China's Economic Prospects and Sino–US Economic Relations

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Abstract

A better comprehension of the mixed sentiment in the rest of world towards the rapid rise of the Chinese economy will depend on the understanding of some key features of the Chinese economy, such as those associated with its size, structure and institution. To further sustain its high growth, China is facing more challenges than it has encountered in the past 2 decades, including a gamut of material constraints. Although polices and technological progress might alleviate many of these constraints, the ultimate solution will still lie in continued institutional reform. China's recent move towards a more flexible exchange rate regime is in line with its broad reform and in accordance with the progress of its development. However, such a move will have limited immediate effects on the prodigious US trade deficit, which itself is a problem rooted in the flawed international reserve system, far beyond a Sino–US trade issue.

Key words: China, reforms, trade, exchange rate

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I. Introduction

The rapid rise of the economic weight of China in the world economy has increasingly caught the attention of many analysts as well as policy-makers, eliciting various opinions on the global implications. Although China's economic performance in the past 2 decades

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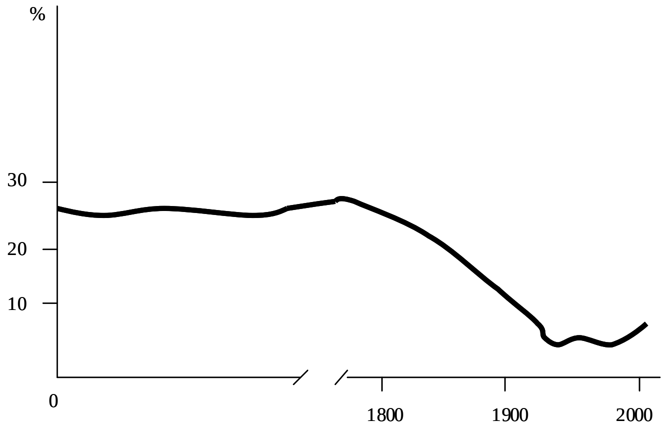
Figure 1. China's Share in the World Economy



or so is indeed miraculous, the rest of the world should become less surprised or bewildered if they see China's recent performance from a long-run historical perspective.

According to some economic historians (e.g. Maddison, 2001), China had maintained a share of above 20 percent in the world economy for the most part of the past two millennia, until the eighteenth century, when China took a fall. The fall had been protracted, lasting for 2 centuries, until recently. Therefore, as indicated by Figure 1, despite China's recent rise, its share in the world economy remains conspicuously lower than its historical average.

In this context, we might wonder whether China's rapid growth in recent years is just a brief rebound within its downtrend of the past 2 centuries, or whether it indeed signifies China's renaissance and its regain of the glorious position it once had during its long history. A definitive answer to this question is beyond this article.

This short article will focus on three groups of issues. First, some special features of the Chinese economy will be discussed along with the implications of these features for the rest of the world. Second, comments will be made on China's economic prospects, in terms of the major constraints China has to overcome to sustain its economic development. Finally, the last section will focus on trade and exchange rate issues that are particularly relevant to Sino–US economic relations.

II. Some Special Features of the Chinese Economy and their Global Implications

China's high growth and its rapid integration into the global economy have generated mixed sentiment in the rest of the world. On the one hand, consumers worldwide are benefiting from the low prices of the products made in China, and businesses in many countries are also profiting from the booming Chinese economy. China is considered to be another locomotive for global economic growth besides the USA. On the other hand, some developed countries are complaining about job loss as a result of an inundation of Chinese manufactured goods, whereas quite a few developing countries are upset about China's takeover of their export shares in the global market. Some analysts have attributed the recent surge in global oil prices to China's demand, and many economists are warning of a hard landing of the Chinese economy, which might send the world into a recession. Although the benefits China has brought to the global economy are beyond gainsay, these anxieties are not frivolous; however, they may tend to be exaggerated from time to time.

To understand better the global implications of the rise of China, we should pay attention to a few special features related to the size, the structure and the institution of the Chinese economy.

Size matters. At 1.3 billion, China's population accounts for approximately 22 percent of the world total. Its large size allows China to enjoy more benefits from economies of scale, such as "network effects", and "increasing rate of returns" than many other countries of smaller size. Its size can also make it possible for China to become internationally specialized in some sectors while maintaining a certain degree of diversification for the economy as a whole; thereby, China can strike a balance between the benefits and the vulnerabilities of integrating into the global economy.

