Key Elememts in the Study of China's Economy:

Institutions, Geography, and Globalization

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In this discussion, I will highlight the importance of three key elements in the study of China's economy.

1. Institutions

The primacy of institutions

All the endeavours of China's two-decade long economic transition are about building institutions for a modern market economy. Major problems and shortcomings of China's economy arose from the legacies of the centrally planned socialist economic system, including the three areas of problems highlighted by Professor Chow—the SOE reforms, the banking and financial sector, and the legal framework.

Frontier developments in institutional economics and new comparative economics in the recent decade have established good institutions as the root causes of performance differences in economic development (Acemoglu 2003, Shleifer 2002). The theme of World Development Report 2002 (World Bank) is "Building Institutions for Markets", reflecting the growing influence of intellectual progress in this field on the international-aid agency's policy recommendation.

China's economic takeoff in the past two decades has been initiated and driven by institutional reforms, at first mainly taking the form of bottom-up and spontaneous institutional innovations at the local level and later led by top-down transplanting of institutions from matured market economies (Lu, 2001). A crucial rationale that motivated China's decision to join the WTO is to lock the country's institutional changes onto a market-oriented course enforced by international commitments.

Pitfalls in China study with respect to institutional impact

Among economists who study China's transition economy, there are roughly two schools, namely the "experimental school" and the "convergence school", as defined by Woo (1999). As the e-school scholars base their analysis on the uniqueness (or exceptionality) of China's transitional institutions, they tend to appreciate the experimentalist innovations in economic reforms and the need to develop institutions adapted to the characteristics of Chinese society and the post-socialist socio-economic conditions. In contrast, c-school economists believe that the long-term goal of transition is simply transplanting (or converging to) the (good) institutions of the existing matured market economies. They generally support comprehensive, non-compromised, straightforward, and perhaps swift adoption of these institutions. A similar presentation of these contrasting views is given by Roland (2000), who compares "evolutionary-institutional perspective" with "Washington Consensus".

There are truths in both schools in their observations of various aspects of the transition. But fallacy may occur by taking one step beyond the truth. Over-emphasizing institutional exceptionality may mistake imperfect substitutes for normal market institutions as innovative and optimal arrangements. Over-stressing the need of transplanting standard or "normal" market institutions may downplay the complications in the local "soils" for transplantation.

A related pitfall in the study of China's economy is the overlook of the transitional natures of the economic system. Beauty of economic analysis lies in simple models that reveal the fundamental links under the facade of real-world complexity. However, when we apply the economic models developed under the assumptions of a stylized market economy to the analysis of China's economy, we must remind ourselves of the institutional differences. For instance, using the statistical data trespassing the centrally planned period (1950s–1970s) and the reform period (1980s–early 1990s) to estimate the "long-run equilibrium" relation between inflation and money supply would be useless if not misleading.

In the recent debate on the need for the revaluation of China's currency, there is also a danger of ignoring the particular features of China's exchange rate regime and saving-deposit mechanism. It is true that market demand and supply are the determinants of RMB exchange rate. But the demand and supply for foreign currencies in China's currency control regime are constrained by institutional arrangements. If, say, the government relaxed the restrictions on households' and firms' holding of foreign currencies, a significant amount of demand for RMB (or supply of foreign currencies) would disappear. Given the unknown amount of embezzled money in the economy, if capital account transactions were less restrictive, demand for foreign currencies for capital flight needs could easily shoot up, reversing the upward pressure on RMB.

As for impact of China's WTO membership, many discussants derive their observations of market access conditions from official commitments made by the Chinese government. The case of telecommunications industry shows that domestic regulations and industrial restructures directed by central planners have been more important than the government's WTO commitments in determining the market access conditions (I will discuss in more details in the panel).

