

Getting Incentive Right:
The Institutional Sources of China's
Growing Influence on the
Globalisation

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China Rises as Cheaper Producer

- Virtually all discussions about the impact of China's economic rise on global economy can be simply boiled down to an open-ended question of “ is it a threat or an opportunity?”
- And virtually all the short-cut answers to this question, either believing it a threat or an opportunity, are grounded on the assertion that China makes goods too cheaper.....

- China makes the goods cheaper, so China is the destination for multinationals to outsource their production bases, which is good for world producers;
- China makes the good cheaper, so Chinese exports to American and EU are soaring, which is good for world consumers;

- China makes goods cheaper, so it makes no inflation in the rest of world;
- China makes goods cheaper, so it makes cost of financing in capital market low enough to sustain the highly-leveraged American economy;

- China makes goods cheaper, so it hurts the relevant domestic industries in advanced economies producing substitutes; so it makes those related workers unemployed;
- China makes goods cheaper, so it ramps and dumps the profits of other comparable economies;

- When some economies in Asia were emerging, they were making goods cheaper too, making more exports to the US and EU, too;
- In 1970-80s, Japan made cars cheaper than the US, so Japan competed against the US in cars markets, in 1990s Korea made both cars and electronics cheaper, so US-Korea trade was growing rapidly. How is China different?

- China is different in terms of the rising size of economy and markets;
- China is different in the way it participates in the globalization: China is much more open than Japan, Korea and India;
- China is different in its highly decentralized way to promotes the economic development;

- China is different in its capacity of production in manufacturing sectors;
- China is different in its ability to enjoy the external economies(complementarities) and economies of scale.
- China is different in its long lasting capability of supplying cheaper labor forces;
- In short, China is different because it can makes goods *too* cheaper.

How is China unique?

- China is unique, not only because the labor is cheaper, though it is, but also because its unique way in making the goods cheaper;
- China has evolved into an institutional structure for cheaper production: governments ownership of production factors and the incentives for governments are just right.

Mr. Rajiv Sikri, Special Secretary, Ministry of External Affairs, Government of India, said:

“Firstly, the Indian economy has grown within a *democratic, federal framework* that necessitates consensus and imposes many well-known constraints. Secondly, *the indigenous private sector* has played an important role in the growth of the economy and the process of economic reforms. Thirdly, the bulk of the resources for India’s economic development have been generated from within the country, *not from FDI*”

Getting Incentive Right

- Compared with most developing and East Asian economies, China has evolved into a unique institutional structure which *gets incentive right for governments*, and competition is magically generated among governments for better productivity and economic performance.

Legacy of Centrally Planned Economy

- Multiple tiers of regional property rights over means of production: land, natural resources, capital (Granick, 1990);
- Rural-urban divide, making rural labor cheaper;
- State banking system, making credit cheaper;
- Political cohesion;

Rural-Urban Divide



Multi-tier Decentralization

- Top-down way of intergovernmental fiscal decentralization (Wong, 1995, 2000);
- Political monitoring and control of local officials;
- Fiscal federalism, Chinese style (Qian and Weingast, 1996;1997);

Selection and Turn-over of Local Officials

- Relative performance of economic growth and development is a major determinate of turnover of local officials (Whiting, 2003; Zhou, Li and Chen, 2005);

Quasi Corporate Governance

- Combined elements of above-mentioned institutions result in an unique market-preserving and growth-oriented mechanism: Chinese local governments act as commercial corporate entities seeking faster output growth; The governments have built up similar corporate structure and local officials carry their duties as managers of corporations. Here comes the competition.

Competition

- Competition, or race, between and among local governments is the key to a better understanding of the dynamics of Chinese economy (Zhang, 2005);
- Competition for better performance is created at different tier of governments, from provincial down to county and town level;

- Competition between and among local governments makes markets perfect competitive;
- Competition among Chinese local governments makes downwards pressure over prices of land, taxes and credits in order to attract for flux of FDIs;

- Competition squeezes profitability; thus transferring producer surplus down to consumer surplus;
- Competition therefore makes goods cheaper, cheaper, and much cheaper;
- Competition therefore improves quality of goods for domestic markets and for exports;

Growing Impact of China on Globalization

- Increasingly becoming destination of outsourcing from multinationals;
- Intensifying the global competition for low-end manufacturing industries;
- Re-orientation of intra-Asian trade flows;
- Increasingly worsening China's term of trade, making the world better off;