If the 1.3 billion people are properly motivated and well organized, they can generate tremendous aggregate economic activity. The size factor alone will pose significant challenges for the global economy. For example, China's total consumption of the five basic commodities – grain, meat, oil, coal and steel – has already surpassed that of the USA in all but oil. Many analysts wonder how far the supply of global energy and raw materials can accommodate such a rapidly growing demand from so large an economy.

The structural implications of the Chinese economy are also important. The Chinese economy is characterized by such structural features as a plethora of low-skilled labor, very low average labor costs, a scarcity of arable land per capita, or a scarcity of per-capita natural resources in general, and an extremely high savings rate.

These major structural features have defined China's comparative advantage in producing and exporting labor-intensive goods in the world economy. For the rest of the world, most developed economies have benefited from importing Chinese manufactured goods and from exporting capital-and technology-intensive products to China. Many developing countries that produce raw materials and land-intensive products have benefited from their complementary structure with China, but other countries with a similar labor-intensive structure are facing heightened competition.

Some of these structural features can change over time: unskilled labor can become skilled and low labor costs can rise; so the international comparative advantage of China will not remain the same.

Besides the size and the structural features, the institutional implications for China are probably the most crucial. China has made great efforts to transform its economy from a centrally-planned economy into a market-oriented one, but China’s institutional framework remains quite different from many other economies: for example, it features a large proportion of state ownership, direct involvement of the governments at different levels in economic decision-making, and underdeveloped legal, banking and financial systems.

These institutional factors have directly or indirectly compounded some of the international tensions during China’s integration into the global economy. Various trade disputes, issues about intellectual property rights, and the most recent international pressures on China’s exchange-rate policy, for instance, are all related to institutional factors.

We should bear all these special features in mind when we discuss any issues related to the Chinese economy.

III. Economic Prospects and Major Challenges

The outlook for the Chinese economy remains optimistic in the short run. After a growth rate of 9.9 percent in 2005, a pace of 8 percent or higher is expected in the near term (as indicated in IMF (2005) and United Nations (2006). Macroeconomic policies should continue to address the problems of overheating and over-investment. Recent policy adjustments to reduce fiscal stimuli and to tighten the monetary stance seem to be in the right direction.

In the longer run, according to some official or quasi-official projections, China is expected to quadruple its GDP within the next 2 decades. This is indeed a very ambitious goal, given the fact that China has already quadrupled its income in the previous 2 decades. No economy in modern history has ever been able to sustain such high growth for 4 consecutive decades.[1]

To fulfill this goal, however, China will have to overcome a myriad of constraints: constraints that are much more formidable than China has encountered in the past 2 decades. There are two broad categories of constraints: material and institutional.

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[1] A remark made by Professor Lawrence Klein when he was attending a conference in Su Zhou, China in 2003.

Material constraints refer to those associated with tangible factors for economic growth, such as population, labor force, capital, land, energy, raw materials, water and environment.

For example, population remains a top challenge for China. From a dynamic point of view, however, the growth of population might not be the most challenging problem for China in the next few decades, as China has just entered into a stable and low-growth demographic stage with the total population likely peaking below 1.5 billion around 2030. Nevertheless, China will still face an increment of approximately 10 million in its labor force each year, which is more than the sum of the annual increase in the labor force of all the OECD countries. If combined with the large surplus labor in the countryside, estimated at 200 million or more, employment pressures will remain high. More challenging is the issue of how to improve the quality of labor through education and training.

Given the high saving rate in China, there seems to be no dearth of capital, but the quality, or the efficiency, of capital is a problem. The ratio of capital investment to GDP in China has been above 40 percent for many years, the highest in the world, and it is still rising. Such a high investment ratio is an indication of low returns to capital, and it is an alarming sign that the current growth pattern is hard to sustain.

Many analysts believe that the most evident material constraint for China is probably the shortage of energy. China for sure needs to improve its energy efficiency, but it is worth making a little digression here to debunk a widely held view accusing China of wasting energy and blaming China for the recent surge in the international prices of crude oil. For example, in Bremner and Carey (2005) and Tashiro and Dawson (2005), the analysts claim that China would consume four times as much as the USA and eight times as much as Japan for producing the same unit of GDP, labeling China as "profligate" of oil.

