

China's industrial and foreign trade policies: what are they and how successful have they been?

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May 2006

This paper briefly considers two major questions about China's industrial and foreign economic policies. First, what is the best way to describe China's economic growth model, particularly as it relates to international trade and investment? And second, how successful has this model been, not only in generating high GDP growth, but in respect of three other criteria:

- a) acquisition of technology and development of innovative capacity;
- b) development of competitive domestic firms; and
- c) acquisition of political power in the international trading system.

The conclusion is that China's economic growth model shares the goals of a classical East Asian developmental state, but at the policy level is severely constrained by the paradoxical task of dismantling the old communist economic system while maintaining the Communist Party's absolute monopoly on political power. To the extent that the exigencies of political stability make it difficult to execute economic reform, an unusually high degree of openness to foreign investment and trade is required as a catalyst for economic reform. This model, which differs markedly from those employed by other Asian countries, has been highly successful at generating economic growth and facilitating the import and diffusion of technology. However the relative dearth of domestic innovation and internationally prominent Chinese firms is a persistent source of anxiety for policy makers.

Description of the model

China's economic development model, while combining elements of other models, is a unique amalgam reflecting various peculiarities of Chinese state and society. It also depends to a significant degree on China's sheer size, which makes it virtually unique – India being the only country in the world with anywhere near the same population and hence potential market size. Comparisons with the experiences of other countries are thus of limited value. To describe the Chinese model, we will look at it from three angles: the post-communist emerging market, the East Asian developmental state; and the free-market liberal state. Although China conforms to none of these ideal types, it embraces important elements of each.

1. Post-communist emerging market. Beginning in 1978, China gradually abandoned most elements of the Soviet-style planned economy it had set up in the 1950s and 1960s. A key difference between this reform effort and those of eastern Europe and the former Soviet Union in the years after 1989 was that in China the Communist Party succeeded in maintaining its grip on political power, and this grip remains undiminished to this day. Thus China is an almost unique example of a post-

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communist economy with continuing Communist Party government (Vietnam is the other instance).

The most significant effect of this difference between China and other post-communist economies came in privatization of state-owned enterprises. Instead of the varieties of mass privatization executed in eastern Europe and many of the states of the former Soviet Union, China deliberately avoided privatization and focused on deregulating prices and creating competitive markets. There was no large scale privatization effort until after the 1997-98 Asian financial crisis; and even then this privatization focused on smaller enterprises while leaving the main, centrally-controlled state enterprises untouched. Almost a decade later, the state sector still controls around 40 percent of business-sector output² and state firms dominate many key industries, including aviation, shipping, steel, oil, chemicals, telecoms, coal, metals and power generation. China has a huge number of private companies but they are mostly tiny; there no large private business groups able to exercise political influence at the national level. Meanwhile the party-state, which has shown a surprising degree of resilience, has done an impressive job of restructuring and rationalizing the largest state enterprises, evidently with the view of keeping these business groups firmly in state hands, but at greatly increased levels of profitability and global competitiveness.³

One of the biggest unknowns of China's future development path is how the relationship among the party-state, the top-tier state enterprises, and the rapidly growing private sector will play out. Although there is significant debate on this subject, it seems clear that at present the party-state has no intention of divesting itself of the 150 or so largest state enterprise groups.⁴ Thus the central government intends to continue exercising control over substantial elements of the national economy through direct ownership of operating companies. Meanwhile, private-sector companies will increasingly be encouraged, as they are the principal engine of job-creation, as well as the main mechanism for meeting demand in consumer markets.

This raises the question of what occurs when the interests of the entrenched state sector and the up-and-coming private sector conflict. Up to now, such conflicts have been minimal. This is partly because policy has roughly divided the economy into sectors where state dominance is presumed and barriers to private-sector players are high, and other sectors where competition is virtually unrestricted. State enterprises can survive in these latter sectors but only by competing on more or less equal terms

² The most systematic analysis of the ownership structure of the Chinese economy is in OECD, *Economic Survey: China* (Paris, 2005). Available at www.oecd.org.

³ For Chinese privatization practices, see Stephen Green and Guy Liu, eds., *Exit the Dragon? Privatization and State Control in China* (London: Chatham House / Blackwell Publishing, 2005). For the performance of post-restructuring state enterprises, see Carsten Holz, *China's Industrial State-owned Enterprises: Between Profitability and Bankruptcy* (Singapore: World Scientific, 2003).