- When global economy is hit by with external shocks, China makes it less vulnerable to recession;
- China-US trade imbalance;

Firms with Foreign Capital (FFC) in China's Trade with Selected Partners 2002

	World	EU-15	USA	Japan	Hongkong	Singapore	Korea	Taiwan
In % of China's Exports								
FFC Exports,	52	50	58	62	63	65	49	57
FFC Processed Exports	41	40	48	47	54	54	35	45
In % of China's Imports								
FFC Imports	54	49	48	67	63	61	63	67
FFC Imports for Processing	32	12	21	39	53	36	41	49

Source: Chinas Customs Statistics, authors' calculations.

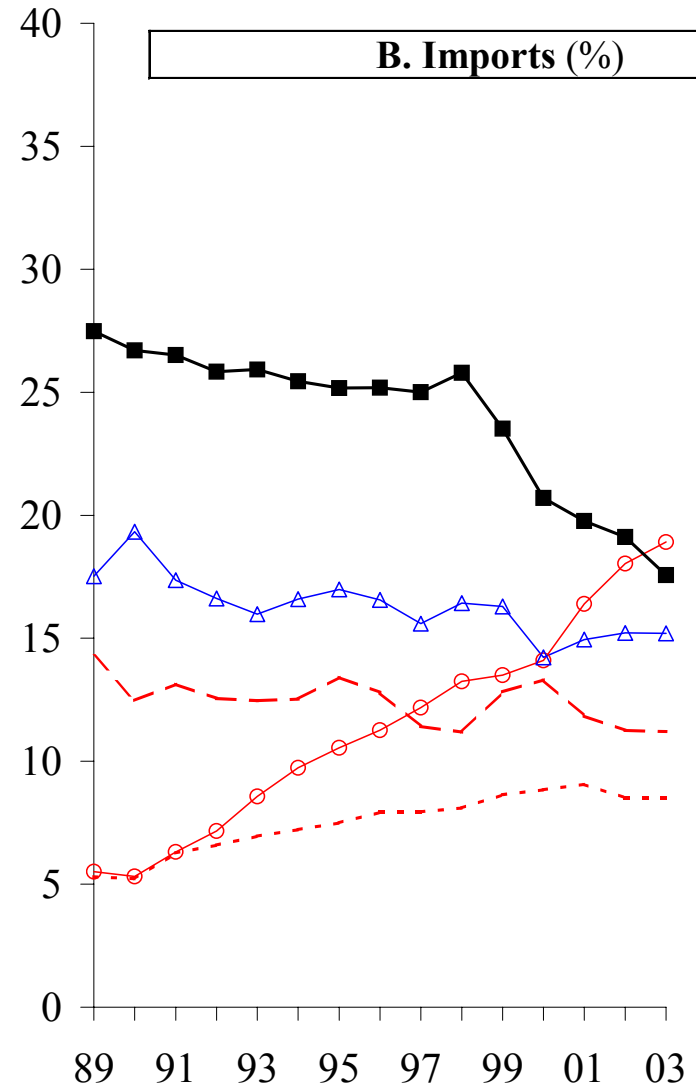
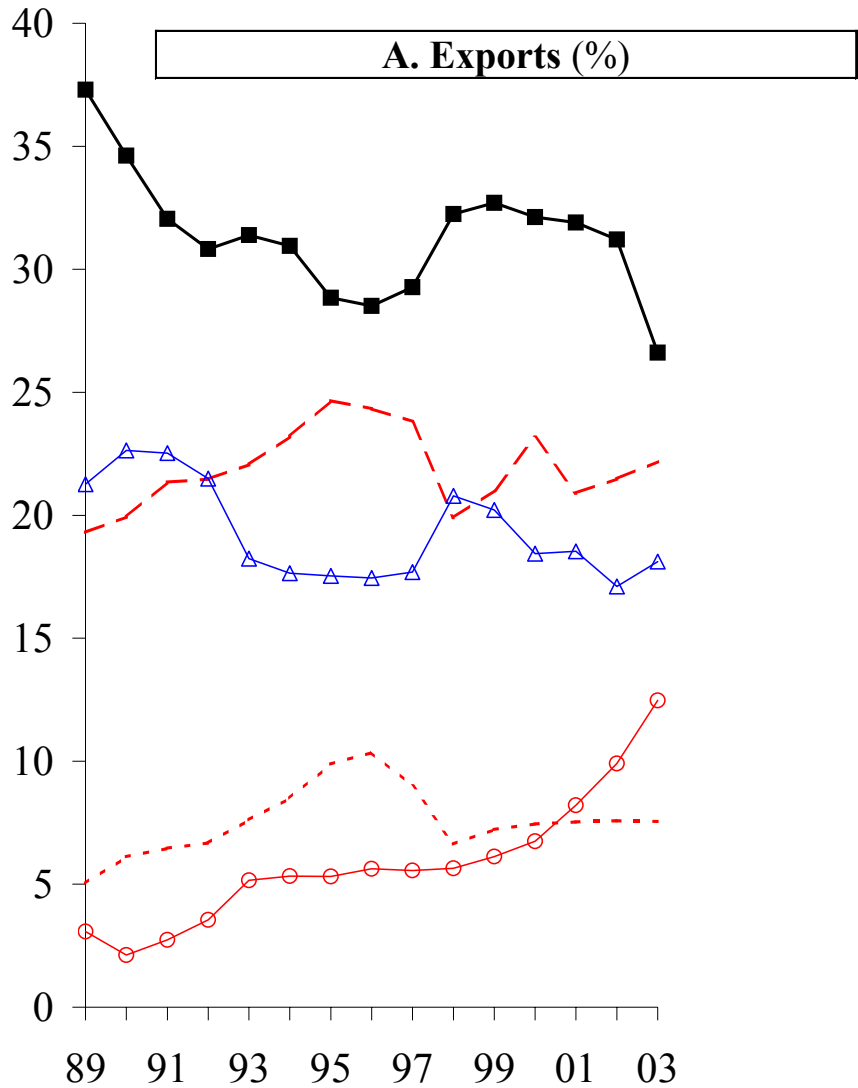
Re-orientation of Intra-Asian Trade: More Centred on China

