# The China Dream Revisited

*by Joe Studwell*

IS CHINA SUFFICIENTLY complex that one's predictions about it might be 180 degrees wrong throughout one's entire career? It sometimes seems that way. In 2002, I published *The China Dream*, a best-selling book about the travails of foreign investors in China in the 1990s (and, indeed, over the centuries leading up to the 1990s). The Chinese economy promptly exploded onto a faster growth trajectory, leading to what may be the first really good returns foreign investors have had from China since the Middle Ages. Now, many China pundits think that the show is over, as the economies of the United States, Europe and Japan slow, and China's domestic economy faces up to the consequences of its own, gargantuan leveraged investment cycle.

However, I have been telling anyone foolish enough to listen that dire short-term predictions for the Chinese economy are overblown. Inevitably, I will be wrong again, but perhaps also worth explaining is how the past four years I spent studying Southeast Asia, and latterly Japan and South Korea, have changed some of my views on China and modified others. I haven't joined the "China-takes-over-the-world" camp, but I have come to see the rationality of some of the strange things that go on there.

This summer I reread *The China Dream*. This was not an act of narcissism but of necessity. I have almost no memory for things I write, even after relatively short periods of time. When the book was first published I fell into a state of near apoplexy because Michael Heseltine, the former British deputy prime minister, did not respond to an invitation to my London book launch. After putting up with various diatribes about the condition of British political life, my wife asked if I recalled what I had written about Mr. Heseltine in the book. I didn't. In fact I had recounted with great glee the amount of time and money Mr. Heseltine had wasted in China without seeing a return. No wonder he didn't show up.

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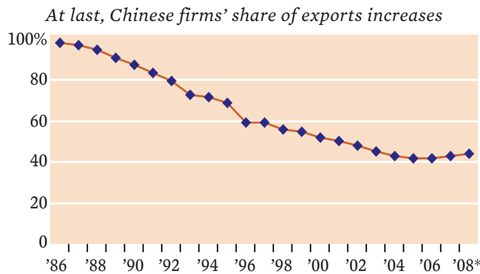
**GO CHINA!**

*At last, Chinese firms' share of exports increases*




*NOTE: 2008= JAN.-JULY ONLY
SOURCE: MINISTRY OF COMMERCE

While reading through my book again, I divided the major arguments into three separate lists. I labeled the first column "Young and foolish." It contains arguments that were completely and utterly wrong and for which, in a better world, people would get their money back. The second column, headed "Could do better," is for arguments that were neither fully right nor wrong, but incompletely informed. The third column has anything that was actually correct. If we run through a few items on these lists, it will become apparent why I don't think China is headed for a meltdown, but also why I am not quaking in my boots as I wait for the dragon to immolate me.

## The Young and the Foolish

HEADING THE COLUMN "Young and Foolish" is my attack on China's capital controls. *The China Dream* contains a chapter, entitled "Other People's Money," which rails against the Chinese government's policy of trapping, by means of exchange controls, domestic savings within the country. To be fair, my revulsion at this strategy was based on the observation that it guarantees that any crisis in China will automatically be paid for by the destruction (via inflation and depreciation) of the savings of ordinary Chinese people, sequestered as they are by capital controls in a state-controlled banking system. My reaction to this today—how age devours idealism—is that of ruthless Texan huckster J.R. Ewing explaining the nature of life to his wife in the soap opera *Dallas*: "Sue Ellen, whoever told you life was supposed to be fair?"

There is no doubt that the financial structure of China's development strategy is a high-risk one. But development itself is highly risky, which is why so few countries manage to succeed. The last few years have convinced me that—despite all the theoretical claims to the contrary—the only really sure result of an open capital account for a developing country is to improve stock market returns for international investors, as has been the case throughout Latin America over the past 30 years. On the other hand, developing countries almost inevitably give rise to situations that suck in the least helpful kind of flighty international capital: high nominal interest rates arising from structurally higher inflation rates (as, repeatedly, in Latin America and in Southeast Asia before the 1997 Asian financial crisis); bubbles in nascent, relatively small and illiquid stock and bond markets (particularly serious in Latin America and Russia); and spikes in trade surpluses and trade frictions leading to speculation on currency realignments (as in Japan, South Korea and Taiwan in the 1980s, and now China).

I do not believe that the absence of capital controls was the root cause of the financial crisis in Southeast Asia (bad government is a far stronger candidate), but equally, open capital accounts produced no obvious net benefits. In China by contrast—as was the case in Korea and Taiwan until the 1990s—government has used capital controls to create, for as long as those controls hold, an artificially large window of opportunity for sustained growth.