⁴ Central government ownership rights in 196 major state enterprise groups were vested in a new agency, the State-owned Assets Supervision and Administration Commission (SASAC), in 2003. The number of enterprise groups directly under SASAC has since shrunk to around 150, through mergers (not privatization). SASAC has also asserted regulatory authority over state enterprises at the provincial and lower levels, where it does not exercise direct ownership rights. Although evidence is ambiguous, it appears that as of the date of writing SASAC is cautiously attempting to accelerate the privatization process at the provincial and local levels, even as it consolidates state control of enterprises at the central level.

with their private competitors.⁵ This policy in effect creates separate spheres of operation for private firms and “strategic” state enterprises.

A second strategy is co-optation of private entrepreneurs, either through financial mechanisms or by membership in the Communist party. An example of the former is telecommunications firm Huawei, which in 2004 received a concessional Rmb10 billion (US\$1.2 billion) line of credit from the China Development Bank, a state policy-lending institution. Co-optation via Communist party membership, long an informal practice, was re-instituted on a formal basis in 2002 when a 13-year-old ban on inducting entrepreneurs was eliminated from the Party constitution.⁶

These methods serve present political purposes fairly well. One consequence, however, is that the state has a fairly clear interest in discouraging the emergence of the large family conglomerates that are characteristic of Chinese commercial culture everywhere else in Asia.⁷ This poses a potential problem for the future. What happens when these sorts of conglomerates start to grow, as they must, out of the small-scale private business groups that exist today? Do the new tycoons begin to insist on an autonomous political role free of Party interference? Can a new accommodation be reached? Or will the state insist on restricting or dismantling these groups as they become too big, with a resulting cost in economic efficiency?

2. East Asian developmental state. In broad terms, China clearly shares certain key characteristics with Japan in the 1950s and 60s, and with South Korea in the 1970s onwards. Economic growth is driven by a high savings rate, large state investments in infrastructure, rapid transfer of population from agricultural to manufacturing employment, and export-oriented industries.

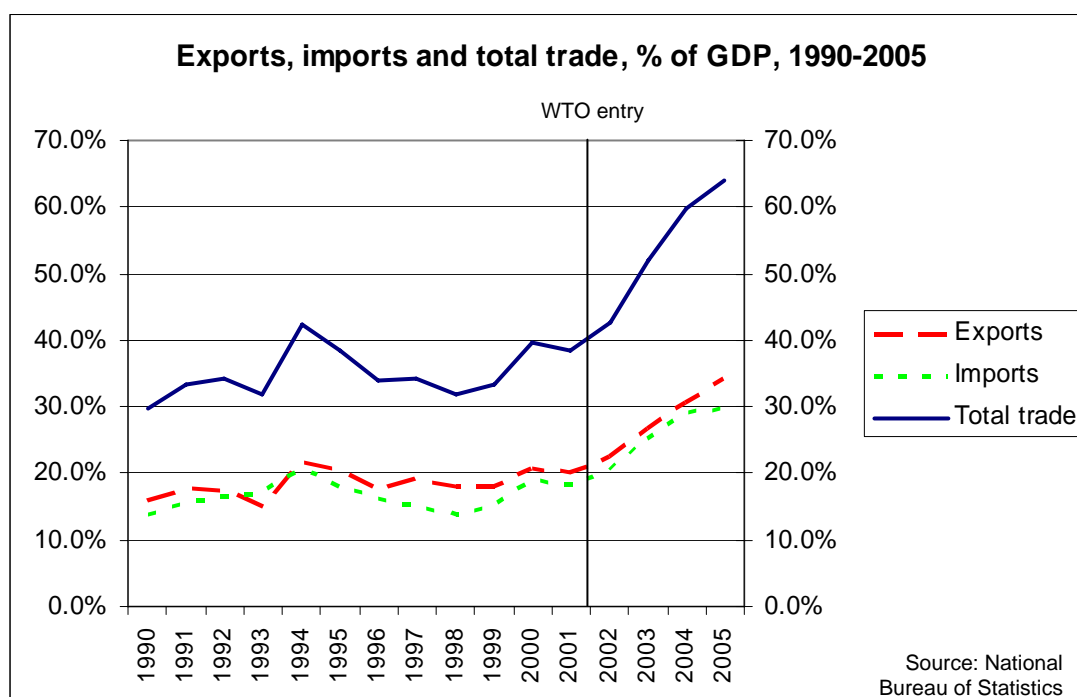
A key difference, however, is that the effective level of protection for domestic enterprises in most sectors is far lower in China than in its east Asian neighbors, and the participation of foreign companies in both the domestic market and in export trade is much higher. As will be seen below, this has important implications for China’s technological development path. It also means that China has not yet developed what might be called the “clientelist” type of capitalism, different varieties of which prevail in many Asian economies. In Japan, clientelism took the form of cartels orchestrated by the government, which kept domestic prices high and ensured fat corporate profit margins. In southeast Asia, the standard form was the granting of monopoly concessions for key commodities to favored entrepreneurs, who used the cash flow thus derived to build up diversified family-controlled conglomerates. In China, as noted above, the main mechanisms of accommodation between state and private sector have been the creation of separate spheres of activity, and *ad hoc* forms of co-optation. Because of the highly competitive nature of most markets, cartels are ineffective, and commodity extraction is seen as inherently a state activity. The main