Intra-Asian Trade Flows, Manufactured Products (in %)

2003								
<i>Importers</i>	Japan	Dragons	Tigers	China	India	Other Asia	Oceania	Asia-Oceania
<i>Exporters</i>								
Japan		10.8	3.7	6.1	0.3	1.1	1.3	23.3
Dragons	3.6	8.6	4.3	11.5	0.8	2.0	1.1	31.9
Tigers	2.6	5.6	1.4	2.0	0.3	1.0	0.6	13.4
China	6.3	11.8	1.4		0.3	1.1	1.0	21.9
India	0.2	0.6	0.2	0.3		0.4	0.1	1.7
Other Asia	1.1	1.2	0.6	0.5	0.2	0.2	0.3	4.1
Oceania	0.7	0.8	0.4	0.4	0.2	0.2	1.0	3.7
Asia-Oceania	14.3	39.5	12.0	20.8	2.0	6.1	5.4	100.0
1989								
Japan		24.7	6.5	4.0	0.9	2.8	4.7	43.6
Dragons	10.9	6.0	4.7	1.0	0.8	2.1	2.3	27.7
Tigers	2.6	4.3	0.6	0.4	0.1	0.7	0.5	9.3
China	3.1	0.9	0.4		0.0	0.2	0.4	5.1
India	0.6	0.5	0.2	0.0		0.2	0.1	1.6
Other Asia	2.0	1.5	0.4	0.2	0.1	0.2	0.2	4.4
Oceania	3.1	2.0	0.7	0.2	0.1	0.4	1.8	8.3
Asia-Oceania	22.2	39.8	13.6	5.7	2.0	6.6	9.9	100.0

