China's Economic Growth

Remarks before the Annual Symposium on Critical Global Markets: China's Remarkable Rise

Center for American and International Law

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Dallas, Texas
June 14, 2005

The views expressed are my own and do not necessarily reflect official positions of the Federal Reserve System.

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I am delighted to speak about China to this distinguished group of counselors. Let me note at the outset that, being what I hope is a good Episcopalian, I am not accustomed to speaking of myself in the first person and prefer to use "we" instead of "I." But a Federal Reserve Bank president who refers to "we," whether he is talking baseball or China, might be thought to be speaking on behalf of the System or of the Open Market Committee. The comments I am making today are personal observations and are not spoken as a representative of the Federal Reserve System or the Federal Open Market Committee. They are mine alone, though many of the numbers I will share with you today were developed by the great research staff at the Dallas Fed.

I speak with a bias. That bias is based on a quarter century of dealing with China. In the interest of full disclosure, here is the background.

I was part of the team, led by Treasury Secretary W. Michael Blumenthal, dispatched by President Carter to Beijing to negotiate with Deng Xiaoping in 1979. We were there to settle the counterclaims the U.S. and China had on each other as a result of the Communist government's seizure in 1949 of the railroad stock we lent the Nationalists and the concomitant freezing of Chinese banking assets in the United States. We negotiated a settlement with Deng in order to enable commercial interchange between our two countries.

During the late 1980s, after I had returned to the private sector, my firm, Fisher Capital Management, was one of the few investors in so-called "B" shares traded in Shenzhen and Shanghai, in addition to "H" and "Red Chip" shares traded on the Hong Kong exchange.

In the second Clinton administration, I helped negotiate China's accession to membership in the World Trade Organization as deputy to U.S. trade representative Charlene Barshefsky. (I mention this to remind you also that China's accession was negotiated by a Democratic administration, finalized by a Republican administration and approved by a bipartisan Congress. Remember that when you listen to the current debate about trade matters with China.)

And finally, I was able to glean a modicum of insight into China from a true master, Henry Kissinger, when I served as vice chairman of Kissinger McLarty for three years before becoming president of the Dallas Fed.

All told, I have been dealing with China for 26 years. So you are going to get an earful.

I remember our first encounter with Deng Xiaoping. We were awaiting him in the Great Hall of the People. Suddenly, a door opened behind us and Deng cackled, "Where are these big American capitalists I am suppose to be so afraid of?" We swung around, our eyes having to adjust downward to find him. He was under 5 feet in height. But we knew we were in the presence of a giant of a man.

Over the course of those meetings in Beijing, Deng laid out the basis of the reforms he had begun to implement in 1978, what he would later describe publicly as "the capitalist road." In my

book, that was the beginning of China's emergence, and I feel fortunate to have been there at the dawn of a new era.

Since 1978, China's economy has grown at an average annual rate of 9.3 percent and grew at a reported 9.5 percent last year. So we know from the statistics, however imperfect they may be, that Deng laid the foundation for a pretty sturdy expressway.[1]

China's rapid growth has been unrelenting. I have been asked today to predict how long the fast growth will last. Naturally, I'm very hesitant to take the bait, so I'll hedge my answer and say ... it depends. Possibly, China can grow this fast another two or three decades. Perhaps just a decade, if not less. Certainly, though, it can't do so indefinitely.

The answer to how long depends on several factors. Will China continue to reform its economy? Can its leaders maintain political cohesion while they do so? Can China deal with its emerging pollution and infrastructure constraints? There are a myriad of issues the Chinese must deal with, none of them easy.

As you contemplate them, you might start by putting China's economy in context. One can paint two starkly different pictures of China right now, the Big China view and the Little China view.

The Big China view centers on China's manpower and prowess in manufacturing, and it uses purchasing-power-parity adjusted dollars to embolden its case, a convention adopted by economists to adjust for local purchasing power, which has its utility but may or may not be a useful tool in measuring comparative geopolitical power.

Here are some statistics to support the Big China view:

- America has a labor force of 147 million; China's is 761 million—five times as large.
- China's factories produced just 200 room air conditioners in 1978; today, they produce 48 million. Back then, they turned out just 11 billion meters of cloth; last year, 35.4 billion meters (over three times as much).
- Chinese households have a rapidly increasing abundance of appliances and electronic products—refrigerators, TVs, DVDs, cell phones, etc.—at ownership rates not far below those in this country.
- They have 28.3 million broadband users and 98.8 million Internet users, according to their Ministry of Information and Industry.
- There are 28 billion square feet of floor space under construction in China, compared with just 5 billion in the U.S. Five of the world's largest shopping centers are now located in China.
- The U.S. manufacturing sector produced goods worth $1.5 trillion in 2004; China's produced $3.4 trillion, adjusted for purchasing power parity.
- And the grand statistic of them all: On a purchasing-power-parity adjusted basis, economists put China's gross domestic product at $7 trillion, compared with our $12 trillion—making it already 60 percent of our size.