We should understand that the indictor of "amount of crude oil needed to generate $1 in nominal GDP", or the so-called "GDP oil intensity", is not a valid measure for comparing energy efficiency across countries. China's GDP consists of 70–80 percent value-added from material production, whereas GDP in many developed countries, such as Japan and the USA include 70–80 percent value-added from services. It would obviously make no sense if we would compare the usage of crude oil in an attorney's service worth US$100 to the usage of energy in producing a piece of aluminum equivalent to US$100, and then claim that an attorney in the USA is more energy efficient than a foundry in China.

We have witnessed a decline in energy intensity in many developed countries since the oil crises of the 1970s and 1980s, but not all such achievement has been a result of improvement in energy efficiency or conservation in these countries. It has been made possible partly by relocating energy intensive, as well as pollution intensive, manufacturing sectors into developing countries. A measurable proportion of China's energy usage today reflects increasing energy consumption by many developed countries through China's exports to these countries, with energy being embodied in the exports. Meanwhile, China's per-capita consumption of crude oil is only 5 percent of that of the USA, and less than 10 percent of that in many other developed countries.

Economic efficiency of energy in an economy should be defined as an optimal allocation of energy relative to the allocation of other resources in the economy; therefore, such optimality would vary from country to country, and from time to time within a country, depending on resources endowment and on development stage of the economy. In China, an efficient energy allocation will definitely have to take into account the job opportunities for a prodigious surplus of low-skilled labor. In this sense, energy efficiency, as well as the standard of pollution, is not simply a technical issue, but a complex economic issue involving permutation of many trade-offs.

In broad sense, although each of the above-mentioned material constraints are big hurdles individually, combined, they would become even more challenging. For example, the export-led development strategy to promote manufacturing seems to be a good one for resolving the problem of surplus labor, but this same strategy directly exacerbates already severe energy and environmental problems.

Facing such a dilemma, China will have to make trade-offs among these material constraints. Some of these material constraints can be alleviated by various policies and by technological progress, but the ultimate solution might have to be found in institutional reforms.

Institutional reforms have played a key role in China's rapid growth over the past 2 decades (see e.g. Qian, 2003), and will continue to do so for at least the next 2 decades.

Institutional reforms in China have now reached some of the most difficult areas, such as the banking and financial system, and the legacy of the central-planning economy can be very tenacious in some areas. Meanwhile, many new issues that have emerged in the market economy are calling for new institutions.

For example, on reading the news about how the Chinese Prime Minister helped a construction worker get back his wages owed by the developer, we should admire the kindness of the Prime Minister, but we might also question about the function of the rule of law and the legal system in China: such a case ought to be resolved in the court, not by the intervention of the Prime Minister.

Many serious problems, such as corruption, infraction of intellectual property rights, and widening inequality, all indicate that China needs much better social and economic institutions. Dismantling of the old central planning system cannot substitute for the building of modern institutions. The latter task is much more challenging than the former.

We need a little elaboration on the issues of inequality and corruption.

With rapid growth, China has managed to reduce absolute poverty substantially, but income inequality has widened significantly. For example, the degree of income inequality in China, if measured by the Gini coefficient, is now above 0.4 (World Bank, 2005), higher than many countries, even higher than the USA, which has the highest income inequality among the developed countries.

We should make a distinction between equity in opportunity and equality in income. In terms of social justice and economic incentives, equity in opportunity seems to be even more important than equality in income. In China, part of the worsening in income inequality over the past 2 decades could be precisely the result of improvement in equity of opportunity: many early reforms were mainly designed to break the egalitarian system by giving people more opportunities. Some people did get rich faster than others by virtue of their talents and efforts.

However, in some cases, the deterioration in income inequality is indeed because of worsening inequitable opportunity. Corruption is a case in point. Corruption has been enriching a group of people through unfair and illegal means. In the 1980s, the earlier years of reform, corruption was characterized by individual officials' accepting small bribes, and by their relatives' profiting from the price differentials in the dual-track system. In the 1990s, corruption has become pervasive, featured by rapacious rent seeking from officials in all ranks.

Apart from evoking moral and legal issues, corruption has led to prodigious economic losses as well. We have read many official reports about the collapse of newly built bridges, serious defects in highways and other projects, and the instances of huge embezzlement in state-owned banks.

In the earlier years of reform, some views suggested that corruption might "lubricate" the progress of the reforms. Even if there was a semblance of truth in such a statement in the 1980s, today's corruption has become a completely insidious cancer in the economy, devastating the fruits of the reforms, rather than facilitating them.

