

21 China's Economic Growth: Challenges and Opportunities for Europe¹

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In the first half of the twenty first century, world economic power will be shared by Europe, North America and Asia. Modern economic development began in Europe with the Industrial Revolution, followed by the development in the United States and Canada and more recently in many Asian countries. The latest country to become an economic power is China. Because of its large population, China's rise to an economic giant has a great impact on the balance of economic and political power on the globe. Today I am honored to speak to this distinguished group of European and Asian leaders gathered in Switzerland on the nature of China's economic growth, the opportunities for Europe and the challenges it poses.

Having been the leaders of the world for over three centuries, Europeans have witnessed the rise of the United States, especially during the Second World War, and more recently the rise of Asian countries including China, with some apprehension. In the second half of the twentieth century, Europe lost its dominance to the United States, and in the first half of the twenty first century, Europe and the United States will share their power with China, Japan and other Asian countries. We hope that later in the twenty-first century African and Latin American nations will experience rapid economic growth as well. World economic development and economic integration are good for all of us. Within a country, people prefer a balanced growth with the increase in wealth shared by all citizens rather than being concentrated in the hands of a few. The same ideal applies to the economic development of nations. Furthermore, as Adam Smith pointed out in the *Wealth of Nations* (1776), division of labor and specialization lead to efficient economic production, and competition among individual productive units, each pursuing its self interests in the market place, will benefit the country as a whole. Similarly, division of labor and competition among nations are benefiting the world as a whole. Competition between China and European nations is inevitable as each country pursues its self interest. On the other hand, trade and foreign investment have benefited both Europe and China. The question I would like to address is how we can improve on the economic relationship.

21.1 Nature of China's Economic Growth

To help improve economic relations between European countries and China, it is necessary to understand the nature of China's economy and its growth process. In the 1920's and 1930's, before the Sino-Japanese war beginning in 1937 and the civil war ending in 1949 when the

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Peoples Republic of China was founded, China's economy was essentially a market economy. Some eighty five percent of the labor force was engaged in agriculture while some light industries were being developed in the coastal provinces. Economic development was hindered by the war with Japan and the civil war that followed. Peace in 1949 brought about recovery and growth until 1958, when Chairman Mao launched the Great Leap Forward Movement to change the cooperative farms organized in the middle 1950's to Communes, and raise output of steel by converting iron tools in backyard furnaces. The economy collapsed. It is estimated by demographer Ansley Coale that some twenty seven million people died during the Great Leap period from 1958 to 1963. Yum K. Kwan of the Hong Kong University of Science and Technology and I (1995) have estimated that if the Great Leap, had not occurred, per capita output in China in the early 1990's would have been about twice as large as the actual amount. After some economic recovery following the Great Leap Mao started the Cultural Revolution of 1965-1975. Human suffering and the loss of morality was great during these ten years, but the economic loss (narrowly defined as the loss of physical output measured by official statistics) was much less than during the Great Leap. Without the Cultural Revolution, China's real national output per capita would have been about 1.2 times its historical figure in the early 1990s. In spite of the great suffering inflicted upon the Chinese people, Premier Zhao Ziyang once said to me in 1985 that the Cultural Revolution had the positive effect of freeing the Chinese people from a restrictive ideology.

China adopted Soviet style central economic planning in 1953, with the first Five-Year Plan that year. It is beginning its ninth Five-Year Plan in 1996 (it started its third Plan in 1966 after an adjustment period following the Great Leap). Although the extent of central economic planning was limited and varied according to political circumstances from 1953 to 1978 when economic reform began, much of the market economy that had existed in 1949 was destroyed. Private farming was replaced by collective farming by large teams of farmers in the Communes. Trade of agricultural and other rural products was replaced by compulsory purchase by government agencies. Private industrial enterprises were abolished or transformed to state, provincial or local enterprises. Even peddlers, small shops, private raising of pigs and chickens in Communes, and rural markets were prohibited during the Cultural Revolution as being capitalistic. When Deng Xiaoping started economic reforms in 1978, the country was ready for a change. The new leaders could dissociate themselves with the mistakes of Mao. Officials in the government had learned from sad experience the economic inefficiency of central economic planning. Furthermore, the successful economic development of Taiwan, which was achieved by adopting a market economy, provided the needed stimulus and example. The farmers knew only too well the advantages of private farming as compared with the Commune system. The responsibility system, which assigned a piece of land to each farm family and collected from it a fixed amount of produce (rent) while allowing it to reap all the profits from the sales of its output in the market, was initiated by local Commune leaders. When the system was demonstrated to have resulted in large increases in output, the central government adopted it as a national policy in 1979. This was the center piece at the beginning of China's economic reform. It was successful, as compared with agricultural reform in Russia, partly because Chinese farmers in 1978 still knew private farming, having been prohibited from doing in only it 1958, and allowed to return to it partially during the recovery of 1963-65.