That's the Big China view.

The Little China view has many more statistics in its support:

- U.S. productivity in agriculture is 33 times that of China; productivity in U.S. industry is five times that of China.
- The U.S. has 19,497 airports; China, just 126.
- We have 150,000 miles of petroleum pipelines; they have less than 10,000.
- We have 481 cars per 1,000 people; they have seven.
- We have much, much higher levels of education, technology ...

I could go on and on with statistics to show where China comes up short. But here are two good summary statistics: On a straight U.S. dollar basis (not adjusted for purchasing power parity), their economy is roughly the size of California's! China's GDP *per person* is just $1,300, compared with our nearly $40,000. That's just one-thirtieth of our per capita GDP.

I personally think we overstate the current prowess of China by emphasizing the Big China view. But from either perspective, China has room to grow. To do so, they will have to deal with infrastructure and other problems, which present significant challenges.

The various parts of any and all economies are constrained somewhat to grow in proportion to one another—not in totally rigid ratios, but not in completely flexible ones either.

For example, you can't expand your manufacturing sector if you don't have the electric utility plants to power industry. Already, China has reached capacity in electricity generation, and many factories have had to resort to diesel-powered generators to keep the wheels turning. That's not to say that they can't expand generation capacity—they can and they have. Here are the numbers: China produced just 257 billion kilowatt hours of electricity in 1978; in 2003 (the latest data) they produced 1,911 billion—seven times as much.

But building infrastructure takes time. China only has one-fourth the road system of the U.S., and it has taken them a quarter century to double it (from 533,144 miles in 1978 to 1,124,555 in 2003). They have a fraction of the pipelines, dams, satellites, Internet servers, fiber-optic cable and other infrastructure assets that we do and a fraction of what they need to support a big economy. Pollution is a big and growing problem. Institutions have to be designed, and laws debated and written to support commerce. All these things take time. Everything can't be built as fast as a textile plant. Especially not the key ingredient for economic prosperity in an interdependent world: an educated, knowledgeable population.

Developing basic infrastructure is important, but developing education is crucial if China is to stay on the capitalist road.

Manufacturing is a means to an end. It's not the top rung on the income ladder. No economy can reach the pinnacle of wealth without its labor force becoming highly educated, and highly educated people tend to work in services. Doctors, lawyers, dentists, accountants, engineers, scientists, professors, computer programmers, systems architects, consultants, financial advisors, pharmacists, actuaries—these are all service-sector jobs, and high-paying ones at that. They all

have one thing in common—education. To keep climbing the income ladder, China will have to make a huge investment in education.

Presently, just 18 percent of China's population aged 25–65 has a high school degree, compared with 84 percent in the U.S. Just 1 out of 20 Chinese in that age group has a college degree, compared with almost 1 in 3 in the U.S. China has just 86 university students per 10,000 of the population. We have 562—seven times as many. To be sure, China imports education from the rest of the world. In 1978, only about 1,000 Chinese students were studying abroad. At last count in 2002, 182,000 were.

However, even if China were to reach the knowledge-driven rung on the income ladder of nations, there is no reason to assume that China will overtake the United States in size and influence. Do the math. Were China to keep growing at 9 percent and the U.S. to keep growing at, say, 3.5 percent, it would take them nearly four decades to catch us in terms of GDP.

Thirty-eight years to be exact, starting from their base of $1,300 in per capita GDP (the Little China view) and ours of $40,000. It would take 83 years if their growth slowed to an average rate of 6 percent, well over a century if it slowed to 5 percent, a more probable trajectory for growth. Even then, it's not certain to happen. Remember that Japan grew much faster than us for three decades after World War II, then slowed as it converged to U.S. per capita GDP levels. Same for Germany, same for Korea. There's a good reason for that. It's one thing to run down the path already cut by the leader, a whole other one to become the leader yourself.

If you're not willing to eliminate protectionism, reduce red tape and regulation, encourage free markets for capital as well as goods and services, live by the rule of law, punish public corruption and corporate malfeasance, if you're not willing to let old jobs go by the wayside and otherwise unleash the competitive forces that make an economy nimble, you won't keep pace with the leaders. Leaders do these things. That is how they *stay* leaders. That is how the U.S.A. got to where it is today, becoming the mightiest economic machine in history.

China has improved somewhat in a few of these dimensions, but it is still far behind in every single one. For example, they rank 31st in the International Institute for Management Development's 2005 competitiveness score. They rank 112th in the Heritage Foundation's economic freedom score. They rank 71st on Transparency International's 2004 corruption score. These and other indicators indicate China has a long way to go before it creates conditions of truly sustainable economic growth in today's world.

