Issues/Questions

Section 1.

What can the U.S. sell to China? Stated alternatively, where does our comparative advantage lie? In the short run, China appears to be specializing in manufacturing goods amenable to labor intensive production methods. Also, consumer demand will be dominated by the (still) very low average per-capita income. In the long run, the productivity of China's work force will increase as the quality of its human and physical capital improves. This in turn will lead to higher per capita income and a substantial expansion in the middle class, with an associated increase in the demand for the types of goods mass produced in the U.S. Having said this, given China's huge population, even a proportionately small middle class can mean a significant "high-end" market in absolute numbers, as evidenced by expanding automobile sales. The issue of comparative advantage is also important for trade policy. In particular, negotiations to assure access to China's internal markets by U.S. firms should be guided by a prior notion as to where opportunities exist. For example, FDI in China currently requires government approval, and certain domestic products are protected by trade barriers.

Section 2.

China's development has broad long run implications for world trade and globalization. As its technological capacities and productivity increases, and with its huge population, it has the potential to be a (the?) dominant player in world trade. It could also develop a similar role with regard to capital flows, migration of people, and cultural influence. A key related policy issue is "managing" China's integration into a globalized economic system. At the first level is integration within China. This includes Hong Kong and Macau (for example, CEPA), and Special Economic Zones such as Shenzhen. It also involves the integration of the rapidly developing coastal areas with the poorer interior, a key issue in assuring political stability. The next level is China's integration with other Southeast Asian nations, including ASEAN members, and Korea, Japan, and Taiwan. The last level is integration into the world trade and political system, as represented by entry into the WTO.

Section 3.

Financial market development, or lack thereof, is a major issue in China that has several aspects. First, a main reason to have well-developed financial markets is to generate capital. The total capitalization of the Shenzhen stock market, however, is only $200 billion U.S., about the same as the market capitalization of Walmart. While Shenzhen is the smallest Chinese exchange, its not that much smaller than the others. Thus, equity markets are not able to provide much capital for domestic enterprises. The debt market is even less developed than the equity markets. A second benefit of a mature financial market is the re-allocation of capital. For example, insurance companies in China are beginning to offer many types of insurance. Where will they invest the premiums they receive? If restricted to China's nascent debt and equity markets, they will be unable to manage risk effectively, making the system vulnerable to collapse. A third issue is the thin equity markets, i.e., most shares trade infrequently. For example, ZTE said that only 40% of its shares trade. Thin markets imply greater volatility and risk.

Section 4.

China's domestic competition policy may become an important issue under the WTO agreement. The agreement presumes open access (minimum entry barriers) to foreign firms seeking to compete inside China. However, entry can be blocked by monopoly, or oligopoly firms working together, whether in national or regional markets. For example, a monopoly firm can impose exclusive dealing arrangements
on its distributors and retailers, blocking the entry of new firms. Similarly, vertical agreements with parts and materials suppliers can be written to exclude outsiders, or such firms simply can be bought up to achieve the same end. The potential for abuse is especially present when the dominate firm is a state owned enterprise. Provincial and local authorities have the ability to affect the viability of new business via numerous regulations, licensing requirements, infrastructure supply decisions, and other matters under their control. This can be used to favor the SOEs, and block foreign competitors. An example is Kodak's purchase of a 20% share in its Chinese competitor Lucky Film, an SOE. The two firms apparently control the bulk of the domestic Chinese film market. The arrangement suggests that the two firms will henceforth work together ("collude") rather than compete, and would therefore most likely be disallowed under either U.S. antitrust law or European Union competition policy. Kodak's "partnering" with Lucky might also be construed as an attempt to gain from the government the same favored market treatment that Lucky probably enjoys.

Section 5.

Corruption by government officials is widely recognized as a problem throughout China, as is the case with most developing/transition economies. Unrestrained, it can seriously impede economic development. Nevertheless, the Pearl River Delta has shown dramatic economic growth over the last two decades. How come? The answer may lie in economic competition among local government entities (cities, townships, districts, counties, etc). In Guangdong province political power is apparently decentralized, with authority delegated to various local entities, rather than concentrated in the provincial government. From an economic perspective, government services are supplied by competing "firms", rather than a "monopoly". New economic enterprises, whether foreign or domestic, can choose to locate in different jurisdictions depending on the package of services offered and the "prices" of those services (e.g., taxes and utility rates). As Saimond Ip put it at our "wrap up" discussion, a local government attempting to earn excess "profits" via high prices for its services will simply drive customers to competing jurisdictions. The same argument applies if a local government is known to provide unreliable services, or to renge on promises. This recipe for minimizing or "optimizing" the level of corruption, per Don Stevens, could be a model for the rest of China, and perhaps other developing/transition countries as well.