Having succeeded in reforming its agriculture, China began its urban and industrial reform in the early 1980s. The policy was not to privatize the state enterprises but to change the rules of their operations to make them more efficient. China continued to be a socialist country with

due emphasis on the role of the state enterprises. However, the enterprises were given autonomy to make decisions concerning the production of their outputs, the acquisition of their inputs, the marketing of their products and the investment of their retained earnings. Limited autonomy was first introduced to some six thousand state enterprises. After successful experimental results were observed, a higher degree of autonomy was extended to more enterprises. In 1987, a contract responsibility system was introduced to almost all state enterprises. Under this system, state enterprises were allowed to keep all the profits after surrendering a supposedly fixed amount of annual tax to the government unit controlling them for a period of five years. In October 1984, an important decision of the Central Committee of the Chinese Communist Party was passed to provide guidelines for further reform. It consisted of seven elements: (1) more autonomy for state enterprises, (2) a change from mandatory planning to guidance planning, (3) allowing more prices to be decontrolled, (4) developing macroeconomic control mechanisms together with an improved financial and banking system, (5) introducing responsibility systems for units within enterprises to promote efficiency, (6) fostering the development of individual and collective enterprises as a supplement to state enterprises, (7) expanding foreign trade and investment and technological exchanges. Today, the most successful measures are (6) and (7), and the least are (1) and (4). Thus, while collective and individual enterprises as well as foreign and jointly operated enterprises provide dynamic growth to compensate for the slow growth of state enterprises, modern macroeconomic control mechanisms and a modern banking system are yet to be established in China.

As economic reforms were gradually introduced, much of the energy and ingenuity of Chinese workers and entrepreneurs were being released to develop the Chinese economy. The rate of growth of real material output in China from 1979 to 1995 averaged over 9.5 percent per year, with higher than average growth occurring in 1992-1995. Over seventy percent of the output of China, including almost all of agriculture and some sixty percent of industry, is produced by economic units for profits as in a market economy. The market component of China's production and distribution system is large enough to sustain rapid growth of, say, over 8 percent per year for at least two more decades, so I see nothing in the foreseeable future to hinder the continued growth except for unlikely and yet unpredictable political turmoil. China will therefore be a larger economic power to contend with in the first half of the Twenty-first Century.

21.2 Competition from China

Economic competition from China has come and will intensify in the coming decades. As pointed out in my introduction and as we have witnessed, competition among nations is good for the world. If competition among General Motors, Ford and Chrysler are good for America, why is competition among Italy, Taiwan and the United States not good for the world? Of course, each company or nation subject to competitive pressure has to work hard to survive and the people employed in sectors adversely affected may have to seek alternative employment, but this is a fact of life that Europeans and Asians have to accept. Toynbee has suggested that some stimulus from outside is good for a civilization, and such a stimulus is coming for both the Europeans and the Asians.