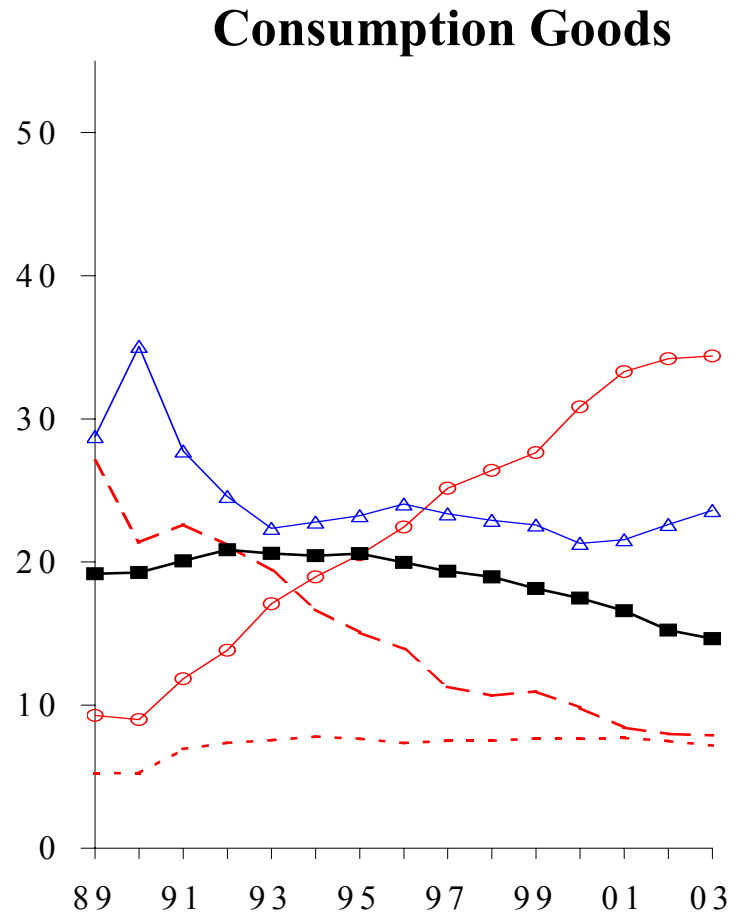
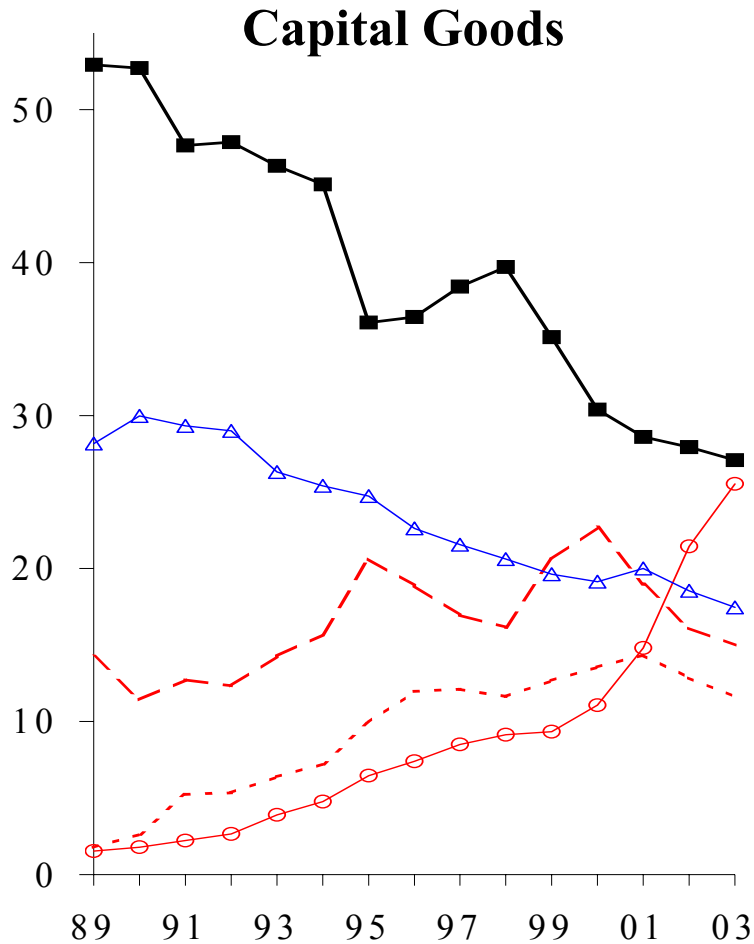
The Rise of China in Japan's Trade (%)

-- Dragons -.-.- Tigers -○- China -△- European Eco. Area -■- NAFTA



Japan's Imports of Final Goods shifted from NAFTA to China: Geographic distribution of Imports by selected partners and production stage (%)