In China's long history, extreme social inequality and corruption have been the major catalysts for social unrest, and for the toppling of many dynasties. The current Chinese government seems to have realized this risk. Many new policy measures, such as the "people centered" development strategy and the goal to build a "harmonized society" are all aimed at rectifying these problems.

Rooted in Chinese culture, many such problems have been considered the result of ethical flaws of individual officials, rather than the result of institutional failure. China might need to discard such a traditional way of thinking and to find effective institutional solutions to these problems.

IV. Trade and Exchange Rate Issues Closely Related to Sino–US Economic Relations

Trade between China and the USA has been growing rapidly, but a widening bilateral trade imbalance has caused growing concerns.

According to the US trade data, the USA is running an annual trade deficit of approximately US$200bn with China, the largest deficit it has ever recorded with a single economy in history (US Department of Commerce, 2006). Some US politicians and analysts believe that this deficit is the main cause for the loss of jobs in the US manufacturing sector (for example, US-China Economic and Security Review Commssion Annual Report to the Congress). They believe that the low prices of Chinese goods are driven by an unfair dumping strategy and by an undervalued Chinese currency. Therefore, they advocate anti-dumping and safeguard measures and press China to revalue its currency.

However, China rebut that the US trade statistics have exaggerated the bilateral imbalance. China also argues that the low prices of its manufactured goods are mainly the result of its low labor costs. Meanwhile, China believes that the American economy has greatly benefited from the low prices of the products made in China to the extent that the USA is able to maintain low inflation and robust household consumption. China also complains about the US restrictions on certain high-tech products, which China could otherwise have imported, to narrow the bilateral trade gap.

Both sides seem to have some valid points, but I would like to add my personal views on these issues.

First of all, neither side should pay too much attention to the bilateral trade imbalance. Given today's globalized manufacturing network, in which most products are made in a multi-stage process distributed across several countries, the bilateral trade balance has lost much of its economic meaning.

It is the total external balance that matters the most, not its bilateral balance. In this sense, the large total US trade deficit, which is running at approximately US$800bn annually, is a problem. In comparison, China's external account is running only at a small surplus of less than US$100bn.

Many analysts have tried to explain the large US deficit as the result of some structural differentials between the US economy and the rest of the world, such as the difference in saving–investment gaps, in GDP growth, and in macroeconomic policies. In my opinion, the chronic US external deficit is also rooted in the flawed international reserve system, in which the US dollar is acting as the world currency, giving the USA the exorbitant privilege of living beyond its own means. The issue of the large US current-account deficit goes far beyond bilateral trade between the USA and China and the low prices of Chinese exports.

Second, on the issue of job loss in the USA, we know that a decline in manufacturing jobs is nothing new; the trend has been there for many decades, reflecting partly continuous technological progress and partly deepening international division of labor in the world economy.

By the classic trade theory, both China and the USA should gain from trade, but the same theory also implies a downward pressure on the wages of low-skilled labor in the USA. A net loss of jobs can occur under certain circumstances: for example, when low-skilled workers in the USA find it difficult to meet job requirements in high-tech sectors, and when gains from international trade are not properly distributed in the economy.

The USA can enact safeguard measures to protect certain industrial sectors. The USA did just that a few years ago with regard to the iron and steel products, and took similar action for textiles in 2005, as the imports of Chinese textiles surged when the global quota system on textile and clothing was phased out. As history attests, however, these measures cannot revitalize sunset industries in the USA: the textile industry in the USA had been under protection by the Multi-Fiber-Agreement quota system for half a century, but the sector is still not ready to face competition. The long-run remedies for alleviating the problem of job displacement should be policies to improve education and income distribution.

Besides the worries about the loss of low-skilled jobs in the USA, the recent phenomenon of outsourcing some high-tech work to China and India has triggered a new concern in the USA not only about the conventional manufacturing sector but also about the high-tech sector. For example, Samuelson (2004) recently outlines a scenario in which the USA could suffer a permanent measurable loss in per-capita income from trade with China. His intellectual exercise is a challenge to the "win–win" scenario postulated by classic trade theory, and some analysts might use this argument to engender new protectionism. Theoretically, he is right, but the result is based on a hypothetical assumption that China could make a significant leapfrog in the high-tech sector and overtake the leadership of the USA in all major high-tech areas. This is not likely to occur in reality, at least not for the next few decades.