⁵ A noteworthy example of a competitive sector with successful state and private players is the telecoms equipment industry, where private firm Huawei is the clear leader and state-owned ZTE runs a strong second.

⁶ For details on relations between the Party and private entrepreneurs, see Bruce Dickson, *Red Capitalists in China* (Cambridge University Press, 2003).

⁷ To pick only the most obvious examples: Wang Yong-ching’s Formosa Plastics Group in Taiwan; Li Ka-shing’s Cheung Kong group in Hong Kong; and the business empires of Robert Kwok, Mochtar Riady’s Lippo group, and the Chaeravont family in Malaysia, Indonesia and Thailand respectively.

Figure 1



consequence is that China has not so far fostered either internationally competitive and technologically advanced multinational firms (as in Japan or Korea), or internationally prominent family-run conglomerates (as in southeast Asia).

3. Liberal free-market state. Because of its extraordinary degree of openness, it is tempting to imagine that China is headed toward some version of a liberal, free-market state. And it is true that in downstream manufacturing industries from which state players have exited, China is characterized by an astonishing degree of competition, which in many cases includes not only dozens or hundreds of Chinese companies but also the major players from virtually every other country in the world.

This state of affairs results from the fact that Chinese economic reform, since its inception in 1978, has been explicitly a process not only of domestic reform (*gaige*) but also of opening-up to the global economy (*kaifang*). The relentless ubiquity of the phrase *gaige kaifang* in official parlance over the past quarter-century has perhaps dulled the understanding of the momentousness of this word choice. The clear implication is that domestic reform is impossible without openness; and because the phrase was enunciated by Deng Xiaoping himself it is politically impossible to jettison it. Reformers have used openness as a tool to spur domestic reforms that otherwise would have been far more difficult or even impossible, most notably via China's accession to the WTO in December 2001.

China's degree of openness is illustrated first by Figure 1, which shows exports, imports and total trade as a percentage of GDP. These figures are quite high for a large economy: China's total trade ratio, 64 percent of GDP, is about triple that of Japan or the United States (although similar to Germany's). Notably, growth in both

Figure 2
Foreign enterprise share of China's export and trade balance

<u>Year</u>	<u>Exports</u>	<u>Trade balance</u>
2000	47.9	9.0
2001	50.1	32.7
2002	52.2	31.8
2003	54.8	33.1
2004	57.1	43.7
2005	58.3	55.6

Source: Ministry of Commerce

imports and exports rose steeply right after WTO accession. In the four years since, trade has grown at more than double the rate of nominal GDP, whereas in the preceding eight years trade and GDP grew at about the same rate on average.⁸

Unique to China among large trading nations is the enormous share of exports and the trade balance accounted for by foreign invested enterprises (FIEs), as shown in Figure 2. At 58 percent and 55 percent respectively in 2005, these figures are without doubt far and away the highest for any major economy, although definitional differences make direct comparisons hard. Moreover, the foreign share of both has risen steadily.

