CHINA in the World Economy

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Preface

China has clearly become a major participant in the world economy. It is virtually certain to become even more important in the future because of its size, dynamic economic growth, and continuing policy reforms. Yet there is relatively little understanding of many of the fundamental elements of China's emergence, ranging from the actual magnitude of its economy to the extent of its openness to external influences.

Hence the Institute decided to conduct a comprehensive analysis of China's present and potential role in the world economy. Author Nicholas R. Lardy emphasizes the growing integration of China into the world trading system and global capital markets. He also addresses the entire array of economic policy issues now being discussed between China and the United States, including the continuation of most-favored nation status.

This is the fourth such volume that we have produced at the Institute. I personally wrote *America in the World Economy: A Strategy for the 1990s* in 1988. Bela Balassa and Marcus Noland authored *Japan in the World Economy* at about the same time. We released *Korea in the World Economy*, written by former Korean Finance Minister Il SaKong, in 1993. We plan to prepare similar analyses of other key countries and regions as part of our future research program.

The Institute for International Economics is a private nonprofit institution for the study and discussion of international economic policy. Its purpose is to analyze important issues in that area and to develop and communicate practical new approaches for dealing with them. The Institute is completely nonpartisan.

The Institute is funded largely by philanthropic foundations. Major institutional grants are now being received from the German Marshall Fund of the United States, which created the Institute with a generous commitment of funds in 1981, and from the Ford Foundation, the William and Flora Hewlett Foundation, the William M. Keck, Jr. Foundation, the Andrew Mellon Foundation, the C. V. Starr Foundation, and the United States–Japan Foundation. A number of other foundations and private corporations also contribute to the highly diversified financial resources of the Institute. About 16 percent of the Institute's resources in our latest fiscal year were provided by contributors outside the United States, including about 7 percent from Japan. The Rockefeller Brothers Fund provided generous support for this project.

The Board of Directors bears overall responsibility for the Institute and gives general guidance and approval to its research program—including identification of topics that are likely to become important to international economic policymakers over the medium run (generally, one to three years), and which thus should be addressed by the Institute. The Director, working closely with the staff and outside Advisory Committee, is responsible for the development of particular projects and makes the final decision to publish an individual study.

The Institute hopes that its studies and other activities will contribute to building a stronger foundation for international economic policy around the world. We invite readers of these publications to let us know how they think we can best accomplish this objective.

C. FRED BERGSTEN
Director
March 1994

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Introduction

At the outset of its economic reforms in the late 1970s, China was an insignificant participant in international markets for goods and capital. In 1977, the sum of its imports and exports, or its total trade turnover, was less than $15 billion, and it was only the 30th largest exporting country in the world. As shown in table 1.1, its share of world trade in that year was only 0.6 percent, significantly less than in 1927–29, when China's trade attained its peak precommunist levels, accounting for a little more than 2 percent of world trade. China's role as a trading nation on the eve of reform also was significantly less than it had been in the 1950s, when the Communist Party launched its ambitious first five-year plan, which was heavily dependent on machinery and equipment imported from the Soviet Union.

Prior to the late 1970s, China also was barely a participant in world capital markets. Except for short-term trade credits, China was not a borrower either in international commercial markets or from international financial organizations such as the World Bank, did not receive foreign aid from bilateral development agencies such as the Japanese Overseas Economic Cooperation Fund, was not a recipient of private foreign direct investment, and did not invest abroad. Finally, the central government fixed the exchange rate at a level that highly overvalued the domestic currency.[1]

The resulting excess demand for foreign exchange was managed through a rigid, highly centralized system of exchange control that

1. The Chinese currency is called the *renminbi* and is denominated in yuan, symbolized by Y.

Table 1.1 Merchandise trade, selected years, 1927–93

Year	Billions of dollars	Percent of world trade
1927	1.33	2.1
1928	1.53	2.3
1929	1.44	2.1
1953	2.37	1.5
1957	3.11	1.4
1959	4.38	1.9
1962	2.66	.9
1970	4.59	.7
1975	4.75	.8
1977	14.80	.6
1978	20.64	.9
1980	38.14	.9
1985	69.60	.9
1990	115.41	1.6
1992	165.61	2.2
1993	195.72	2.5[a]

a. Estimated.