In what ways are the Chinese competitive? First, China has a vast and high-quality labor force, with much of the high quality derived from an old culture of good handicrafts, respect for intellectual pursuits and the habit of working hard. Chinese are skillful in making electronic

products; Chinese are good computer programmers and designers of computer software. Also, Chinese labor is cheap at all skill levels. Second, Chinese are good merchants and entrepreneurs, as demonstrated by their performance in Hong Kong, Taiwan and South East Asia. Third, China has adopted an open door policy that allows investment and technology to flow in from economically more advanced countries and especially from overseas Chinese. As a result we have found many foreign joint ventures in China utilizing the cheap and skillful labor force to produce goods for exports to the world market. For the world market, China produced processed food, sports goods, watches, clothing, electronics and almost any manufactured goods except automobiles and computers – according to official Chinese custom statistics (see *Statistical Yearbook of China* 1993, p. 633 and 1994, pp. 512-514). The volume of Chinese foreign trade in U.S. dollars grew at an annual rate of nearly 20 percent in the first half of the 1990s. China's export in 1993 amounted to 91.8 billion U.S. dollars and its imports amounted to 104 billion dollars. Asia accounted for 52.6 billion of China's export and 63 billion of China's import. Europeans purchased 16.4 billion of China's exports and provided 24.0 billion of China's imports. The United States purchased 17.0 billion exports from China and shipped 10.7 billion imports to China. Thus, while the U.S. is running a trade deficit with China, Europe is having a trade surplus with China. In the future China will be able to compete in technologically more advanced manufactured goods as well as financial services, especially after Hong Kong is returned to China in 1997. What are the opportunities resulting from China's economic growth?

21.3 Opportunities for Europeans

A. Profit making opportunities.

Let me first discuss the profit making opportunities. By producing what is needed in China, either demanded by the governments at different levels or by the consumers, and by producing in China for exports, a European company can make profits. The Chinese government is eager to build infrastructure including highways, ports, telecommunication systems, etc. that require modern technology which China does not have. Chinese state enterprises are also looking for foreign partners to upgrade its technology, management, labor and marketing abilities. These needs are well known. Many Europeans have already been taking advantage of them. The Chinese consumer markets are being opened wider as import quotas and tariffs are being reduced, partly as a result of the Chinese government's desire to join APEC and WTO, and partly as a result of the rapid increase in China's reserve in hard currencies which can be spent to increase imports. Besides selling to the Chinese, market European companies can also take advantage of the cheap and skilled labor in China to produce for exports, and many companies have done so already. To take advantage of economic opportunities in China, Europeans may find the following suggestions useful.

(1) Finding the right contacts

Doing business in China is different from doing business in Western countries, mainly because in China economic power is to a large extent in the hands of bureaucracies at different levels of government, because China does not have a Western – styled legal system and because Chinese workers and managers have different habits, ethics, outlooks and training from those found in the West. To do business one needs approval and help from the Chinese bureaucracies, in addition to assistance from Chinese labor and management. To set up a busi-

ness or joint venture you need the approval of many levels of the government, possibly including the central government in Beijing, a provincial and/or local government, ministry A and/or bureau (a) as well as ministry B and/or bureau (b), etc. It sounds like an impossible task. In each step, the approval or required agreement may take a long time and require patient negotiations. Many Western companies have had the sad experience of believing that the agreement of one or two Chinese bureaucrats is sufficient to conduct its business, only to find that many more bureaucrats must grant approval or at least must be dealt with. Some less relevant bureaus or people can simply give you trouble in order to reap some profits from your operations. The reason for the existence of so many bureaucrats surrounding your project is that almost all bureaucrats are looking constantly at opportunities to make money in the same way that all Western business men are looking for opportunities to make money. They are working under a system in which economic power is still in the hands of the government bureaucracy to a large extent.

Now that I have given you all warning, what can I suggest for you to find the right contact? Your contact or partner must have the authority, or be able to acquire sufficient authority, to do the business desired. If the person or the agency is the right one, he/she can get the approval, or can help you get the approval from all others that may be trying to extract something from you. If you cannot find such a person, you should not do business in China. How do you find such a person? That depends partly on what your business is and how much you have to offer. If you have a world – recognized product to sell that China needs, the task is easy because many Chinese bureaucrats would be chasing after you and you only need to pick the right partner among them. Choosing the right person requires your ability to recognize who knows what. If you have such an ability, by definition, you can find the right people. Otherwise you cannot.

(2) Be patient in negotiations

This suggestion is obvious in view of the discussion of the last point. It is strengthened by the point that follows. I make this point of the need to be patient explicit so that you can plan your project accordingly. You have to figure in the extra time in your cost calculation and time allocation. It is not unusual for the negotiation to complete a contract for a joint venture to take more than two years, depending on your skill, experience and knowledge of China and the Chinese.