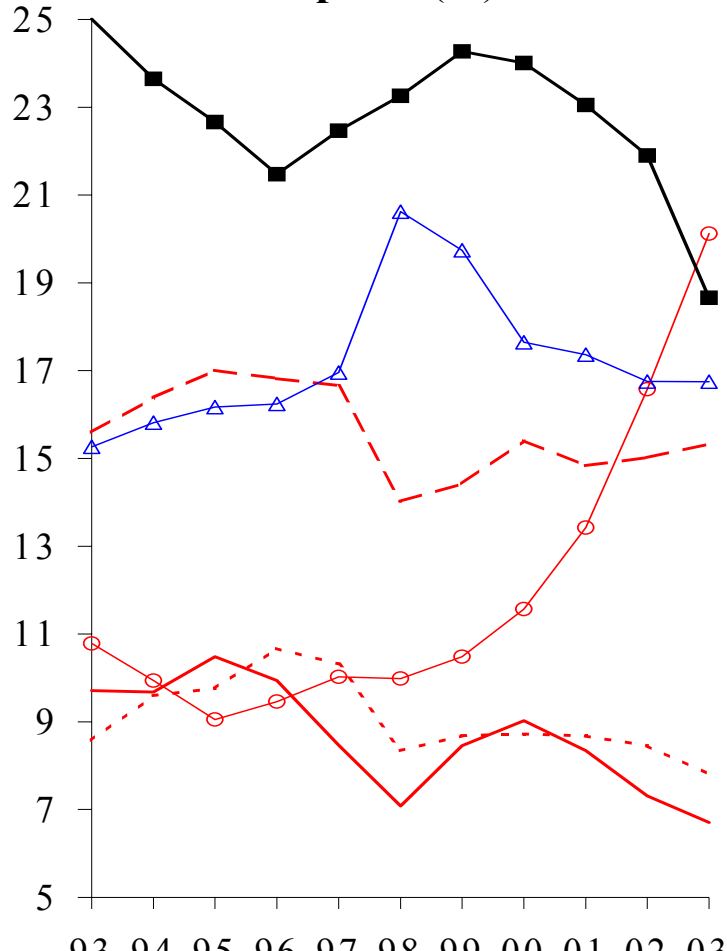
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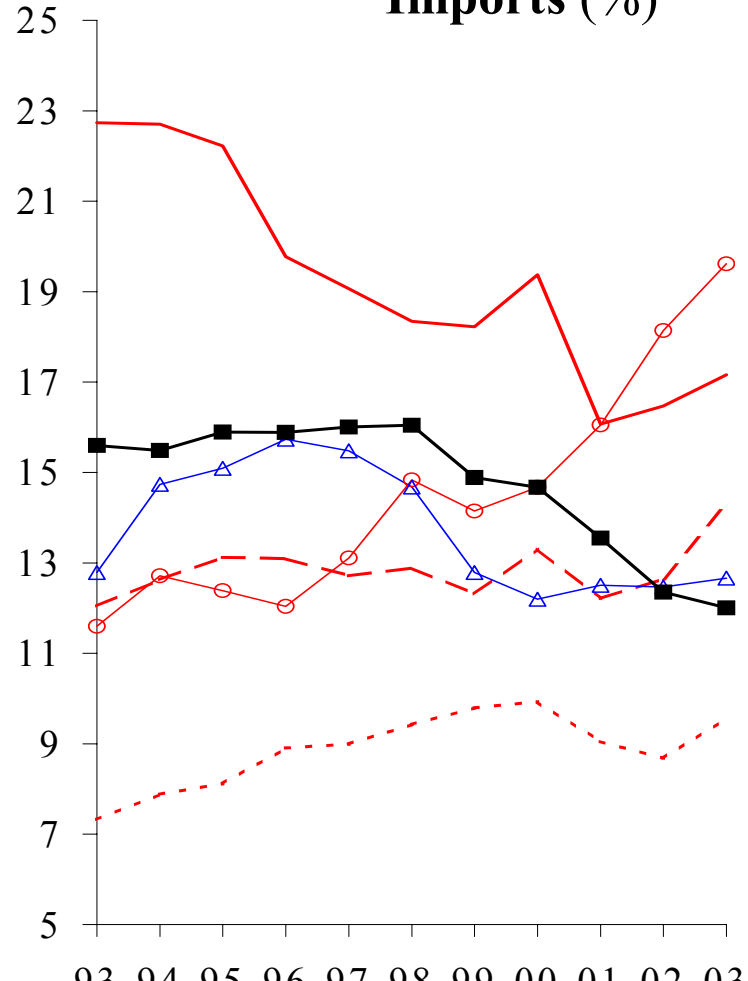
Dragons: Trade Shifted Away from Japan and NAFTA to China (%)