Sources: League of Nations, *Statistical Yearbook of the League of Nations, 1930/31*; General Agreement on Tariffs and Trade, *International Trade*; table 2.1.

inhibited China's interaction with the outside world. The Maoist ideology of self-sufficiency, pursued most vigorously in the Cultural Revolution years of the mid- and late-1960s, had left China largely isolated from the world economy.

By the early 1990s China's role in the international economy had been totally transformed. In 1992 China's total trade exceeded $165 billion, accounting for 2.2 percent of world trade. In 1993 turnover was $196 billion, accounting for about 2.5 percent of world trade. As a consequence, China's share of world exports had finally exceeded the previous peak level of the late 1920s. In 1992 it was the world's 10th largest exporter, lagging behind only the largest and most advanced industrial states.[2] It also was a significant recipient of foreign aid and a major

2. According to GATT data, China was the 11th largest exporter in the world in 1992. Hong Kong ranked 10th, just ahead of China. But an unusually large percentage of Hong Kong's exports were reexports of goods produced in China. After adjusting to take this factor into account, China was actually the 10th largest producer of export goods.

borrower on international capital markets. For example, in both 1992 and 1993 it was the single largest borrower from the World Bank and sold large quantities of bonds on international credit markets.

Even more significantly, by the early 1990s China was attracting substantial inflows of foreign direct investment. In 1992 these flows, on a gross basis, reached more than $11 billion, far larger than any other developing country or former communist state. In 1993 actual inflows more than doubled to reach $25.75 billion. Approved foreign investment in 1993 reached the astounding level of $110.85 billion, almost double the level of 1992. Although there is some attrition between approved and actual investment, these data suggest actual foreign direct investment in China will continue to rise over the next few years.

Since reform began, China has made substantial progress toward making its currency convertible. Successive devaluations in the 1980s reduced the degree of overvaluation that was so characteristic of the late 1970s and early 1980s. A rapidly growing, formally sanctioned secondary market for foreign exchange provided additional flexibility for more decentralized trading in goods and services. Since the beginning of 1994, the official rate has been determined in this secondary market, effectively unifying what had been a dual exchange rate system and constituting an important step toward achieving convertibility of the *renminbi* for trade transactions. China also loosened controls on capital flows so that by 1992 it became the source of significant capital outflows.

Over the same period that trade and capital flows registered startling advances, China's domestic economy boomed. From the beginning of reform in 1978 through the end of 1993, real GNP expanded at an average rate of over 9 percent per year so that real output almost quadrupled. By most calculations, this was the fastest growth of any country in the world. China's rate of growth was more than twice as great as the average of all developing economies and even exceeded that of all of the other newly industrializing economies in East Asia, often described as the most dynamic center of economic growth in the world.

By the early 1990s China's rapidly rising economic star had begun to attract significant worldwide attention. Several organizations published new studies of the Chinese economy that evaluated China's real GNP at international prices. These estimates, based on the purchasing power of the Chinese currency, suggested that the Chinese economy had already become, or shortly would become, the third or even the second largest economy in the world. For example, a study of the International Monetary Fund found that on a purchasing power basis the Chinese economy in 1990 accounted for just over 6 percent of world output, ranking third behind only the United States and Japan (*World Economic Outlook*, International Monetary Fund 1993, 117).

The purpose of this study is to examine the implications of China's rise as a major player on the international trade and financial scene. In the postwar period, other countries, notably Japan, achieved a similar meteoric rise. From 1953 through 1973, Japan's imports and exports grew by almost 13 percent annually in real terms (Patrick and Rosovsky 1976, 57). Japan was admitted to the International Monetary Fund and the World Bank in 1952 and became a contracting party of the General Agreement on Tariffs and Trade (GATT) in 1955, when it was the world's ninth largest exporting country. Reflecting its vastly expanded economy and the achievement of the convertibility of the yen, in 1964 Japan became a member of the Organization for Economic Cooperation and Development (OECD), the so-called rich nations' international organization. In 1975 Japan's critical role in the international monetary system was evident in its participation in the first summit of the G-5 nations.