2. Geography

Geography matters

China's two-decade economic boom has largely a coastal phenomenon. As a vast continental country with huge geographic diversities, geography matters a lot to the local opportunities of development. The huge geographic diversities are complicated by diversities in local cultures, customs and traditions, connections to overseas diasporas, and ethnic / dialect group features. On top of these are the legacies and impact of pre-reform and post-reform unequal treatment of various regions by the central government through its "preferential policies". All these diversities have profound influence on regional income and wealth distributions as well as the level of development of physical production capacity and market-based institutions.

Recent studies (Young, 2000; Poncet, 2003) show that there exists significant domestic market segmentations across various regions in China. Contrary to greater openness of the national economy to the rest of the world, the domestic market segmentation remains and even is intensified. There are also indications of significant regional differences in institutional developments (Taiwan EE Trade Association, 2001). Any foreign investor who ventures into China would immediately notice these differences and must take these differences into account when making major business decisions. Any China-study researcher must also keep in mind the role and influence of geographic diversities in country's development.

Implications on China study

Sachs (2003) observes that there are three types of countries/regions around the world. First are the countries/regions with reasonably favourable policies, institutions and geographic conditions. Second are the regions relatively well endowed geographically but for historical reasons have poor governance and institutions. The last are those impoverished regions with an unfavourable geography. Based on these observations, he concludes that international aid and policy recommendation packages for the second and third types of countries/regions should be entirely different.

Similar observations may apply to the geographically diversified China. At the turn of the century, the Chinese government launched the West Region Development Program, in a bid to reduce regional income disparity and consolidate national unity. The diversified local conditions, however, suggest that many elements of such a program must have adapted to local needs. Overlooking these diversities may result in misleading observations as well as wrong policy advice. Sachs (2003) warns that globalization may not succeed in raising living standards in impoverished regions but accelerate brain drain and capital flight. Myrdal (1957), the economics Nobel Laureate, cautions about the "backwash effect" of building a new transport link between a centre and a periphery may cause peripheral areas to become less economically attractive under certain conditions.

3. Globalization

China is not small and open

Many economic models are built on the assumptions of a "small and open economy". China is definitely not small and is far from being sufficiently open. This simple and obvious fact has many implications on China studies.

In an era when globalization prevails, any major change in the trade-currency regime of a country of 1.3 billion people will have great consequences on China's neighbours, trading partners, and the whole world economy as well as its own welfare.

Again, this relates to issue of RMB exchange rate. Revaluation is inevitable, as agreed by many. For China, it has to consider all the costs and benefits as well as timing and manner of revaluation. For China's trade partners, such as US and Japan, will revaluation solve the trade-imbalance problem? Given the sizes of the economies on both sides, the exchange rate adjustment is only instrumental and may not be effective as it would be in a small and open economy. The trade imbalance among US-China and Japan-US are more of an issue of different national saving rates and domestic demand structure (as I will discuss in more details in the panel). The bottom-line issue is how these economies' domestic demand structure will evolve over time.

Implications of globalization

To assess China's role in the world economy and the consequence of China's opening, an in-depths understanding of globalization is essential. The term "globalization" describes the increased mobility of goods, services, labour, technology and capital throughout the world. Although globalization is not a new development, its pace has increased with the advent of new technologies, that have substantially reduced transportation costs and communications costs in the last two decades. A major aspect of globalization is the global reconstruction of manufacturing-distribution value chains in many industries. The rise of China as a global manufacturing base (or "world factory") is integral to this trend.

One concern among China observers is the fear that China's abundant and cheap labour resources would make this emerging world factory an industrial monster, hollowing out neighbouring economies' industries, sucking in international capital like a vacuum machine, wiping out the job opportunities of its trading partners (Ohmae, 2001). Such fears counter the cardinal principle of comparative advantages. With global value chain restructure, the overall benefits of international division of labour have become more significant than ever as firms are increasingly specialized in tasks rather than in products. The development is phasing out the nationality of industries and products, demanding change of mindset in public policies regarding national industrial development. Nevertheless, the distribution issues of the trade-generated benefits are more acute nowadays, thanks to economics of factor equalization and the "Stolper-Samuelson" effect. These issues call for more research efforts in China's economic relations with other countries in the context of globalized production system.

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