unpublished and inaccessible without personal connections. Recently China has agreed to publish trade and FDI-related measures (which in any case is called for under Article X of the General Agreement Tariffs and Trade (GATT) and incorporated in the WTO), and, although practice has improved, regulations are sometimes vague, arbitrary, and inconsistent. Bureaucrats still have much latitude in interpretation, and some rules are still not made public. Also provincial and local governments’ actions often vary among each other and with the central government. There is much to be said for a federal system of government that allows for variation among the parts, and China exhibits federalist properties. However, a crucial attribute of federalism is an American type of constitution of interstate commerce clause, and China effectively lacks one.16 Ironically, for a system that was founded on the principle of central control (a “command economy”), today China has too little of it in some ways.

Informed observers are skeptical of the capacity of the WTO dispute resolution system to secure Chinese compliance with agreed-upon goals and schedules and fear that the system could become seriously overloaded. Concerns have been expressed as to whether “even if the central government makes a commitment to develop Chinese legal

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institutions in order to approach treaty standards, it would be able to carry out such a commitment.”

Accession has major implications for how the Chinese government handles a wide range of trade and investment topics. Its purpose is to lower barriers in several ways: tariffs, nontariff barriers such as quotas, import licenses, unwarranted inspections, and standards related to agriculture, health, investment, textiles, and dumping. Separate agreements are supposed to include intellectual property and services. The agreement with the United States includes foreigners being able to own 50 percent of telecommunication firms within two years and having management control, foreign banks being able to do local currency business with Chinese firms, and tariff cuts, including about a 75 percent reduction in those on autos. China has said that it will sign the global Information Technology Agreement on the occasion of its accession to the WTO; that would soon bring Chinese tariffs on many high-tech products to zero. China has made progress on intellectual property protection in recent years, but it will remain a contentious topic.

According to a World Bank report, China’s full entry into the world trading system will lead to it more than tripling its share of world trade, to 10 percent by the year 2020, making it the world’s second largest trading nation. This probably will require annual growth in exports at 12 percent a year, modestly less than the growth rate of the 1990s. China might account for 40 percent of the increase in imports of less-developed countries between 1992 and 2020. This would not be entirely at the expense of such competitors as the Southeast Asian nations, but their terms of trade would suffer. Altogether, the benefits to China of membership have been estimated at $116 billion a year by 2005 (about 6 percent of its projected GDP).

THE EXCHANGE RATE

The Western financial press in the past three years has repeatedly carried stories to the effect that China was about to, or would within

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several months, or would early next year, devalue the yuan to offset the disadvantage from the depreciation of its competitors’ currencies. These stories have lacked plausibility. Much has been made of the Chinese authorities’ desire not to set off another round of devaluations, an explanation that has won them plaudits. This may be so, but there are more self-serving reasons. One is that they have lowered the value of the currency modestly by rebating the value added tax on exports (a common procedure elsewhere); another is that China’s exports, except to countries whose economies were most hurt during the crisis, have held up well—notably to the United States. Yet another is that yuan devaluation would put further strain on the Hong Kong dollar and might lead to its link with the U.S. dollar being altered. Also, given the history of hyper-inflations in China, the government is sensitive to any moves that might cause people to flee its currency. This is not to say that the value of the yuan is forever fixed, but analysts would do well to consider the possibility that the yuan’s next major move might be up rather than down.

It would also be a mistake to infer that American investment in China versus that in other less–developed countries is highly sensitive to exchange rates. It is not because most of it is aimed at serving the domestic market.

CHINA’S HIGH TECHNOLOGY FUTURE

A question of interest for several reasons is China’s high technology future. Research-intensive products and services will become an increasing share of output; they will become increasingly important for trade, both ways; and they will play a large role in China’s defense sector.

China is a large and growing market for computers and their components, telecommunication equipment, and aircraft and is a potentially large one for pharmaceuticals and many other research-intensive products. Its competencies to manufacture such products are growing. With over 1 million scientists and engineers and over 5,000 research institutes, its scientific and technological potential is great. Some of these research institutes are being restructured to become technology companies, some of them in collaboration with foreign
investors or partners. The government has invested in 47 engineering centers with 11 so far operating as corporations.\textsuperscript{19} About 100 high technology parks have been created (many of which so far display little activity).

The success of Taiwan in the computer industry serves as one model for the mainland. Its was a largely market-driven process, but with important help from the government’s Industrial Technology Research Institute. Other features of the Taiwan model were the recruiting of engineers with experience from the United States; links with firms in Japan, the United States, and Europe to learn about technology and markets; favorable tax and securities laws; the emergence of private sources of finance in the form of individual and venture capital; and the development of good universities whose science and engineering faculty members have developed close ties with firms. A contributor to Taiwan’s success (notably in the computer industry) is close links with the leading sources of technology and market know-how in Silicon Valley. There is much moving back and forth of data, ideas, and—despite the supposed “death of distance”—people on airplanes.

Taiwan serves not only as the best model of how to catch up in a fast-moving sector, but it is already serving as a bridge to help the mainland move ahead as firms in Taiwan out-source jobs to the mainland. But as the mainland develops, the task its aspiring high technology enterprises increasingly face will be one of creating intellectual property. Judging from the experience of Taiwan (as well as India, Israel, Ireland, and other places), this will be helped by close ties to the main centers of technology in developed countries.

An inevitable by-product of technologic advances for civil applications is advances for military applications. This is a switch from the situation several decades ago when advances in military technology often led to civilian ones, as happened, for instance, in jet aircraft, nuclear power, computers, and telecommunications. Now, for example in computers and telecommunications (whose technologies are converging), civil applications are often in the lead. There are, of course, important military sectors that have little or no significant

civilian counterparts, such as stealthy aircraft, but overall, countries that come to be advanced technologically in general, as will be true of China, will find the barrier to military uses of these technologies lower than in the past.

CONCLUSION

For those who recognize that openness promotes development and that a country’s development, if it goes far enough, is a sufficient condition for its political evolution to political pluralism, China’s increased involvement with the world economy should be welcomed not only for the familiar commercial reasons but for political ones as well.20 According to this view, Deng Xiaoping’s initial instinct to push exports, reinforced by his southern tour in 1992, has turned out to be fateful and highly beneficial for China’s political as well as its economic development. Of course, this is not to maintain that all will be smooth sailing ahead on either front.