While the world economy has adjusted, more or less, to transformations such as Japan's, China poses three additional challenges. First, its role in the world economy in the 1990s far exceeds that ever played by a communist country. The significance of this will be discussed immediately below. Second, China combines, to an unprecedented degree, large absolute economic size with relatively low per capita income. In the postwar period, no other country with a per capita income as low as China's has played such an important absolute role in the world's trading and financial system. The implications of this will be explored at the end of this chapter. Finally, from the US perspective China is unique—a country combining a global trade deficit with a large bilateral surplus in its trade with the United States. The challenge this poses for US policy will be explored in the concluding chapter.

The Communist Legacy

While the Chinese government, at least in its interaction with the West, attempts to play down the role of Communist Party ideology, China is perceived by many as a historical anomaly—one of the last surviving communist regimes in an era when democracy is commonly perceived to be an ascendent international political force. The accommodation of China's increasing international economic role is all the more difficult because the image of the slaughter of students in Tiananmen Square in Beijing in June 1989 seems indelibly ingrained in the West's collective memory.

Even at their zenith, the Soviet Union and the communist countries of Eastern and Central Europe were minor participants in world trade and finance. Although the Soviet economy was large in absolute terms, its international trade was limited, and of this more than half was with other members of the Council of Mutual Economic Assistance (CMEA). The exports of the Soviet Union to market economies reached a peak of $56 billion in 1988, about 2 percent of world exports. This aggregate figure in some sense overstates the role of the Soviet Union in international product markets since Soviet exports consisted predominantly of crude oil and other raw materials, not manufactured goods that competed with domestically produced goods in the countries importing Soviet goods. At least by 1991, and perhaps as early as 1986, China's exports to market economies exceeded those of the Soviet Union.[3] Moreover, compared with the Soviet Union, manufactured goods comprised a much higher and growing share of China's exports.

Hungary, Poland, and Romania had more diversified trade partners and were more open than China by the conventional criterion of the ratio of exports plus imports to GNP. But, because of the small size of these economies, their annual exports to the West in the 1980s, prior to the collapse of communist political domination, never exceeded a few billion dollars.

Not only was their trade with the West small, before the collapse of communism none of these states had attracted significant amounts of foreign direct investment. In the Soviet Union, for example, the Council of Ministers did not issue the first decree to establish a framework for foreign investment until 1987. Steps to allow majority foreign ownership were taken in 1988, and special tax provisions to attract foreign investment were not enacted until 1990.

The most significant form of economic interaction of the CMEA states with the international economy was borrowing. By the end of 1989, the external debts of these states (excluding Yugoslavia) totaled about $140 billion (Collins and Rodrik 1991, 10). Most of this had been borrowed on commercial terms. However, several Eastern European countries encountered severe balance of payments difficulties beginning in the late 1970s. In 1981 first Poland and then Romania were forced to ask for a rescheduling of their external convertible currency debt. After the imposition of martial law in Poland in mid-December 1981 and the imposition of economic sanctions by the Reagan administration, Western banks

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3. $56 billion is the product of estimated total Soviet exports of $110.5 billion and the share of exports going to countries that were not members of the CMEA (Collins and Roderick 1991, 9 and 30). The estimate of the total value of Soviet exports is highly sensitive to the prices used to estimate trade within CMEA. Collins and Roderick rely on the estimates of PlanEcon, a private consulting group based in Washington, D.C. The Central Intelligence Agency's estimate of Soviet exports to market economies is much lower, supporting an even more modest assessment of the role of the Soviet Union in the world trading system. The CIA *Handbook of Economic Statistics* (1991, 77) estimates the hard currency exports of the Soviet Union at only $31 billion in 1988, just a little over half the estimate of Collins and Roderick. Based on the CIA's estimate and taking into account the fact that all but a few percentage points of Chinese exports were hard currency exports, China's hard currency exports first exceeded those of the Soviet Union in 1986. There seems little doubt that the margin by which China's hard currency exports exceed those of the former Soviet Union (FSU) widened in the early 1990s. The hard currency exports of the FSU in 1992 are estimated by the World Bank (1993e, vol. 2, 139) at $40.0 billion, less than half the Bank's estimate of the level of 1990 and only around half of China's hard currency exports.

effectively withdrew from further lending to Eastern Europe. Eastern European countries regained access to private international capital markets only gradually, beginning in the early 1990s.