On the issue of China's exchange rate, the recent move of the Chinese authorities towards a more flexible exchange-rate regime was in the right direction, for its own benefit. A revaluation of RMB within a reasonable range will, however, have only limited impact on the US deficit.

An exchange-rate policy is a trade-off between flexibility and stability, as both would have advantages and disadvantages for the economy. By pegging RMB to the dollar for more than a decade, China managed to benefit from the currency stability, but as China's economy develops, the benefits of a flexible exchange rate might now outweigh the benefits of a fixed one. For example, by adopting a more flexible exchange rate, China might enhance the dynamic, rather than the static, competitiveness of its firms, improve the efficiency in resource allocation between the domestic sector and the external sector, and strengthen risk management capacity in the long run. The adoption of a more flexible exchange rate regime should be done gradually and in accordance with the reforms in the banking and financial system.

A revaluation of the Chinese RMB by, for example, 30 percent, would still have limited impact on the retail prices of many Chinese products sold in the USA, because the proportion of the value-added by Chinese workers in these products is just a fraction. Of course, a revaluation of RMB will increase the purchasing power of Chinese consumers to buy more foreign goods and services, including US products. It might reduce the US deficit, but not of a significant magnitude to solve the US imbalance.

For its own benefit, China should also evaluate the benefit and the cost associated with its prodigious amount of foreign reserves, which, piling up to US$800bn, seems far beyond the level justified by economic fundamentals. The conventional view held by many Chinese who consider the amount of foreign reserves to be an indication of the nation's wealth, or the strength of the economy is completely misleading: the nation's wealth can be of many different forms, physical or monetary, and it does not directly correlate with the amount of foreign reserves. For example, except Japan (the return on Japan's holding of the US dollar reserves is higher than its domestic financial assets), few rich countries hold a large amount of foreign reserves. In contrast, many weak economies need to pile up foreign reserves as an issuance policy for dealing with uncertainties in the future, but they have to pay a seigniorage to the issuers of foreign reserve currencies, mostly the USA.

In general, as its economy continues to grow, China should include more international responsibility in its economic policy considerations: enforcing intellectual property rights and strengthening international economic cooperation, for example. However, the world should be patient: reforms take time and involve risks if pushed too quickly.

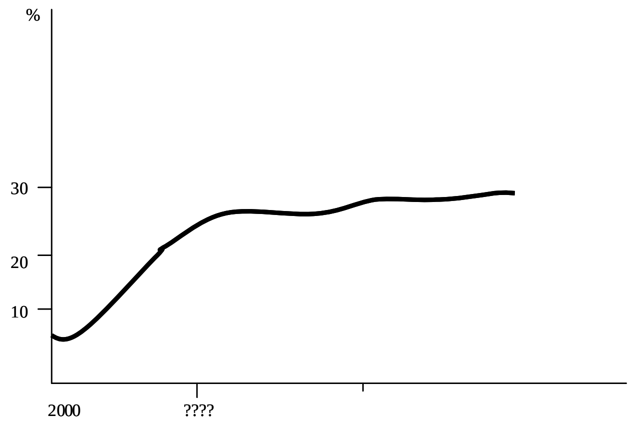
More than 200 years ago, China had for the first time in its history registered a sizable trade surplus vis-à-vis a group of countries in Europe and America, as the growing demand in Europe and America for Chinese goods, such as tea, porcelain and silk, had not been matched by Chinese demand for products in these countries, such as cotton and woolen goods, fur, clocks, tin and lead. The result was a serious balance-of-payments problem, a steady outflow of silver from these countries. By the late eighteenth century, the UK had developed an alternative product to balance its trade deficit with China: opium (see Spence, 1991). The disastrous consequences of that episode with China are well known.

Today, the USA has a better alternative: the greenback, which is virtually costless to print, and not deleterious (is it also not addictive?). Anyway, China seems to be delighted to keep accumulating the greenback, at least so far.

V. Conclusions

We conclude with a mirror-image transformation of Figure 1, with the horizontal axis changed from history to future. Hopefully, Figure 2 foretells the path for the Chinese economy in the future, and, more importantly, hopefully, the rise of China won't generate as many grave

Figure 2. China's Share in the World Back to the Future



international clashes as China suffered when it converged with the developed world for the first time a few centuries ago.

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