It is, of course, impossible for capital controls to function perfectly, or even near-perfectly. If one makes the easiest, crudest calculation of likely illicit capital flows in China's case—foreign-exchange reserve

growth minus the current-account balance minus net foreign direct investment—it is apparent that the equivalent of up to 8% of GDP fled the country in a year in the late 1990s, and up to 8% of GDP has been entering the country in recent years. But without the controls, how much greater would the gyrations have been?

The point is that exchange controls give China a chance to increase international competitiveness and to move toward the global technological frontier, before the risks involved in capital controls lead to a financial blow-out. The biggest risk is excessive misallocation of credit when savings have no offshore alternatives and are mediated by a government-owned banking system. Compared with Korea or Japan, which directed savings through higher-quality, mainly privately-held banks, China's postcommunist financial system looks particularly crude and monolithic. Yet I think it is preferable to the kind of shotgun privatized systems tried out in countries such as Indonesia, Russia and in Latin America, where banks become the playthings of godfathers and oligarchs.

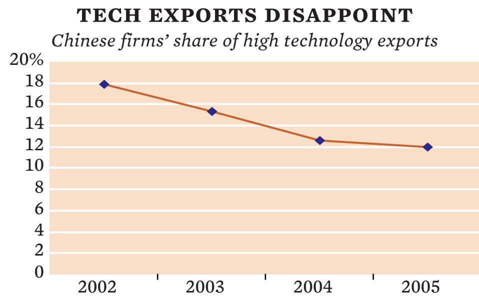
China will eventually be hit by a financial crisis. On this my opinion is unchanged. But every country that has ever developed has been hit by financial crises—from the U.K. to the U.S. to Japan and Korea. What matters is what you can achieve before the crisis arrives. China is doing only a so-so job of locking in permanent gains as its financial risk rises—at least, I believe, when compared with the likes of Japan and Korea.

## Nearly There, But Not Quite

MY "COULD DO BETTER" column is headed by the subject of state industrial policy. *The China Dream*, in Friedmanite fashion, took the state as the enemy. Its heroes are farmers, private entrepreneurs in places such as Zhejiang Province and "the most productive and effective human capital in the country … young women working on the production lines of export processing factories in southern China." It is clear that without the nonstate sector, there would be no Chinese transformation; we would be back in the pre-1978 era. Nonetheless, working in Southeast Asia in particular made me realize that some of the state sector policies of the Chinese government, while not necessarily optimal, have been better than those pursued by other developing countries. Southeast Asia is a region where those businesses most naturally given to outsize profits via oligopoly—such as financial services, telecoms or utilities—have been licensed out to private entrepreneurs who bankroll politics but are subject to no broader requirements to support the developmental objectives of a state. This, to my mind, is a big part of why Southeast Asia has almost no technologically sophisticated, branded businesses that can compete in global export markets. The state has failed to discipline the recipients of state largesse.

In Northeast Asia, by contrast, the Japanese and Korean governments supported indigenous private businesses with capital and licenses only so long as they showed a capacity to develop brands and technologies and, critically, to export. The Korean governments of the 1960s to the 1980s monitored *chaebol* export figures obsessively, on a monthly basis. Conglomerates that failed to expand their international sales sufficiently quickly, and meet other competitive targets, were cut out from government favor and soon dropped from the ranks of Korea's leading companies; one measure of this in the postwar era is that any given chaebol had a less than one in two chance of remaining in the top 10 for a decade.

The grudging recognition I have come to have for Chinese industrial policy is that the government has not been guilty of the same dereliction of duty that occurred in




Southeast Asia. China has plumped itself somewhere in the middle of the Southeast Asian and northeast Asian approaches. The economy's surest cash flows have not been handed over to some friendly political acolyte without reference to a nation's need to compete globally in order to develop. However, nor have those cash flows gone to the strongest private-sector manufacturers. In China, the state sector has clung on to the banks, which might be preferable to privatization to an Indonesian or Argentine or Russian oligarch, but is likely to be inferior to widely held private ownership with strong government oversight. Meanwhile, other financial services, telecoms and utilities firms all remain in the state's hands producing, in recent years, rapidly rising profits. Unlike in Southeast Asia, the cash is available to pay for China's march to the technological frontier. The question is whether China is getting there.