(3) Accept the semi-legal framework

Many Western businessmen and scholars complain that there is an absence of a Western – styled legal system in China and therefore it is hard to do business in China. Whether you complain about it or not, it is a fact that you have to live with if you want to do business in China. As an economist I am much interested in the questions as to why such a non-legal system (in the Western sense) has flourished in China and whether and in what way it is better or worse than the Western legal system. Suffice it to state here that such a non-legal system has functioned in China for a long time and it has worked, although some Westerners do not like the way it works while some Chinese might think it is a superior system. Whatever your opinion is, to do business in China you cannot depend too much on the current system of Chinese law, which is recognized to be imperfect by both Westerners and Chinese. You will increase your profits by accepting the existing imperfect Chinese legal system and learning to do business the Chinese way. By that I mean you have to develop a network in China, getting to know the right people and making the right friends. This is called "developing Guanxi" in Chi-

nese. Interpreted in modern economic terms, Guanxi is a kind of human capital both in the sense of your knowing and having access to influential people in China and their recognition that you are useful to them. Establishing personal connections in order to do business better is common in Western societies, but the degree to which you have to rely on it as compared with the formal legal system is much higher in China. Accepting this fact alone will help you conduct business successfully in China. Note, however, that the way to befriend Chinese may be somewhat different and you have to know some Chinese customs. A very simple issue is who pays the bill when two good friends go out to eat. By the Western way, each pays his/her own bill. By the Chinese way, only one person pays the bill. When a Western person sees his friend pay he may smile and feel that he is getting something free. When a Chinese sees the same he would often prefer to have paid the bill himself because it is an honor to pay and perhaps his friend feels indebted to him, so that in the future his friend will do something for him if he needs it. Being a host is like putting money in the bank, which you can draw in the future when you need it.

If you cannot depend on legal contracts, how can you be sure that your partner will keep his part of the bargain? The way to insure it is to remain useful to him or to stay in a position such that he will depend on you in the future. If you have a contract to share profits in the future, how do you guarantee that your Chinese partner will honor the contract? When Mr. Roebuck presumably lost his usefulness to Mr. Sears, the company's name is changed from Sears-Roebuck to Sears. This can also happen in China. To maintain your usefulness, you have to keep your other business connections and maintain your influence in the world business community so that your Chinese partner will continue to value a good relationship with you. If I were speaking to a Chinese audience on how to maintain a good relationship with Western partners, I would say the same thing -- try to maintain your position in the business community so that your Western partner will keep his promises to you or will keep his partnership in the future with you rather than with someone else. If you lose your usefulness as a partner almost no legal protection can keep the partnership for you. It is wise for a potential investor in China to adapt to the Chinese semi-legal system. However, from a historical perspective, China's legal system is going to improve in the next century as the system has already improved a great deal in the last fifteen years because of the need to deal with foreign investors.

(4) Technology transfer to China

Somewhat related to the fact of an imperfect legal system in China is the lack of sufficient protection of patents and copy rights in China. This issue has been discussed in the Western press. Within the informal framework of doing business, what prevents a Chinese partner who is producing some products in a joint venture with you from setting up a separate factory using the technology which you have introduced? Without sufficient legal protection, you can hardly stop your Chinese partner from doing so. Western investors are aware of this and have tried to devise means to protect their interests, for example by keeping an essential part of the technology secret and known to only a limited number of people whom they can trust. If some technology or patent is difficult to protect from a technical point of view, the investor has to take this fact into account in investing in China, possibly by reaping enough profits in a short time before the technology can be copied or by sacrificing a calculated part of the Chinese market while maintaining a large part of the international market which is protected legally. Even protection in international markets can be uncertain -- recent newspapers are full of stories of Chinese manufacturers copying video tapes, compact discs, movies and software

packages for export into the international market. The number of pirated products in China offered for sale in the world market is so large that it draws much attention in the world community.