China does have an apparent advantage over others, being possessed of a very high savings rate. China's gross national savings rate is reportedly 47 percent (compared with just 14 percent for the U.S.).[2] Many folks ask why and whether it's something that should concern us.

In noodling this through, it helps to remember that China's savings rate pattern is typical of low income countries. Poor, newly market-oriented countries usually try to save their way to wealth.

Economists' dynamic optimization models predict and even prescribe this kind of savings behavior. (This literature is called the "Golden Rules of Economic Growth.") History supports the pattern as well. Japan had a much higher savings rate when it was developing, as did the U.S.

That's the *why* of China's high savings rate. As to the *worry*: No. Rather than fret, we should be glad China is saving so much.

First, China's savings and investment are critical if it is to become a permanent member of the "capitalist club." They will have to develop more sophisticated financial mechanisms to work those savings and channel those investments to earn an optimal return. Accumulated capital forces one to become capitalist! We want the Chinese to be capitalists, interacting with the world through commerce. For we know that nations that trade and invest in each other tend to fight with each other less.

Second, the more China accumulates savings in other currencies—the dollar, the yen and the euro, for example—the more it helps lower world interest rates. China owned $430 billion in U.S. securities at last count (June 2004). And while we do not have precise figures, there are substantial dollar holdings on the books of companies and banks outside of the official holdings of the People's Bank of China. These holdings have lowered the cost of capital here in the U.S. and globally, just as the massive growth in China's exports to the U.S. and Europe have helped keep consumer price inflation low.

The hope of Chinese authorities, however, is to ultimately put those savings to work to grow the Chinese economy, including through building domestic demand. Just last week, the head of the People's Bank said he wanted to see an economy driven more by domestic consumption. When? And on what products is the typical Chinese consumer going to start spending? And what can we sell them?

Chinese consumerism is already starting to happen. It began, of course, with the goods they make so cheaply for the rest of the world—electronic products and appliances, for example. If you can get a DVD player for just $29.99 in the U.S., imagine how little it costs in China, where it's made. Fifty-nine percent of households there now own one, at latest count. There are 209 telephone mainlines per thousand people in China, compared with just two in 1978, and 215 mobile phones and 75 cable TV subscribers today vs. zero in 1978. The vast majority of urban residents there now have washing machines, refrigerators and other household conveniences.

Clothing, footwear, textiles and furniture also fall into this category—all being among China's top 10 exports to the rest of the world and cheaply available for domestic consumption.

Of course, there's also beer and cigarettes. China makes three times the cigarettes and 60 times the beer it did in 1978. As the son of an Australian father who considered beer to be one of the basic food groups, I view that as a sign of progress!

What can we sell them? Well, let's remember that U.S. exports to China have nearly tripled since we struck our WTO agreement with China, far exceeding our internal expectation when we negotiated the deal. America's exports to China are lower than we want, but they have risen at about 10 times as fast as our exports to the rest of the world. We start with food, raw materials and transportation. Soybeans are our No. 2 export to China, totaling $2.3 billion. In 2004, we also sold them $1.6 billion in aircraft.

From there, we must move up the value-added ladder to medical services, financial services, legal services, entertainment and recreation, education, consulting, technology—these are areas of expertise in which the U.S. has a big lead on the rest of the world. They constitute our new comparative advantage.

Our medical industry, for example, is the best in the world. As China gets richer, surely its citizens will behave just like others and demand more medical attention. Currently, health

expenditures per capita in China are just $63, which aggregates to one-half of 1 percent of GDP. Health is what economists call a "superior good"—something folks spend proportionately more on as income grows, as is abundantly clear in our own economy and in Europe's.

The same is true of financial services. There's not much need for financial advice when you have no money. But as income grows, demand for these services grows more than proportionately, and that will happen in China, too. Again, it plays to our advantage—if we take it. Because the U.S. got rich before the rest of the world, we had to learn how to efficiently finance an economy. We have created all kinds of financial products to satisfy this need, from basic banking services to underwriting and distribution mechanisms for financing industry and service providers, to mortgages and other means to finance housing, credit mechanisms to facilitate consumption and mutual funds to channel savings—there are about 2,000 different financial products in the United States today.

China's banking system and securities markets are woefully handicapped by the old, stereotypical disincentives of communist government. American financial services can help the Chinese transition from central planning to market-based efficiency.

The same is true of legal services. As part of their WTO accession obligations, restrictions on foreign law firms have been gradually lifted. As of the latest count in December 2003, there were 116 foreign law firms from 16 countries operating in China—40 from America. Many more operate there now. Some of the firms represented here today have offices in China—Haynes and Boone, Vinson & Elkins, King & Wood and Jones Day, to name just a few.