The major risk of the openness strategy, from the Chinese point of view, is that China's economy could wind up being "Latin Americanized," with many market sectors controlled by foreign firms. In his study of the Chinese auto sector, Eric Thun notes that efforts to create an internationally competitive Chinese automaker have thus far fared poorly, and suggests that the Chinese auto industry does indeed face some risk of repeating the fate of Mexico's, which – in part because of the market-opening North American Free Trade Agreement – is entirely controlled at both the assembly and the component level by multinational firms.⁹

Although fear of domination by foreign multinationals remains a potent political force – even if one which, in the end, is usually trumped by the forces of openness – it is unlikely that large swathes of Chinese industry will end up being dominated by foreigners. The main reason is the sheer size of the country. The lure of this potential market enables China to impose significant entry fees on multinationals, such as technology transfer, mandatory joint ventures, or limitations of business scope. In one way or another these barriers provide breathing space for Chinese competitors.

Perhaps the best way concisely to sum up the Chinese development model is as a symbiosis of the three types indicated above. The **goals** of Chinese development are patterned on the classic East Asian developmental states, Japan and South Korea: China's leaders would like to see rapid economic growth, heavily reliant on exports

⁸ China's trade figures are distorted by the widespread use of bogus or falsified trade transactions as a means of importing or exporting capital in violation of China's controls on capital flows. Those who wish to send capital abroad routinely over-invoice imports; those who wish to bring capital into the country can over-invoice exports. (For a recent estimate of the value of such bogus transactions, see Stephen Green, "China's trade: Bermuda triangle, accounting issue or FX flows?", Standard Chartered Bank research note, 13 April 2006). The relatively depressed trade figures of 1996-99 are probably too low, because of both capital flight and rampant smuggling; the spectacular trade figures of 2003-05 are probably too high, for the converse reasons. Nonetheless, there is little doubt that WTO entry sparked a sharp increase in China's trade, well above the trend growth pattern of the 1990s.

⁹ Eric Thun, *Changing Lanes in China* (Cambridge University Press, 2005)

and rapid technological advance, with a stable administration of elite technocrats playing a substantial coordinating role.¹⁰ However the **methods** for achieving these goals are dictated by China's peculiar status as a *post-communist economy with a continuing Communist government*. Unlike South Korea and Japan, China must gradually dismantle the constricting apparatus of the planned economy. This process of dismantling, however, must not threaten the rule of the Communist Party itself, and carries the additional condition that the party-state must remain in direct control of large chunks of the economy through ownership of dominant enterprises in strategic sectors. Left to the mercy of purely domestic forces, such a complicated and contradictory reform process would most likely run aground. Thus a high degree of market openness is essential as a **catalyst**, to ensure that structural reforms continue without which economic development and technological advance are impossible.

Measuring success

Having defined as best we can the nature of the Chinese economic development model, we can now make a brief survey of how successful the model has been. In terms of economic growth the question is easy to answer. Between 1980 and 2005 China's GDP grew by an annual average rate of 9.6 percent. No other country (including Japan, South Korea and Taiwan) has ever sustained that rate of GDP growth for such a long period of time. It is not within the scope of this paper to disentangle the various contributions of policy, demographics, and other factors to growth; it is sufficient to suggest that in the context of such spectacular growth, it is inconceivable that policy played a negative role, and it is probable that it played a strongly positive one.

Impact on technology and development of competitive domestic firms

But as we have noted, it is not the goal of Chinese policy to create economic growth pure and simple. Other policy goals include the creation of domestic technology capacity, and the development of internationally competitive Chinese firms. On both of these counts China's success is ambiguous.

To understand this it is necessary to go back to China's trade figures. Between 1980 and 2005 China leapt from being a negligible trader to the world's third biggest trading nation, behind only the US and Germany. This was accomplished in large measure by policies designed to attract export-oriented foreign direct investment. These policies were enormously successful; as noted above foreign enterprises accounted for well over half of China's exports in 2005, and the foreign share has been rising. Moreover, as shown by Figure 2, the foreign contribution to China's trade surplus, quite modest in the 1990s, became dominant in recent years. The most likely explanation is that foreign enterprises were heavy importers of capital equipment in the 1990s, as they were installing their factories. While these imports continue, they are now outweighed by the production value of exports from the installed base.