There is no solution yet for the problem of pirating in China. This phenomenon is easy to understand from the historical and cultural background of the Chinese. Patents are a recent product of world history after the Industrial Revolution. There were not too many scientific inventions to protect in Chinese history. If the Chinese knew of certain ways to produce useful drugs, for example, they would keep it a family secret. Many products in China were protected in this way. If products cannot be so protected they are generally available, including all the herbs that are sold in traditional Chinese drug stores and are therefore available to benefit the Chinese population. The lack of patent protection is said to be bad for the society because it may discourage people from investing to discover or invent new products. Such discouragement may have negative effects which have to be weighted against the benefits of having the perhaps smaller number of invented products available in the market at lower prices sooner. Before legal protection can be effectively enforced in China, foreign businessmen have to live with this fact. A related point is that some Western governments may also have to accept this fact. In February 1996, the United States government registered a strong protest to the Government in Beijing for the large number of Chinese pirated products being sold in the world market. This worsened the already tense diplomatic relations between the two countries. This protest to the Chinese government has a similar effect as a protest to the government of Mexico that illegal drugs produced in Mexico were sold in America. The difference is that some of the Chinese products were said to be produced by firms which are otherwise legal in China, in some cases allegedly firms affiliated with the Chinese military. The similarity is that in both cases there is simply so much money to be made that the central governments in both countries have found it difficult to stop its production and sale in the world market. The protest to the central government in either country is unlikely to be very effective. The government itself wishes to stop the illegal activities.

(5) Cooperation with Chinese state enterprises

There are a number of examples of successful joint ventures between a foreign investor and a Chinese state enterprise controlled by the central, provincial or local government. By successful, I mean both the Chinese and the foreign partners have made money. Such joint ventures are still available and plentiful if the foreign partners have made money. Such joint ventures are still available and plentiful if the foreign investor is wise enough to find them. The advantage of helping operate a state enterprise is that the Chinese partner is likely to have sufficient authority to produce and market the product and may even have sufficient power to protect the product from infringement by pirating. If the foreign investor can find ways to protect his share of the profits, as discussed above, there may be much profit to be made by both partners. A potential investor should study the successful cases to find out what makes the cooperation successful. He or she should also look into successful cases of cooperation with township and village enterprises. These enterprises, in contrast with the slow growing state enterprises, constitute a very important component of the rapid economic growth of China.

Nonprofit cooperation with the Chinese

Forum Engelberg has a number of participants who are interested in technology transfer to and technological cooperation with China to benefit the world. Some of these activities are not, or not mainly, profit motivated. For example Cornell University in the United States is

currently interested in cooperating with appropriate people in China to transfer its knowledge of agricultural technology to China. Whatever its motivations are, Cornell has developed technologies in many fields which have benefited mankind. Several of the points made above to insure successful cooperation with the Chinese are valid here. One has to find a right partner, be patient in negotiations with the Chinese, accept the fact that things get done by personal connections and influence, and deal with Chinese technological, scientific or educational institutions which have authority and power in the area of work that they do. Finding the right people in the right organization to cooperate with is the most important factor guaranteeing success. I have cooperated with Chinese organizations to promote economic education and economic reform in China. In both cases I was fortunate to find the right people in the right organizations, these being the State Education Commission and the State Commission for Restructuring the Economic System, respectively. The results of over ten years of cooperation with the first Commission and over four years with the second have been successful and gratifying. The experience is recorded in Chapter 5 of my book *Understanding China's Economy* (World Scientific Publishing Company, 1994).

My experience is that China is full of well-meaning, trust-worthy and very talented people. Of course China has its share of corrupt officials, as we have found in many other countries, East and West. If we can find the right people to cooperate with in pursuing our common objectives, we can be very successful. The right people are not difficult to find. After seventeen years of open door policy, China's talented and trust-worthy people are known to the world or at least to other Chinese who are known to the world. Through direct or indirect contacts with people who know, a European entrepreneur, scientist or educator can find the right people in the right Chinese organizations to cooperate with. In spite of the recent military maneuver around the Taiwan Strait, a serious military conflict between Mainland China and Taiwan is unlikely as neither side has anything to gain by such an engagement. I am optimistic about future economic cooperation between Europe and China. May I wish all of you success in cooperating with people in China to build a happier and more prosperous world community in the twenty-first century.

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