HierosGamos legal directories lists 167 areas of law in which U.S. firms offer services in 19 Chinese cities. Obvious areas of practice are maritime, antitrust and unfair competition (defending U.S. antidumping claims!), bankruptcy, business appraisals, consumer law, copyright, customs, dispute resolution, employment and labor, estate and financial planning, ethics, franchising, foreign investment, human rights, immigration, import/export, intellectual property, joint ventures, mergers and acquisitions, offshore trusts, patents, project financing, trademarks and workers' compensation.

Law leads me naturally to the entertainment industry. The world already loves our movies. Indeed, they love them so much, they steal and copy them—the sincerest form of flattery I suppose, but not one we can tolerate. Just getting China to abide by intellectual property rights would ultimately help pay both a lot of U.S. attorneys and screenwriters. We have much to sell them in this area.

Next there's education. Educating the world—not just China—is an opportunity for America. It's a comparative advantage and one upon which we should build. The U.S. has seven of the top 10 universities in the world; China has just one in the top 40—Beijing University, ranked roughly 20th. Of course, you can also outsource higher education. America's colleges and universities enrolled 586,000 foreign students in 2003—more than second place Britain and third place Germany combined.

It is important to grasp that educating the world also benefits us. Why? Because many of the foreign students we train wind up staying here, building a base for our higher value-added production. Estimates from the 2000 census indicate that at the doctorate level, 51 percent of U.S. engineers and 45 percent of workers in life sciences, physical sciences, mathematical

sciences and computer sciences were foreign-born. This helps us on the sell side; it stocks our technology base. Semiconductor parts were our No. 1 export good in 2004; we sold $43 billion worth, $2.6 billion of them going to China. Then, there's our technology *services*—such as those in oil field and drilling technology. China needs our 3-D seismic technology to help locate oil for a booming market.

There are many such opportunities for us to sell to China. The key is to produce the most dear part of whatever's being done.

Look at the way an IBM computer is made, for example. At the bottom of the value-added chain, the basic battery is made in Asia. Moving up, the keyboard is made in Thailand. Up again, the display screen is made in Korea. Up again, Canada makes the graphics controller. At the very top, the microprocessor is made by Intel here in good ole America.

You can see the same hierarchy in the software pyramid. From the bottom up, the pyramid has six levels—basic programmers, business analysts, project managers, consultants, researchers, then systems architects. At the very bottom, basic programmers have seen their pay fall by 15 percent since 2002 as U.S. jobs have outsourced to, say, India. At the very top, however, the visionary architects who sketch out systems to handle complex projects make between $150,000 and $250,000, and their pay is rising.

To stay ahead today, we have to focus on the most sophisticated analytical tasks and move up the value-added ladder to supply creativity and design, imagination and vision. This is the domain of new, good jobs for U.S. workers, and the numbers bear it out. We're outsourcing jobs that use formulaic reasoning and lesser skills, such as call centers and back office work and basic programming. We're adding many jobs, though, above that line. Over the past 10 years, we've added tens of thousands of jobs for architects, professors, financial advisors, nurses (up 512,000) and many more. Yes, even attorneys (up 182,000, or 24 percent).

That's the way we stay on top. That is the way we will play to China's growth—developing and selling evermore sophisticated knowledge into the pricier tiers of the value-added spectrum.

China exports 36 percent and imports 34 percent relative to GDP. So, they *are* buying from abroad—both consumer goods and intermediate inputs for the production process. South Korea has a $30.6 billion trade surplus with China, up from just $185 million in 1992. Taiwan's trade surplus with China is $17.4 billion—up from a $748 million deficit in 1992. Malaysia's is $9.5 billion, up from just $184 million in 1992. Until recently, Japan had not learned how to take advantage of China's expansion, and the two nations' trade was roughly balanced. But last year, Japan ran a $21 billion trade surplus with China.

Of course, none of these nations perform the role the United States does as the consumer of last resort. We buy anything that looks good, feels good or tastes good. That is an important role for the U.S. to play when the rest of the world, Europe as well as Asia, is devoid of domestic demand. But this need not be a perpetual predicament. Like others, we have much we can sell into China that is uniquely American, especially once China reaches higher income levels.

Here is the bottom line: We're better off if China is rich than if it's poor. China's ascension is our opportunity. We have much to sell the Chinese, and they, us. Trade with China is helping raise our productivity and lower our prices. Competition with China keeps us on our toes and sharpens our wits, forcing us to move up the value-added ladder to new and better jobs with

higher pay. And as they become more like us, their incentives become more in line with ours every day. This is cause for celebration, not condemnation. And to that, I'll raise a glass of Chinese beer and say "Good on 'ya."

Thank you.

Notes

1. Chinese official statistics might charitably be described as "constantly being improved." If memory serves, I recall one quarter when they released GDP numbers the day before the quarter ended, a not unremarkable feat for a country of 1.3 billion people.

2. Gross savings include retained earnings and consumption of fixed capital by business and by government.