Two additional points need to be made. First, the role of processing trade. More than half of China's trade is processing – i.e., final assembly of imported materials and

¹⁰ It is important to recognize that technocratic governance exists in China mainly as an ideal. The practical reality of Chinese policymaking is fragmented and politically constrained, with most policies emerging as compromises between semi-autonomous central government ministries, or as the result of tortuous negotiations between the center and local governments, over which Beijing has at best imperfect control.

Figure 3
China's processing trade

Year	Total exports US\$bn	Processing/ total exports %	Local value added in processing exports %
2001	266.2	55.4	36.3
2002	325.6	55.3	32.1
2003	438.4	55.2	32.7
2004	593.4	55.3	32.4
2005	762.0	54.7	34.2

Source: Ministry of Commerce

components. Processing's share of total trade has not declined appreciably in recent years, nor has the local value-added component of processing increased significantly (see Figure 3). Chinese trade growth, and by extension overall economic performance, are quite reliant on this relatively low value-added processing trade.

When one turns to goods classified as high-tech, the picture is even more stark. In 2005, 88 percent of China's high-tech exports were generated by foreign firms – and 67 percent by wholly owned foreign firms, in which there is no formal mechanism for technology transfer to a local partner. FIEs are now significant net exporters of technology goods, while domestic firms continue to be net importers (see Figure 4). On a more qualitative basis, there is little evidence that Chinese firms are producing significant innovation in core technologies, manufacturing process, or design – either in high tech goods or in any other sector. The primary Chinese comparative advantage continues to be production at low cost and on a large scale. Chinese companies that have demonstrated international competitiveness, for instance steel producer Baosteel, telecoms equipment maker Huawei, and auto components maker Wanxiang, have done so not on the basis of new technology or innovative manufacturing process, but mainly by their ability to manufacture to an acceptable standard at very low cost.¹¹ There are a large number of such companies, mainly small and medium sized manufacturers.

Figure 4
China high-tech merchandise trade, 2002 and 2005

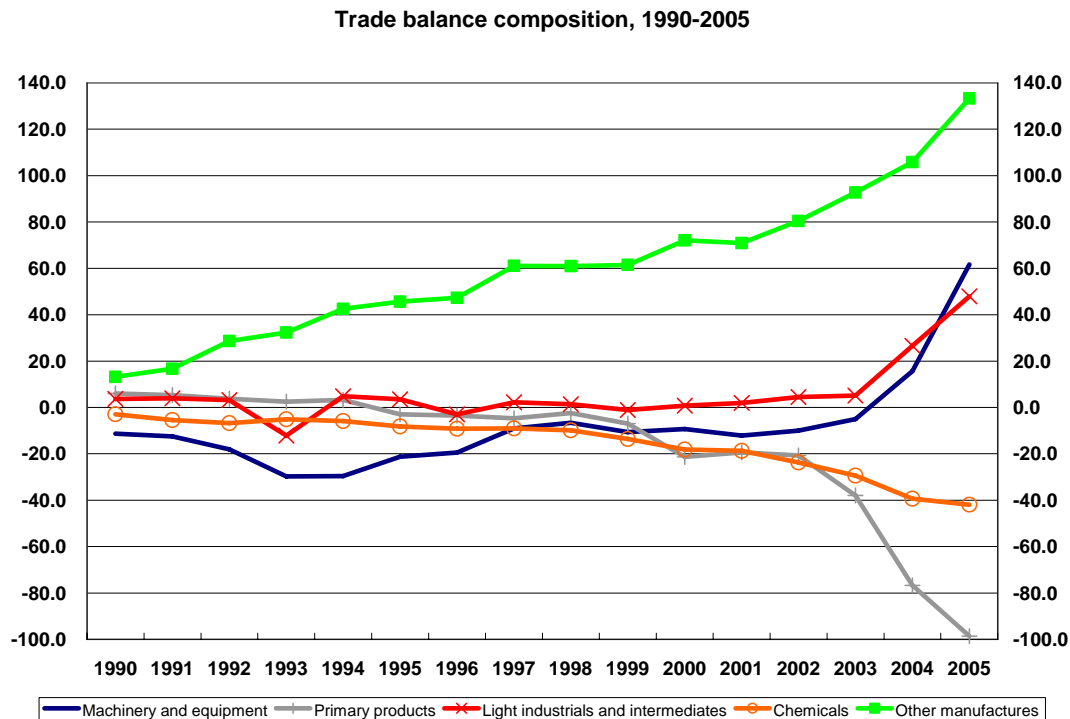
Year	Total exports US\$bn	FIEs		Domestic	
		US\$bn	%	US\$bn	%
2002	67.7	55.6	82.1	12.0	17.9
2005	218.3	192.0	88.0	26.2	12.0