Until recently it was hard to make a serious case that China's structure of state sector-dominated big business was facilitating progress up the technological ladder. Judged in terms of the export performance favored by Japanese and Korean bureaucrats, the Chinese story was not impressive. The share of exports accounted for by indigenous firms shrank every year for two decades from the mid-1980s, while that of foreign enterprises rose: to 58% in 2005 from 2% in 1986. In 2006, however, the indigenous firms' share of Chinese exports rose—very slightly—for the first time. Provisional data published by the Ministry of Commerce on its Web site (see chart on page 26) indicate this trend has continued in 2007 and 2008. If so, it may suggest that some kind of turning point has been reached and that relatively more Chinese firms are producing output that is competitive in the global market place. There is no indication whether the same trend may be occurring in specifically high technology exports (as defined by the Chinese government), as no new data classified by firm ownership appear to have been published since 2005. At that point, the indigenous share of high tech exports had been squeezed down to just 12%, with the balance accounted for by foreign firms (see chart nearby).

The Chinese government's determination to foster what it calls an "innovation society" is not in question. Money is being fired at the target, encouraged by generous fiscal rebates and other support. According to a recent OECD report, gross expenditure on research and development in China rose to 1.43% of GDP in 2006 from 0.6% in 1995 (an average across Chinese and foreign-invested companies). Chinese firms' expenditure on royalty and licensing payments to acquire technology—as captured in accounts such as those filed by law by U.S. seller companies with the U.S. Bureau of Economic Analysis—is rising rapidly, albeit from a low base.

There can be little doubt that China is getting some technological traction, and part of the reason is effective state industrial policy. But we must ask whether it is likely that Chinese big business dominated by state ownership is going to achieve the technological gains posted by the big businesses under private ownership but with government support in Japan and Korea. My guess is that China will do better than seemed likely five years ago, but somewhat less well than its northeast Asian peer group. This is one reason why I am not backing China to rule the world.

## Possibly on the Nose

UNDER THE "ACTUALLY CORRECT" column for *The China Dream*, I would highlight the book's contempt for the notion that an economy's stock of foreign direct investment is a guide to its future competitiveness. This point is connected to the one made above about industrial policy. A decade after the Asian financial crisis, it is all but impossible to argue that the Southeast Asian model of opening economies to foreign investment and then waiting for the foreigners to somehow "make local business competitive" works. It was a "let-the-market-rip" prescription as simplistic as the "let-the-investment-bankers-do-what-they-want" one for which the taxpayers of the developed world are about to pay a significant price. Today Thailand is a wreck, vying with the Philippines for the title of Asia's capitalist basket case. Malaysia opened its doors so wide to FDI that foreign firms drove exports to a level in excess of annual GDP. Yet the country that was once the British Empire's most profitable colony, and which former Malaysian Prime Minister Mahathir Mohamad said would be a developed nation by 2020, is presently a vapid, unhappy and increasingly divided lower middle income nation.

This is not an argument against foreign investment per se. It is simply a statement that the presence of large amounts of FDI in China is not a guide to the country's future any more than was the case in Southeast Asia. Instead, what is intriguing about China is whether it can manage a developmental trajectory that takes it through the unexplored territory between the Southeast Asian model and that of Japan and Korea. The former has proven to be a disaster, whereas the latter is not possible for China. Japan and Korea were explicit U.S. allies in the post-World War II era, and not only allowed to protect their domestic markets while indigenous firms developed, but also given proactive support: American aid and loans, generous contracts during the Korean and Vietnam wars, special export orders such as for Japanese cars. None of this is on offer for indigenous Chinese companies. Of course they enjoy the more benign environment of open international trade, but at the same time the Chinese government has found itself trading market access for U.S. tolerance. This was most obviously the case with the terms of China's accession to the World Trade Organization, where Beijing gave away (at least on paper) much more than non-Chinese observers had expected. Of late, however, it seems China's leaders think they have given away enough market access already, while Sino-U.S. tensions over the yuan ratchet up.

This may be the critical context for the next five or more years of China's development. Will the Chinese government, despite recent nationalist rumblings, continue to give ground on the exchange rate and market access? If so, will this undermine the competitive potential of indigenous firms? Or could the Chinese government make political moves that reassure the U.S. about its diplomatic, military and nationalist aims, and thereby buy a little developmental space for itself and its corporations?

Inevitably, reality will be somewhere in between. But my guess is that the future will turn out somewhat closer to the first proposition than the second; my greater conviction is that along the way Sino-U.S. relations will become very fraught. So, for some more famous last words, in the next few years China will push the U.S. to the brink over its exchange rate and market access, Beijing will ultimately make some significant concessions on the trade rather than the political front, and this will have an impact (marginal, not mortal) on the long-run development of Chinese corporations. The upshot will be that China still doesn't take over the world.