Finally, the Soviet Union and the countries of Eastern and Central Europe were not significant participants in international trade and economic organizations such as the International Monetary Fund, the World Bank, and the General Agreement on Tariffs and Trade. The Soviet Union, far and away the largest of these economies, in fact had no relations with the Fund, the Bank, or GATT, even though it had been an active participant in the discussions in the 1940s leading to their establishment. Poland and Czechoslovakia were founding members of the Fund and the Bank in 1946, before they became centrally planned economies. But the former withdrew in 1950, and the latter was expelled in 1955 (van Brabant 1991, 124–25). In 1972 Romania was the first country in Eastern Europe ruled by a Communist Party at the time of its entry to become a member of the Fund and the Bank. This did not start an immediate trend, since the next Eastern European countries did not join until May 1982 and May 1986, when Hungary and Poland, respectively, became members. However, the World Bank never approved any loans for Poland prior to the collapse of its communist government. Romania discontinued all borrowing from the Bank after 1983.

Only Hungary became a significant borrower from the IMF and the Bank, using two stand-by loans of almost a billion dollars from the former and a loan of almost a half billion dollars from the latter by 1984. The latter loans were combined with approximately $700 million in cofinancing from commercial banks. As a result, Hungary, unlike Poland and Romania, was able to stave off a formal rescheduling of its outstanding hard-currency commercial debt. In the second half of the 1980s, Hungary scaled back its borrowing from the Bank, averaging only a few hundred million dollars annually. Although the Bank's lending was critical for Hungary, it represented only 2 percent of the Bank's annual lending in the second half of the decade. At the end of the Bank's 1989 fiscal year in June, the combined cumulative borrowing of Hungary and Romania was only $4.1 billion, a little more than 2 percent of the Bank's outstanding loans.

The situation with regard to the Eastern European centrally planned economies and the Soviet Union's participation in the GATT was slightly more complex. Czechoslovakia was a founding member. It remained in the GATT continuously after 1948 but participated unobtrusively. Czechoslovakia, for example, did not participate in reciprocal reductions of trade barriers and did not seek to receive most-favored nation (MFN) status in its trade with other contracting parties. Poland, Romania, and Hungary became contracting parties in 1967, 1971, and 1973, respectively. Poland's accession was unusual since it was based not on reciprocal tariff reductions, but rather a pledge to increase imports from other contracting parties—i.e., Western market economies—by 7 percent per year. Poland's economic reform had not yet begun, so its entry was the first of a traditional centrally planned economy. Romania's entry was conditional on its use of planning to ensure that imports from market economies grew at least as fast as total imports during its then-current five-year plan. Hungary's accession came after it had launched its reform, the so-called new economic mechanism. Its entry was accepted as that of a market economy, in retrospect a dubious assumption (van Brabant 1991, 198–206).

Although these three countries were contracting parties of the GATT, their participation was severely constrained. The nature of their trade regimes made it impossible to implement the basic principles of the GATT: reciprocity and nondiscrimination.

China's role in the world economy has already far surpassed that played by the Soviet Union and the communist states of Eastern Europe. Moreover, it is likely to continue to expand. Adjusting to China's increasing international economic role appears to be a particular problem for the United States, especially now that the Clinton administration has embraced the idea that the principal objective of US foreign policy in the post–Cold War era is the enlargement of the world's free community of market democracies (Anthony Lake, speech at Johns Hopkins University School of Advanced International Studies, 21 September 1993). Implicit in this strategy of enlargement is the view that democratization and marketization not only strengthen each other, but that they move forward together.

The formulation of the enlargement strategy advanced by Anthony Lake, President Clinton's national security adviser, seems largely to ignore recent historical experience in East Asia. In South Korea and Taiwan, for example, nondemocratic, authoritarian regimes prevailed until very recently. The development of more democratic regimes in both these states followed several decades of rapid economic growth. That growth was stimulated through economic reforms that expanded the role of the market while reducing the direct role of the state in resource allocation. Democratization followed marketization with a significant lag. Indeed, one could argue that the pressures for political reform stemmed largely from rapid economic growth. Without economic reform it seems doubtful that democratic forces would have become so important in these and some other states in Asia.

The failure to recognize that marketization can ultimately erode the power of authoritarian regimes and create the possibility of an evolution toward more pluralistic political systems has led to a rather strange prescription for US policy toward China. China is grouped in Lake's formulation as one of a small number of "backlash" states, including Iran and Iraq, that pose an explicit threat to what is described as the circle of democracy and markets. This formulation misses the point that