Year	Total balance US\$bn	FIEs		Domestic	
		US\$bn	%	US\$bn	%
2002	(15.0)	0.6	(4.0)	(15.6)	104.0
2005	20.5	34.0	165.6	(13.5)	(65.6)

Source: Ministry of Commerce

¹¹ Arthur Kroeber, "China's push to become a global leader in information technology," in Linda Jakobson, ed. *Is China Challenging the West?*, forthcoming.

Figure 5



From an economic point of view there is nothing terribly wrong with this. Because of its unique cost and scale advantages, China will be able to generate enormous increases in employment and incomes simply by commoditizing an ever wider range of technologies invented elsewhere. As Figure 5 demonstrates, this widening of China’s industrial base – represented by China’s trade balance in five major goods categories – is proceeding rapidly. In 2005 China was a large net exporter of machinery (to the tune of US\$60 billion) and industrial intermediates (US\$45 billion), both categories in which as recently as three years earlier it was a net importer. In the long run, these large concentrations of manufacturing capacity, and the development of a richer and more demanding domestic consumer market, are bound to prompt domestic technological innovation.

Yet from the point of view of Chinese planners who define success in terms of maximizing “comprehensive national power” and would like to create local versions of Toyota and Sony, the picture is distressing. When Chinese planners talk of “internationally competitive” they do not simply mean companies that can compete effectively in international markets, which as we have noted many Chinese firms are already able to do. Rather, they mean companies that have globally recognized brand names; intellectual property rights from which they can reap price premiums, royalties and license fees; and control of distribution channels in foreign markets. In other words, Chinese planners explicitly reject the Taiwanese model of small, nimble manufacturing firms that operate mainly on a contract basis with the owners of brands and distribution channels in developed-country markets. Instead they favor the creation of Japanese-style multinational firms.

Common themes of government pronouncements now is the undesirability of China remaining “locked into low-value assembly production,” and the desirability of

developing indigenous intellectual property so that Chinese firms can collect rather than pay royalties and license fees. This concern has spawned a number of strategies, including incentive packages for technology industries, the promotion of domestic technology standards, and government procurement rules mandating purchase of domestic hardware and software. The most prominent example of the first was State Council Document 18, published in 2000, which provided a wide range of tax and other benefits for domestic producers of semiconductors and software. These were attacked by US semiconductor makers as an illegal subsidy and were rescinded in April 2005.

The problem with these sorts of policy measures is that by constantly trying to create explicit or implicit discrimination between foreign-owned and domestic enterprises, the government converts what ought to be industrial policy into a trade issue. The two things most required for domestic innovation to flourish and for Chinese multinationals to grow are a) an improvement in the rewards system for innovation (including improved intellectual property protection and more flexible capital markets) and b) consolidation of industry so that the most efficient players can focus on research and development and well thought-out international expansion, rather than fighting vicious price wars at home in order to maintain market share.

A final consideration is to what extent China's growth has enabled it to gain power in the international trading system. To the extent that it is now the world's third largest trading nation, China obviously wields influence over the trade policies of many of its partners. Yet as a new entrant into the WTO it does not as yet gain a significant role in setting the rules of international trade; and insofar as it is perceived as a heel-dragger in meeting its WTO obligations, its impact on further adjustments in the WTO regime is likely to be limited, except in a negative sense (i.e. blocking WTO rules on matters that Beijing sees as helpful protectionist tools, such as government procurement policies). This relatively low level of influence does not yet seem to be an issue of great concern in Beijing, where policy makers are far more engrossed in domestic reform issues than they are in securing a favorable operating environment for Chinese firms abroad. China's interest in taking a more active role in WTO rule-setting will presumably grow in tandem with the presence of Chinese multinationals in international markets. It is likely, however, that such international concerns will continue to take a back seat to domestic considerations for many years to come.