— Japan - - - Dragons ···· Tigers ○ China △ European Eco. Area ■ NAFTA

Exports (%)



Imports (%)

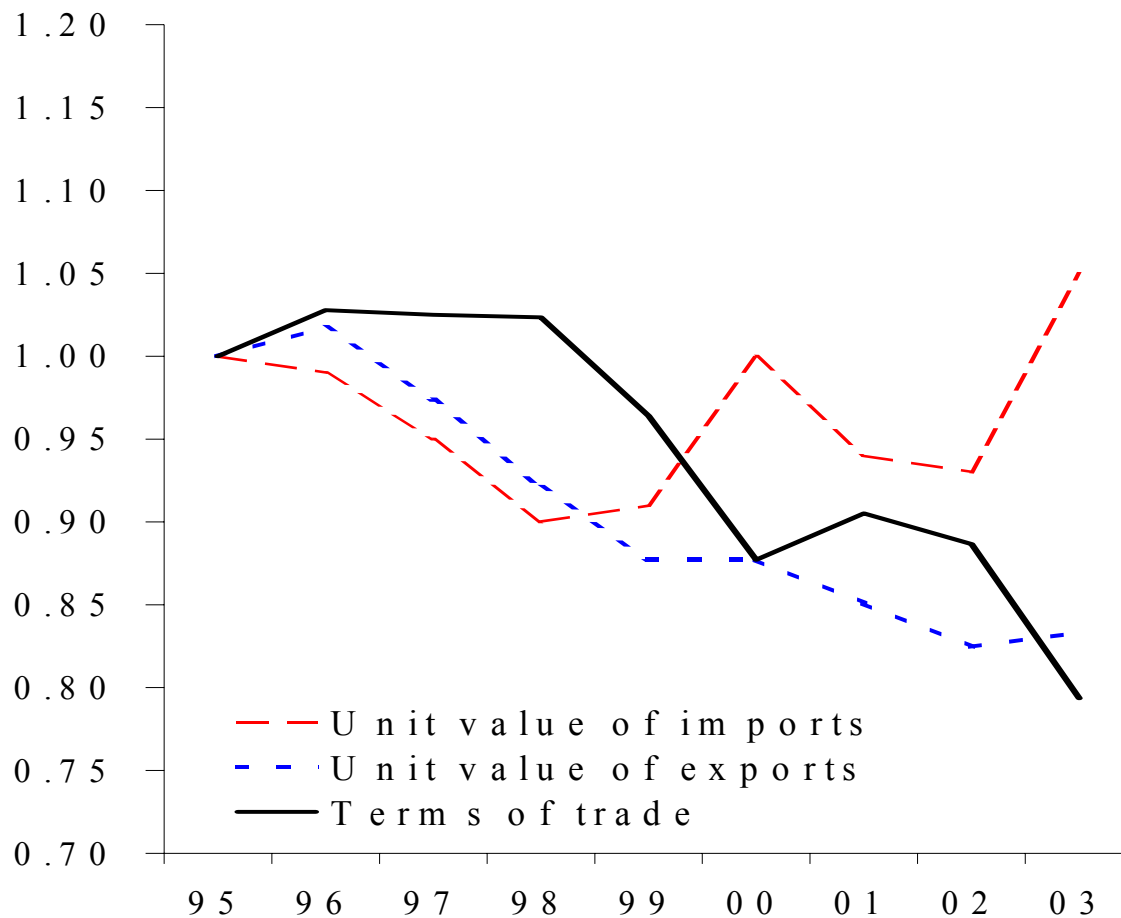


China-US Trade Imbalance

- China runs a huge and climbing trade surplus with the US (about \$162 billion as of 2004). In fact the US trade with the rest of the world is unbalanced by a deficit of \$700 billion in total.

- It is important to remember, however, that China registered a combined trade deficit of \$126 billion with Japan, Korea, Taiwan and ASEAN in 2004, and much of this deficit, especially those with Japan, Korea, Taiwan, is actually a product of a shift to China of East Asia trade surplus with the US, because the US overall trade deficit with East Asia has increased much slowly compared with China during the past decade.

China: Deterioration of Terms of Trade 1995-2003 (Index 1995=1)



Open-Ended Question

- Can China quickly converge towards the market system of best practice?
- How does China converge as China is rising its economic power?

Thank you